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Holistic Business Cases

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Business Cases

Business Case development and approval is a key strategic activity.

- Which business cases are approved or rejected gradually transforms an organisation through the cumulative impact of new initiatives as they are implemented and become part of business at usual.
- Many business cases only analyse the impact of the initiative in an incomplete way. Often many costs and benefits are not fully allowed for, and the dynamic nature of the competitive market is overlooked.
- Often, seemingly precise numerical evaluations are not subject to sufficient testing and analysis.
- This results in companies not achieving the benefits that they thought they would achieve.

A wider, holistic view is required

External, independent review of business cases can improve the quality of decisions.

Not everything that can be counted counts, and not everything that counts can be counted." - Albert Einstein

Typical Business Case

- An initiative is proposed
- A project group is formed
- A number of implementation strategies are proposed
- A financial model is built to evaluate the various options by assessing costs and benefits
- The model is used to determine which is the preferred option
- The proposal is adjusted to optimise the financial and other metrics and the model results are then used to prove that the initiative meets the various corporate criteria for approval.
- The business case is then approved and the project is initiated
- Sometimes, after the project is completed it is subject to a benefits realisation review to see if it has delivered on its business case.

What is in a business case?

- Business cases cover a large amount of information such as project timelines, costs, business objectives/opportunities, business strategic alignment (priority), deliverables, workloads, resourcing, dependencies, risks and mitigations, governance, budgets and such
- This paper focuses on the strategic issues and cost benefit analysis part of the business cases as ultimately they are the key things to get right in order to create value from your projects.

"The price of light is less than the cost of darkness." - Arthur C. Nielsen

Why do projects still fail?

- Projects often fail to deliver the benefits promised in their business cases because many business cases are fundamentally deficient in one or more respects. However, these deficiencies are often not obvious because they require a broader perspective than is often applied.
- Narrow focus
  - Just looks at this project and misses other impacts and issues. The benefits of flexibility are underestimated
- Assume stability
  - The market will stay the same. Customer behaviour won't change, legislation won't change and competitors won't disrupt plans or the market
- Poor Analysis
  - Technical issues are misevaluated. The business case is designed to gain approval

"Most people use statistics the way a drunkard uses a lamp post, more for support than illumination." - Mark Twain

Hidden Costs

- The direct costs of implementation are usually estimated reasonably well (subject to the inclusion of contingencies)
- Indirect and long term costs are usually underestimated. Examples are:
  - Costs imposed on future projects due to this one (ie additional interfaces need to be built and maintained for future projects)
  - Costs imposed on other parts of the business. Usually frictional costs such as additional reporting, reconciliations, more complex operating environment, additional training

Marginal Costing

- Often, for small business cases it can seem reasonable to use a marginal costing basis.
- This allows incremental business to look profitable.
- However, overheads eventually need to be covered
- Costs are often not as fixed in the long run as marginal costing might assume. For example, systems may need upgrading at some point to cope with additional demand.
- Industries with high fixed costs are vulnerable to competitors marginally pricing their products to get some additional revenue. The airline industry is an example of this.
  - As the wealth management industry becomes more technologically based with a higher proportion of fixed costs, could it become vulnerable to this practice?

The Hidden Costs of Outsourcing

- Most outsourcing decisions are based on a static analysis of costs
- This ignores some long term costs
  - Any changes become a negotiation
  - Lose control over the function, often a key area which can be a source of competitive advantage.
  - Can lose IP to the outsourcer, who can then become a competitor, or work with competitors.
- CBA is eschewing outsourcing due to judgement of:
  - Better customer service and relationships
  - Better cross sales

The Need for Flexibility (Real Options)

- What is a real option?
  - An alternative or choice that becomes available or is precluded with a business investment opportunity.
- Taking into account real options can greatly affect the valuation of potential investments. Normal valuation methods, such as NPV, do not allow for real options.
- An example of a real option is using a pilot program to test a proposition at a lower cost and roll it out if successful. If the pilot is unsuccessful then all that is lost is the cost of the pilot.
- Real options can value the ability to wait and learn, resolving uncertainty, before investing (a timing option). This could include waiting and seeing a competitor's attempts (sometimes it's better to be second or third into a market).

Assuming Market Stability

- Often it is assumed that the market and the regulatory environment will remain fairly stable for a long period of time in order to provide for the payback of the project costs.
- This assumption is often wrong
  - Governments feel impelled to make significant changes to regulations and legislation for all sorts of reasons. These can require expensive changes to systems but can also change the competitive environment by changing the relative positions of different players.
  - Technology changes impact on competing offers and customer expectations
  - Competitor innovation can compel responses which may require major changes

Excessive Hurdle Rates

- While companies need to justify the investment of capital with good returns, using an excessively high hurdle rate can have pernicious effects on an organisation over time.
- To get a business case to meet the very high hurdle rate a business case has to do one of three things
  - Leverage off existing strengths of the organisation, such as branding, customer relationships, physical presences and such.
  - Be very risky
  - The business cases are 'tweaked' to ensure that they meet the criteria
- This can mean that a lot of sensible, lower risk projects don't happen, and often these are building blocks for the next stage of growth. Over time the company's business portfolio becomes skewed and riskier and concentrated on shorter term initiatives.
- This is a particular problem today with our very low interest rate environment. What should the hurdle rate be in a 3% interest rate world?

"There is no such thing as high returns without risk." – Gerry Schwartz

Pricing for "Risk" is Still Uncertain

- Need to distinguish between 'Risk' and 'Uncertainty'
  - Risk is present when uncertain future events occur with measurable probability
  - Uncertainty is present when the likelihood of future events is indefinite or incalculable (Donald Rumsfeld's Unknown Unknowns)
- We can price for 'Risk' (subject to parameter estimation)
- 'Uncertainty' can't be properly priced for
  - Needs to be managed or eliminated by structuring
  - Previously unidentified, but realised events can destroy the business case (aka Black Swans)

Frank H Knight *Risk, Uncertainty and Profit (Hart , Schaffner & Marx; Houghton Mifflin Company, 1921*).

Pricing for “Risk” is Still Uncertain

- Pricing needs to accurately reflect the risks being borne.
- Underestimating the risks can lead to systematic under pricing.
- Over estimating risks can, however, lead to opportunities being missed due to excessive caution.
- Given we tend to use capital requirements as a proxy for risk, the new LAGIC regime presents some interesting problems for the level of capital to use for pricing
  - Should diversification benefits be reflected in pricing?
  - If so, how should they be allocated to products?
  - Use a separate economic capital model?
  - What will competitors do?

Underestimating Competitor Reactions

- Many product development business cases underestimate the impact of competitor reactions, particularly over the medium and long term.
- This is a larger risk for products or services that are expected to have a major impact on the market.
- If the product is successful then competitors will react in a number of possible ways:
  - Clone or copy the product (if possible)
  - Improve on one or more features of the product, and concentrate their marketing on that
  - Cut prices on their existing products to change the price/value comparison for your product.
- This means that sales increases and market share increases are likely to cease after a period of time and further investment and innovation will be required to maintain or improve the company's competitive position.

Competitor reactions – smartphone example

- Blackberry initially dominated the market
- Apple revolutionised market with iPhone, dominating an expanded market with innovative product
- Apple continues incremental innovation with iPhone
- Android manufacturers competing on several fronts – innovation, price, flexibility are starting to dominate market by numbers, but not by value (Apple and Samsung make >100% of the industry profit pool)

Competitor Reactions – Business Case implications

- Don't assume market share increases for long periods
  - Need rapid pay back of investment to reduce risk
- Allow for new investments to refresh and improve the product or its associated technology
- Sometimes slow execution means that what was intended to be a market leading innovation becomes a clone itself due to competitors implementing faster.

Underestimating Salespeople!

- Improving sales productivity would make a big difference to the value generated by an organisation
- However, it is quite difficult to improve as the market can be quite efficient at bringing productivity back to the average (at least in financial terms)
- In many cases much of the increased value ultimately gets captured by the distribution network rather than the company.
  - For example, superior training of sales people can result in these salesmen being recruited by competitors on better packages. This can force the company to improve its remuneration packages, offsetting some or all of the value increase.
- Sustainable sales productivity improvements usually rely on company specific advantages that are difficult to replicate, such as brand, existing customer relationships or technology

Reputation and Stakeholders

- A business' stakeholders include:
  - Customers, employees, distributors, government, shareholders and the general public.
  - Will the course of action planned have impacts on any of these and has this been allowed for?
  - At one level this is the front page of the newspaper test
    - Often it is more subtle and longer term than this.
    - Businesses rely on long term relationships. Damaging these can be expensive and difficult to repair.

Underestimating Technical Difficulties

- Example: Rio Tinto's Mozambique coking coal acquisition
  - Assumed high grades of coal
  - Assumed river transport initially, then build a railway
    - Grades of coal weren't as high as believed (due diligence failure)
    - Couldn't get government permits for river transport (also there were dredging problems)
    - The lower coal grades couldn't justify building a railway
    - This leaves the resource basically stranded
    - Rio has written off $3bn of a $4.2bn investment after 18 months

Overvaluing Conventional Wisdom

- There is often a consensus about the key issues facing an industry or where the best opportunities are.
- This results in many companies making similar strategic moves. This can drive up execution costs as companies compete for similar acquisitions or skill sets and drive down returns as the competition for the identified opportunity intensifies.
- Examples include rushes to acquire or lock up various forms of distribution, particular products or service a market segment such as HNW customers.
- Because it is a common course of action it can be implemented with insufficient questioning (the old "people don't get fired for buying IBM" safety in numbers strategy)

"Ignore the conventional wisdom. If everybody else is doing it one way, there's a good chance you can find your niche by going in exactly the opposite direction." – Sam Walton

Group think

- No disagreements can lead to poor quality decisions
  - All agree with the boss!
  - Too little diversity in the group
  - Poor remuneration incentives
- This can lead to the business case being developed to justify a pre made decision.

"Success is a lousy teacher. It seduces smart people into thinking they can't lose." – Bill Gates

The Madness of Crowds

At the top of a business cycle there is a tendency to assume that it will go on forever like this.

This can lead to seriously bad decisions, particularly on acquisitions, where record multiples get paid of record earnings.

- Times Warner and AOL
- Internet bubble
- Resources bubbles
- Housing bubbles

It can be difficult to stand against this as the whole world assumes that this will continue.

Narrow Focus

"We're just going to concentrate on what we've always done, which is to create the best possible online directory, adding content and other features along the way when it makes sense." Jerry Yang (Yahoo)

- Sometimes the problem is defined too narrowly and additional opportunities are overlooked
- For example, while Yahoo was focusing on building a directory/search tool, Google noticed that errors in search queries gave it the material to make the best spell checker, giving it a major competitive advantage in a range of areas.

Bad Revenue

"Good revenue," is the kind that's predictable and profitable, and holds possibilities for further expansion. Bad revenue, in contrast, comes from customers that don't value your core business proposition, requiring excessive customization, complexity or discounting, and causing the sales management team to lose strategic focus. Tempting though it may be, no company can afford bad revenue with its explicit and hidden costs. ***Dianne Ledingham and Darrell Rigby (Bain & Co) HBR 2008***

- It can take a lot of discipline and focus to turn down some revenue opportunities due to the costs that they introduce.
- Note how the excessive complexity introduced by some customers is a key issue.
- An example in the Australian WM market is the discussion of the relative value of IFA distribution versus aligned distribution. Is the higher cost, product design demands and relative fickleness of IFAs worth the additional revenue?

Every Assumption Needs Review

- Within a business case, most assumptions have long term implications and rest on various implicit assumptions.
- These implicit assumptions need to be drawn out and tested to ensure that they are understood and don't compromise the business case.
- This requires a process of challenge and review.
- Robust scenario testing and risk analysis are important but often this isn't enough.

Business Case for Business Cases!

- Lots of subtle issues can lead to failure
- Key business cases would benefit from a formal review process to challenge key underlying assumptions
- This review should be done by people not involved in the business case development in order to get a fresh perspective and to avoid group think.
- It needs to be done with a long term perspective, not just checking the numbers in the cash flow projections.
- The project boards or leadership teams that approve business cases should do this, but in many cases an independent review can be more comprehensive than could be done within a leadership team or project board context.

Think broadly – Think Holistically!