



Executive Briefing Series

# How to Overcome Capital Project Evaluation Challenges with Sound ROI Models and Governance Practice

Capital project investments often fall short of their desired performance outcomes due to inconsistent processes and lack of critical data to make informed decisions. Discover how robust ROI models and solid governance practices can help you sidestep these common pitfalls and optimize the impact of your Capex portfolio across the enterprise.



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50%

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With Capex directly responsible for 50% of all corporate growth, capital investment performance can be seen as an essential foundation of long-term business success.<sup>1</sup> Not only that, but a recent study concluded that companies employing best practices in capital expenditure management earned 25% higher profits than their peer group.<sup>2</sup>

One of the key strengths of these high performing companies is a focus on optimizing which projects to prioritize and fund ... and which to forgo. Doing so is not just a matter of evaluating projects on their individual merits and in the context of a project portfolio; the reality is, there is competition for resources along other enterprise needs, including dividends and stock buybacks, labor, and marketing for example.

Stakeholders in operations and engineering are on the frontlines of this effort. Along with their partners in FP&A, they have much to consider, such as:

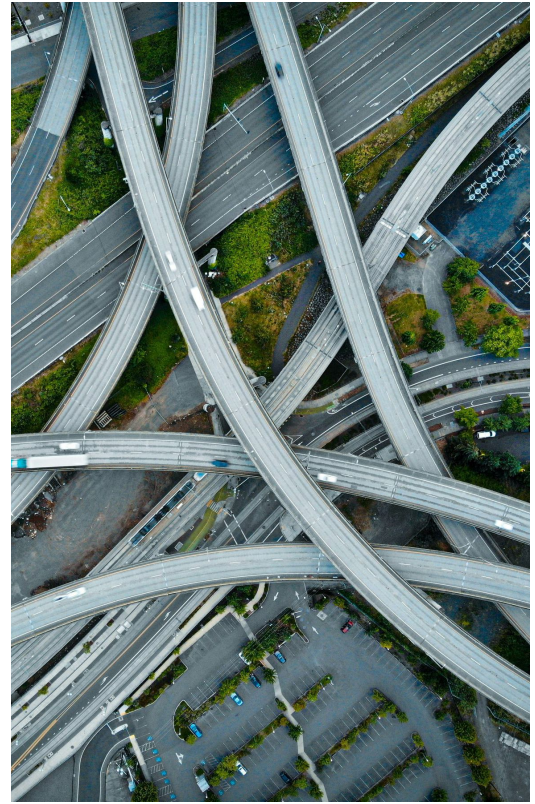
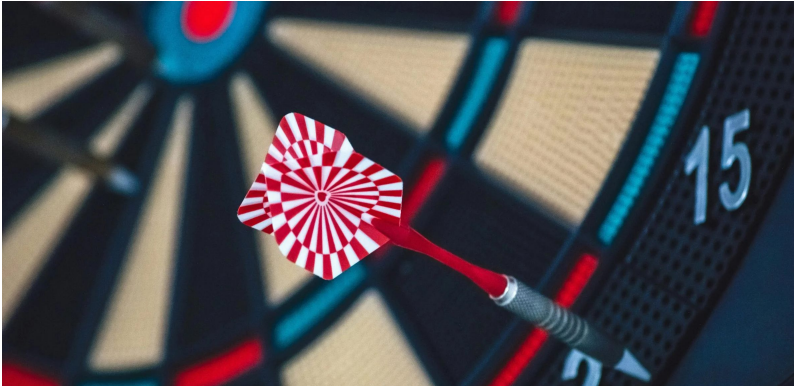
- Balancing maintenance, mandatory (regulatory) and growth requirements and objectives
- Unforeseeable risks in marketplace conditions, volatile end-markets and supply chains, competitive actions and the like
- Executing the organization's strategic mission and priorities, both short- and long-term
- Contending with the needs and management priorities of disparate, diverse or decentralized business units

And perhaps most importantly: how to accurately assess and compare the potential for individual projects to produce a favorable return on investment / return on invested capital – which is the focus of their executive briefing.

<sup>1</sup>Mckinsey & Company

<sup>2</sup>Booz-Allen

<sup>3</sup>Forrester Research



# Understanding Why Projects Fail

A good place to start in any discussion of improving capital project evaluation is to assess why so many projects are ultimately late, over budget, and/or fail to deliver promised benefits.

Is it merely a result of poor project execution? While certainly sound execution is essential, many execution problems are actually an unforeseen result of inadequate project planning and inconsistent capital project approval processes. Indeed, a common Capex fallacy is that every project is unique and requires special information and a custom management approach.

This mindset leads to a lack of standardization, which in turn creates critical information gaps resulting in inadequate project analysis. Insufficiently vetted and overly optimistic assumptions inevitably result in missed plans and disappointment.

In short, while the specific data of any particular project may be unique, the process requirements and pitfalls have significant commonality for most businesses. Which is why it's important to recognize these and ensure complete and effective engagement of all the relevant internal expertise that is essential for sustained success.

# Ask the Right Questions

Great capital projects do not materialize out of thin air. They must be built carefully with ever increasing detail and precision every step of the way. The two principal categories of focus in the development of successful capital projects are cost and benefit. When assessing the purported cost and benefit of every project, it's helpful to ask these important questions:

## Cost:

- Every project has cost estimates, but how accurate will they prove to be?
- What historical or third-party data will be used for benchmarking?
- What role will procurement play in obtaining up-to-date quotes?
- At what stages will different degrees of estimation be used and how often will they be updated?

## Benefit:

- Every serious project purports to provide a positive economic contribution to the enterprise, but will it in fact be delivered?
- What are the critical operating assumptions and how easy is it for senior management to evaluate the impact of varying economic and financial assumptions?
- How have similar projects in the past performed versus plan?
- What is the track record of the individual or business unit proposing the project?

As this sampling of questions suggests, a proper and thorough examination of each category on every material project will require an up-front compilation of the issues relevant to your business and the adoption of a standardized methodology for efficiently gathering and analyzing critical data.

The capacity exists within most organizations to do this very well when: i) the full breadth and depth of the expertise of its people is fully engaged, and ii) they are properly supported by enabling technology.

# Effective Collaboration

While it's evident that tapping into the collective expertise of the organization is critical, it is especially difficult to do for a cross-functional business process such as Capex. Often, people in different departments are asked to work together on projects, but the data they need is separated across a variety of enterprise systems. Unfortunately this issue has arisen because most enterprise applications have been designed and implemented as functional modules and are ineffective for managing Capex - something that 86% of large companies cite as being a “very significant” or “significant” problem.

# The 5 Key Decisioning Elements

Once projects have been developed with the necessary cost and benefit detail, and reflect the collective expertise of the key contributors from across the organization, sound and efficient evaluation is a function of the following five decision aspects:



**Review Process** | Who will be involved in reviewing projects of a particular value or type? Will the final approval decision be taken by an individual or by a committee? If the latter, individual ratings or scores will need to be tracked and tabulated.



**Data Presentation** | Costs should be entered in local currencies and automatically converted into the base reporting currency for each entity.



**Alternatives Consideration** | Detailed information regarding all possible alternative courses of action provides essential context to decision makers, and can be helpful in making informed decisions on future projects of similar makeup.

In other cases, the project information doesn't reside in a system at all and is being managed manually across a series of disconnected spreadsheets that are being distributed between personnel. This approach ultimately makes organizations increasingly prone to data error, in turn hampering project evaluation creating a need for further reconciliation.<sup>3</sup>



**Timing & Scenario Analysis** | Reviewers may wish to examine the impact of varying key economic assumptions or the timing of the project. Processes which impede efficient investigation tend to result in inferior outcomes. This can happen when helpful analysis is skipped to keep the process moving, or sound decisions are delayed until time-constrained reviewers become comfortable with the final analysis.



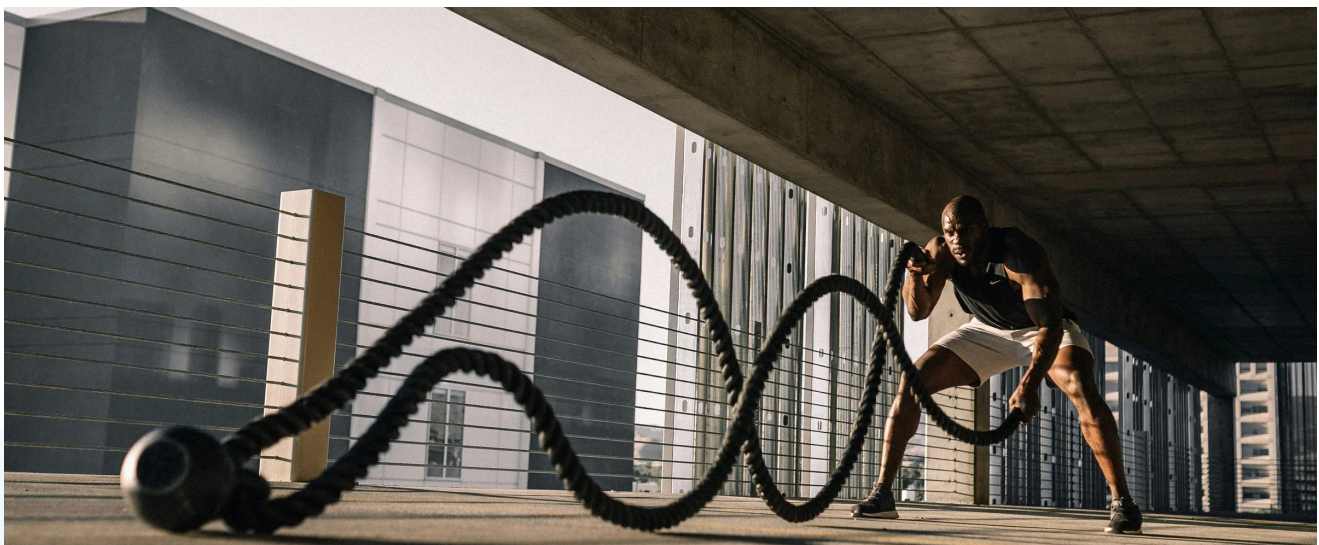
**Decision Metrics** | Finally, it's important to determine what objective standards have been set by the enterprise to guide capital allocation decisions. How can these be applied uniformly across the proposed project portfolio and minimize politically - or emotionally - driven decision making?

# Continuous Improvement

The ultimate measure of success is whether subsequent capital investments deliver a higher return than previous ones. ROI tracked by project and budget cycle versus both budget and prior years will demonstrate progress or highlight areas that need further attention.

Project sponsors and teams that exceed plan can see that reflected in their incentive compensation. Similarly, executives who consistently over promise and under deliver can be held accountable when needed.

Adopting a culture of continuous improvement with respect to Capex will materially diminish attempts to “game” the process with overly optimistic assumptions and forecasts to get projects approved. Moreover, it will position your organization to be able to correct past errors and optimize for maximum returns on project after project.



# The Role Of Technology

The appropriate use of software can be of material aid in improving capital project development and evaluation. The right application can help improve cost and benefit information collection and streamline analysis.

When evaluating technology alternatives, some factors you may want to consider include:

## **How sophisticated is the analytical automation?**

Are NPV and other financial metrics calculated automatically in a consistent manner? Can assumptions be easily tested and multiple scenarios generated and compared? Is it possible to save discrete project types as templates to facilitate data entry and comparison?

## **Does the application provider focus exclusively on Capex?**

Generic applications designed to handle a wide variety of business processes may require heavy customization for Capex, and often provide limited functionality on critical management dimensions such as project evaluation.

## **What degree of collaboration does it enable?**

Many enterprise applications are transactional in orientation and thus poorly suited to Capex which requires a high degree of cross-departmental collaboration. It should automatically notify project participants when their input is required and make it easy for them to understand the project context and exactly what is required. It should encourage unstructured participation and knowledge sharing.

## **Does it provide historical and third-party data benchmarking?**

Despite the common misperception, not every capital project is unique. The use of comparable data can enhance analytical accuracy and position you for continuous improvement.

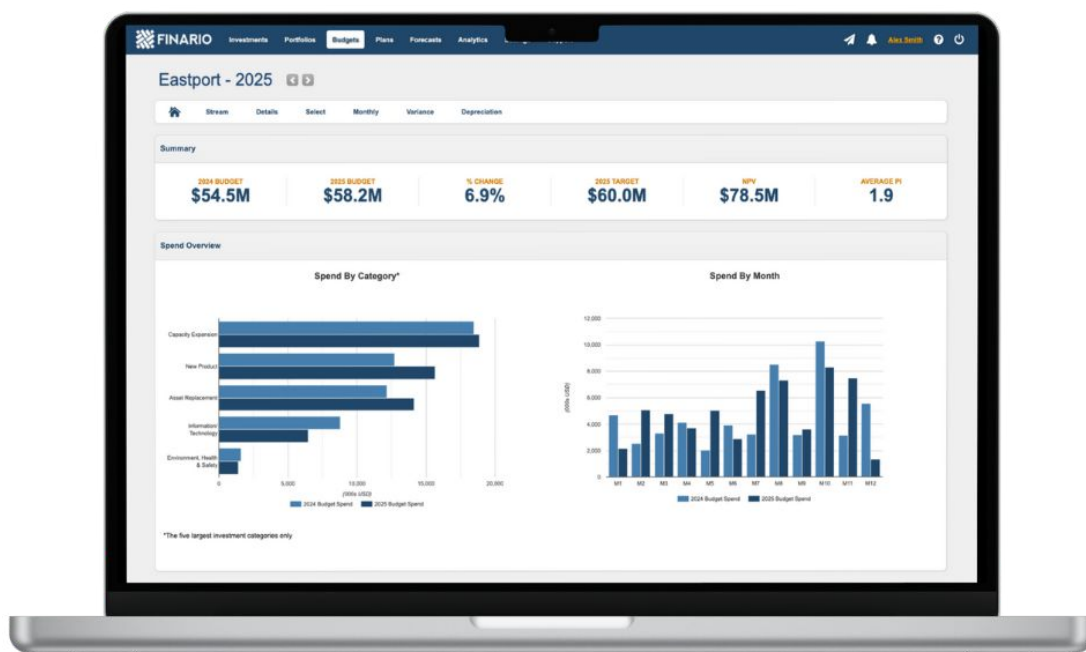
### Is it easy to track performance by business unit or team?

Evaluating performance at a granular level provides a valuable discipline necessary for sustained progress. Identifying the most efficient and productive departments, teams or individuals can help your organization develop an optimal means of collaborating with one another throughout project development and evaluation.

### Can your team easily add to and improve the process over time?

An easy-to-use cloud-based application is more likely to accommodate incremental improvement and adaptation than a traditional on-premise system requiring custom development or IT involvement for every specific system customization no matter how small.

These are obviously only a few of the many issues to consider when evaluating the way that your company develops and analyzes its capital investments. As you move ahead, remember that the capital investment decisions you make today will likely impact your organization for decades.



# Leveraging Your Data And Outcomes

With the right platform, you can be certain that every capital project in consideration is being evaluated uniformly with the same ROI model and risk metrics that your organization has determined are critical to its success. This in turn ensures that choosing one project or set of projects over others will be assessed in “apples to apples” fashion.

Moreover, in so doing, in reporting on results, you’ll be able to communicate to your CEO, CFO or other C-suite executives in ways they understand and value: risk v. return, budget variance, and actual impact. This also is the pathway to sound governance: reliable models, detailed cost estimates, clear understanding of project successes and failures (“lessons learned”) and a thoughtful approval matrix with a clear audit trail.

*For more perspectives on this important tactic, be sure to read “**Why prioritizing Capex projects is more challenging than ever before**” in the Capex Resource Center on [www.fnario.com](http://www.fnario.com).*



# Finario // The Solution for Capex

From the smallest request to the largest project, Finario's industry leading enterprise Capex solution gives finance and operation teams the data, intelligence and insight necessary to be more effective in their roles and translate enterprise strategy into tangible results. Establish a single-source of truth for Capex on our cloud platform and drive higher long-term growth and profitability.

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