Factoring Synergies into Resource Allocation Decisions

By Phanish Puranam , Roland Berger Chaired Professor of Strategy and Organisation Design at INSEAD

Pigeonholing business units into categories like "dogs" and "stars" gives short shrift to the most important elements of corporate strategy.

Part of the rationale behind the multi-business organisational structure is that headquarters can do a better job of allocating resources across the various businesses than the capital markets would if the businesses stood alone. On the one hand, HQ has more knowledge about the businesses and more power to ensure that subordinates take steps to enhance the value of its internal investments. On the other hand, HQ has relatively fewer investment opportunities, and can be subject to conflicts of interest with shareholders.

Further complicating matters is the need to view resource-allocation decisions in light of the larger **corporate strategy**. Investments should be made with an eye toward how the portfolio as a whole will ultimately be impacted. It does no good if a single business within the portfolio flourishes but other businesses languish as a result. At the same time, a seemingly stagnant business may be a net gainer for the portfolio if it generates synergistic value for its corporate siblings.

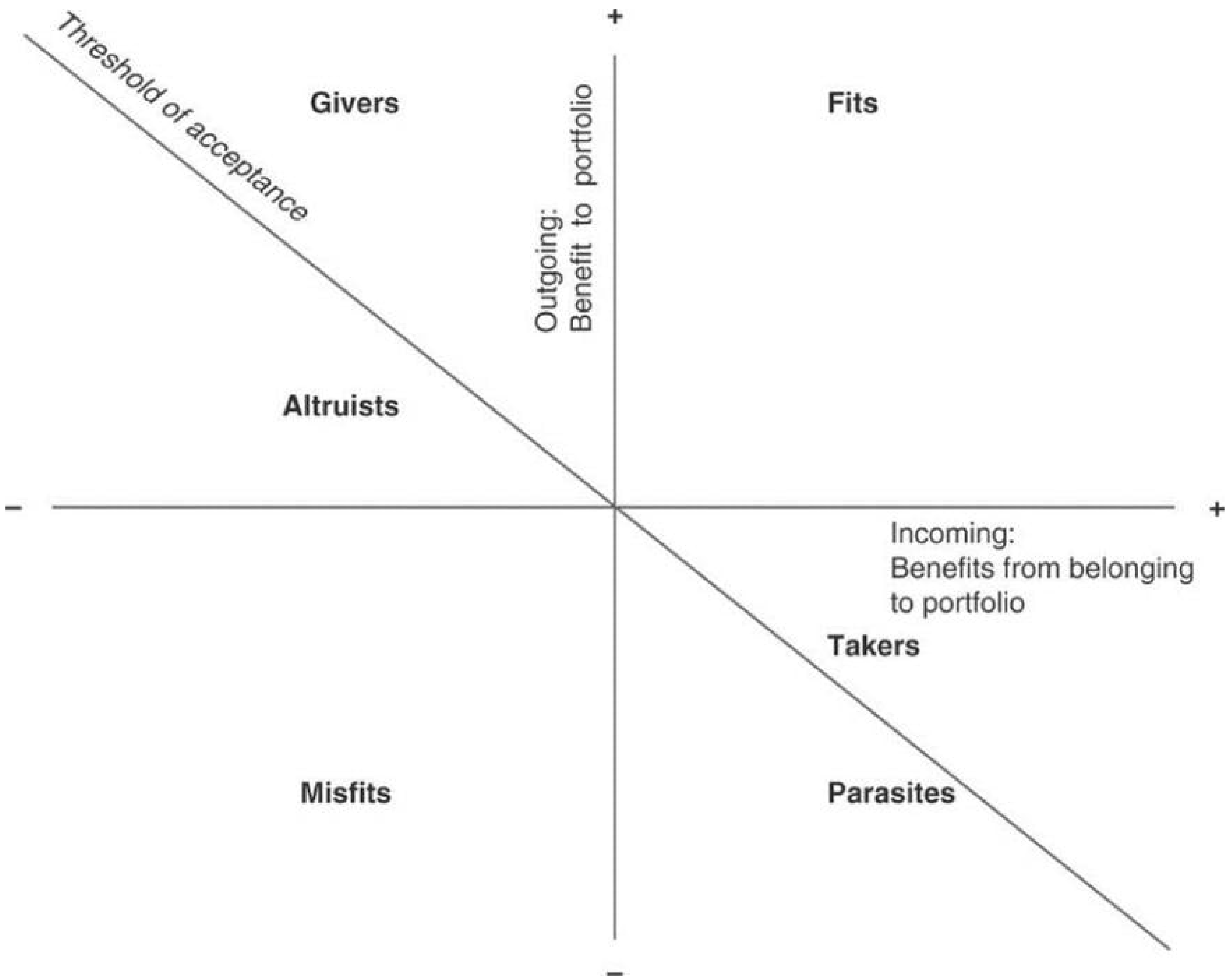
Traditional theories and frameworks pertaining to strategic resource allocation – such as the famous BCG **growth-share matrix**, (or the very similar GE/McKinsey matrix) which categorizes businesses according to market share and growth potential –omit consideration of synergies. Paradoxically, these frameworks, which have been synonymous with corporate strategy, give short shrift to its most fundamental issue: corporate advantage. Thinking about investment in standalone terms may mislead corporate strategists about the real value of the “dogs” and “stars” in their portfolio.

My new book ***Corporate Strategy: Tools for Analysis and Decision-Making*** (co-authored with Bart Vanneste of University College London) presents a new approach to corporate resource allocation that explicitly incorporates thinking about synergies and uncertainty into the resource allocation picture – we call it the “synergistic portfolio framework”.

The Synergistic Portfolio framework

Rather than assessing each business as a solo entity, our framework is based on charting the benefits businesses receive by virtue of being in the portfolio vs. out of it, as well as the net impact businesses have on the rest of the portfolio. These are estimated by doing basically the same valuation exercise when considering a spin-off of a business. If the number of businesses in the portfolio is large, the number of these computations can rise very rapidly to unmanageable proportions. As a first pass, therefore, it is useful to do the exercise for clusters of businesses in the portfolio, and then narrow in on within-cluster effects.

The difference between what a business is worth inside vs. outside the portfolio gives an estimate of how much that business gains or losses from being in the portfolio. We call this “incoming benefit” and it is plotted on the horizontal axis of the below graph. The impact on the remaining portfolio, termed “outgoing benefit”, is shown on the vertical axis.



The top right quadrant of the graph is a no-brainer – these are two-sided synergistic (high ingoing and outgoing benefit) and “fit” well within the portfolio. However, businesses don’t have to be two-sided synergistic to be worth investing in. One can determine whether a business is worth the continued investment by simply seeing where it falls on the graph in relation to the threshold of acceptance for investment opportunities (the 45 degree line sloping from left to right). As you can see, both **givers** (high outgoing benefit, low negative incoming benefit) and **takers** (high incoming benefit, low negative outgoing benefit) appear above the threshold, meaning they have a net-positive impact on portfolio value. However, **altruists** (high and negative incoming benefit, low and positive outgoing benefit) and **parasites** (high and negative outgoing benefit, low and positive incoming benefit) would do better outside the portfolio, thus should be slated for minimal investment or considered for spin-off.

Adjusting for uncertainty

If market conditions are presumed to be uncertain (meaning the future is likely to look different from the present and past), investing in emerging areas could pay off in unforeseen ways. Strategising for the present – while looking to an unknown future – requires balancing investments in sure things with the need to pursue the next big thing. Viewed another way, corporate strategists must measure the costs of errors of commission (i.e., investing in businesses that look promising but turn out to be failures) vs. errors of omission (i.e., missing out on the next big thing).

Good decision making, backed by the best available information and educated assumptions, helps minimize both types of error. Eliminating them completely, however, is impossible. A more reasonable option is to focus on reducing whichever of the two types is the most costly in your particular context. Omission costs are higher, for example, when there is a unique acquisition opportunity, a narrowing range of alternatives, or a temporary regulatory loophole.

When commission errors are determined to be more costly than omission errors, internal capital controls should be tighter. Consequently, the threshold of acceptance under our framework would move to the right. When omission errors are deemed more costly, the threshold would shift left, indicating a more expansive corporate stance vis-à-vis portfolio value.

Don’t forget emotions

In multi-business firms, researchers have noted a strong tendency towards “corporate socialism”. Underperforming divisions tend to be funded to a greater extent than their individual NPV would appear to warrant. To some, this has served as evidence that the multi-business organisational model is inefficient. Our view, though, is that since synergies are the most important element of corporate strategy, and businesses often provide more collaborative value to the portfolio than is reflected accurately in the NPV, there may sometimes be a solid rationale for corporate socialism. This is because HQ is ultimately investing in people, not projects. Projects don’t feel unfairly treated and demotivated (with or without justification); people do.

Starving a division of cash because of financial underperformance can lead to dissension in the ranks and unwillingness to collaborate. The synergistic value contributed by that division could consequently plummet. Rotating the acceptance threshold line in an anti-clockwise fashion (in moderation) is a means to acknowledge and deal with these fairness issues. This implies favouring the givers over the takers to an extent not merited by a narrow consideration of fiscal projections alone. Investors in financial markets can afford to look only at the numbers; corporate strategists, like it or not, should be aware that they are ultimately investing in people.

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