# Improving Capital Allocation

(An Illustration)

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*Preliminary and subject to further review and change. See final page for important information about this document.*

ILLUSTRATIVE CASE STUDY

# Portfolio Analysis: Case Description

The following slides contain a case study of a large diversified enterprise that has 4 Strategic Business Units:

- In 2005, the Company had: $10.1 billion in Revenue, $1.1 billion in Gross Cash Earnings and $10.0 billion in Inflation Adjusted Gross Assets
- Between 2005 and 2007, the Company operated a planning and budgeting process which allocated capital on a proportionate basis to Sales. Using this process, the company invested $500 million into its business resulting in:
  - Approximately $300 million of capital invested below the cost of capital.
  - Overall Business Returns and Residual Income Margin (RIM) remained essentially flat at 10.5% and -0.5%, respectively.
  - The Company's Adjusted Market-to-Book Ratio (MBR) increased slightly from 0.95x to 0.96x. With the larger asset base, Enterprise Value increased by $491 – an increase of less than the incremental capital invested.
- Because of the company's returns and investment strategy, the market valued the Company's assets at a discount to their Infl. Adjusted Cost

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# Portfolio Analysis: Case Description (Cont.)

Following this poor financial and market performance, the company decided to make a change during its upcoming planning process:

- For the 2008 – 2009 planning period, the Company implemented a returns-based capital allocation process. Instead of allocating capital based on sales, capital was allocated where returns were the highest, expected to remain high and provided the most growth potential. Using this process, the Company's subsequent $500 million investment yielded substantially better results:
  - All $500 million of capital was invested in the stronger businesses with better BR, RIM and growth prospects. Additionally, capital was taken out of businesses where returns were weak, even if it meant lower sales volume.
  - Overall BR improved to 12.0%, RIM improved to 0.9% and the company's MBR increased to 1.09x.
  - The company's Enterprise Value improved by nearly $1.2 billion in just 2 years – more than 2.3x the incremental investment.

By allocating capital using principals consistent with *Internal Capitalism*, the company was able to create a tremendous amount of value for shareholders.

ILLUSTRATIVE CASE STUDY

# Portfolio Analysis: A Mixture of Strong & Under-Performing Assets

**Segment A-** asset-lite value added products, acquired by company

- Investment decisions skewed by intangibles

**Segment B-** adjacent products to the Core business, organically developed

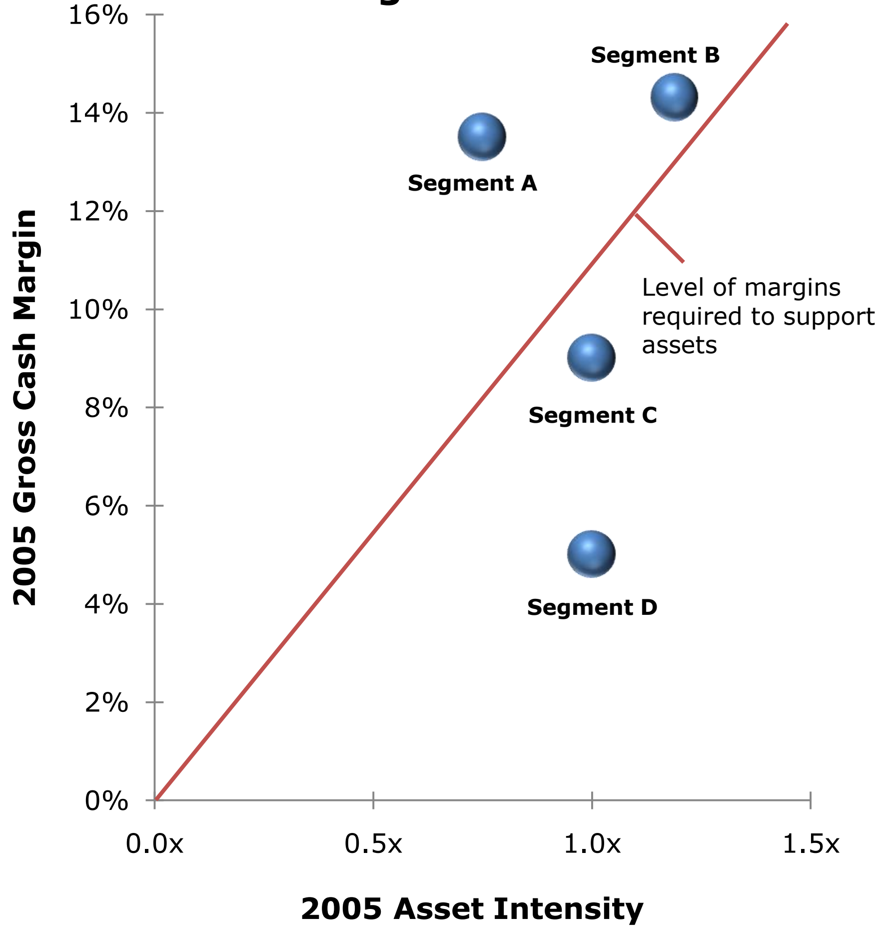
**Segment C-** legacy business of the company, mature industry

- Investment decisions skewed by sales and internal politics

**Segment D-** A turn-around unit that has underperformed over the past several years due to a high cost structure

- Profits continue to prove elusive – always promised during budgeting but never delivered

**2005 Segment Performance**



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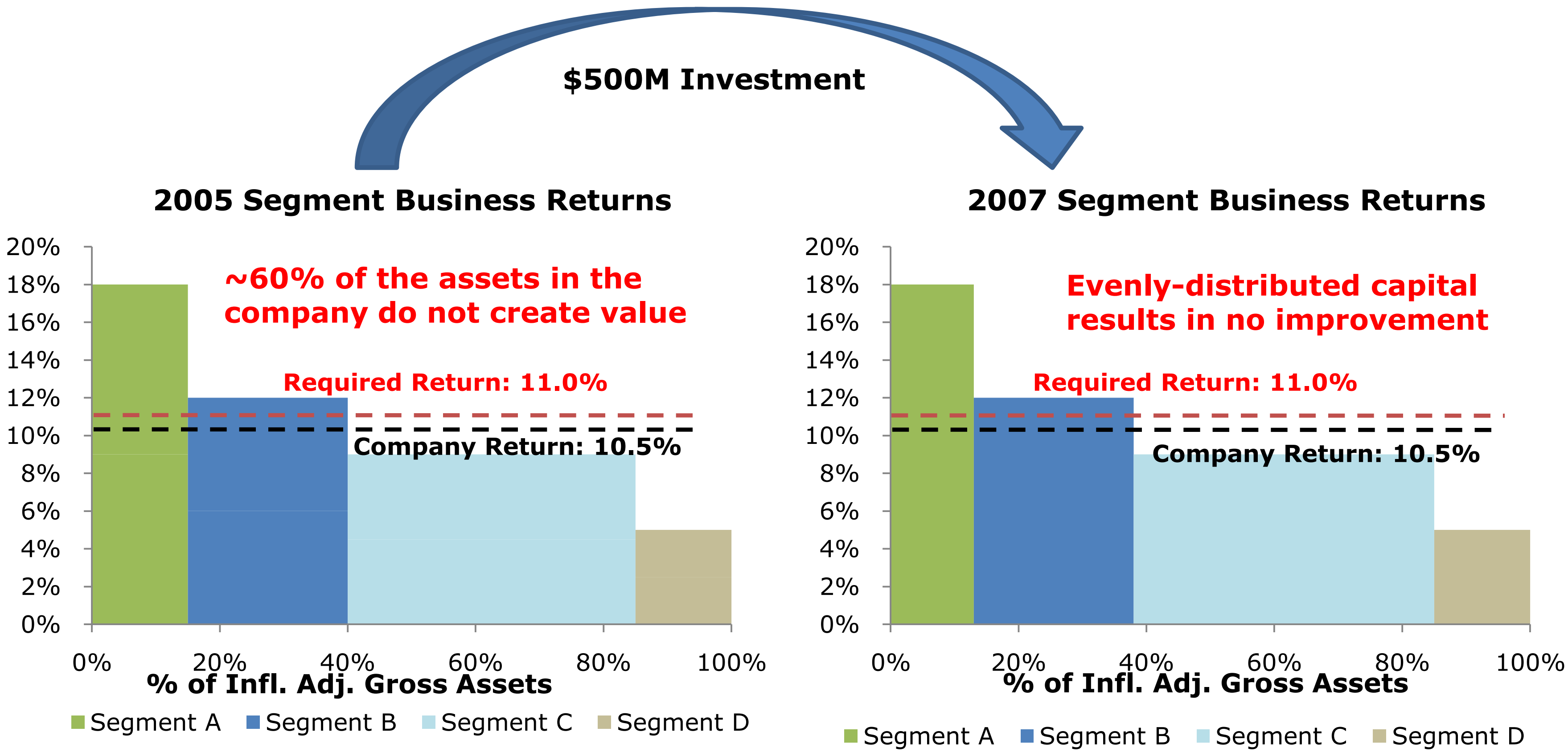
ILLUSTRATIVE CASE STUDY

# Portfolio Analysis: A Sub-optimal Approach to Capital Allocation




Traditionally, capital was allocated based proportionately to size and legacy management issues, resulting in continued sub-par performance



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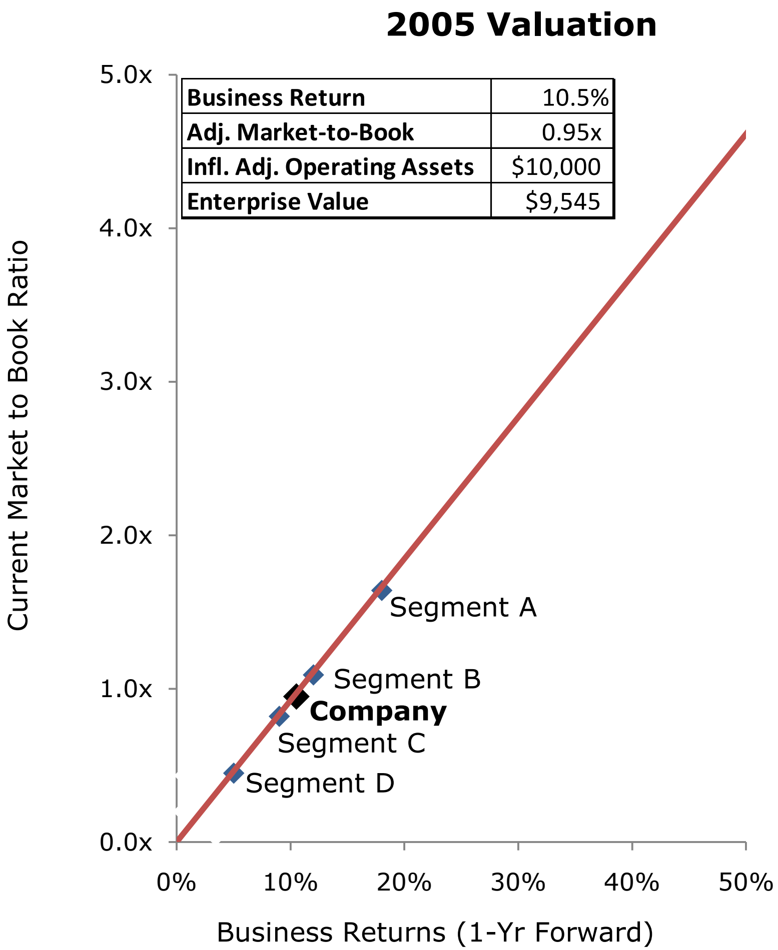
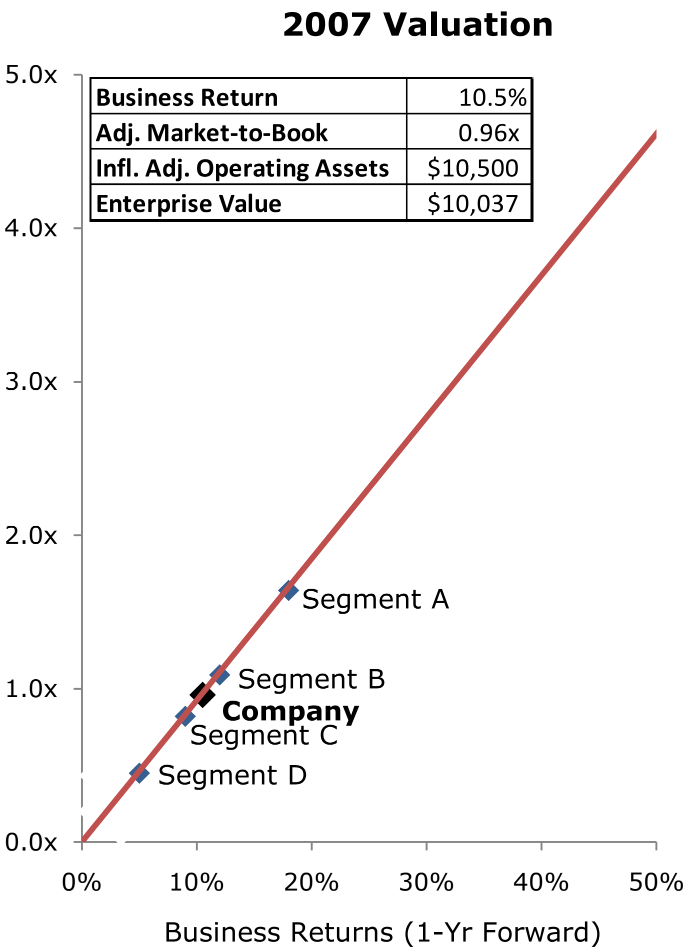
# Portfolio Analysis:
# More of the Same Produces More of the Same




From '05-'07, $500 million of investments increased value by $491 million dollars – a discount to the Company's investment.



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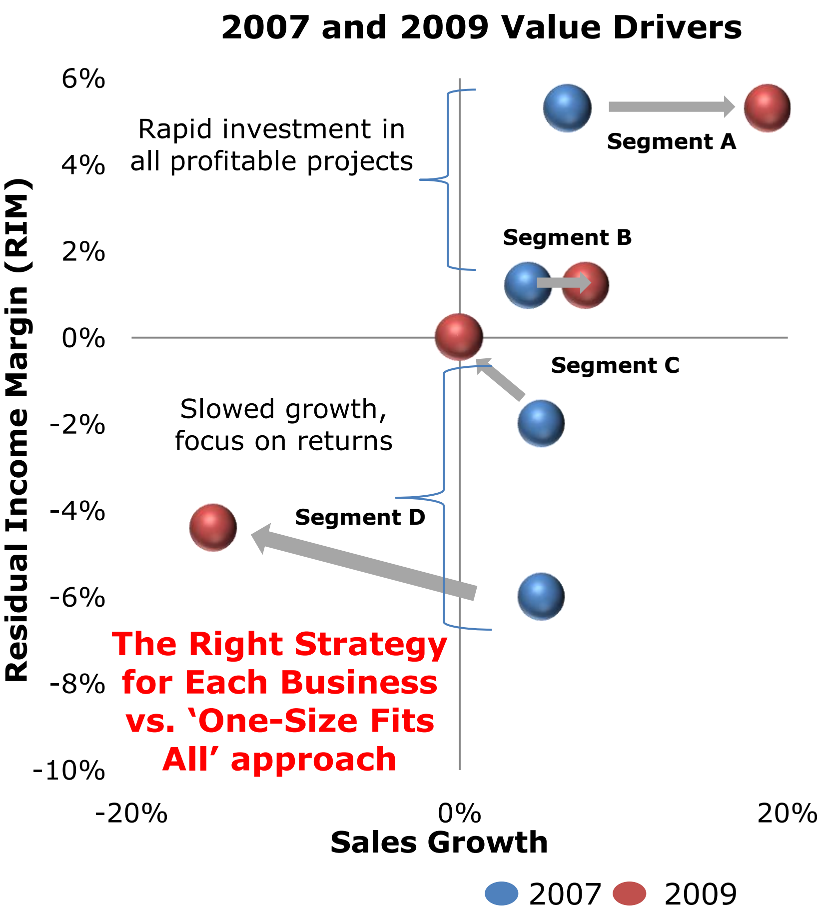
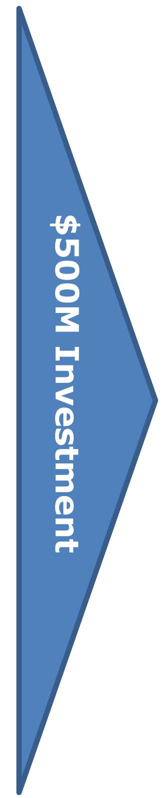
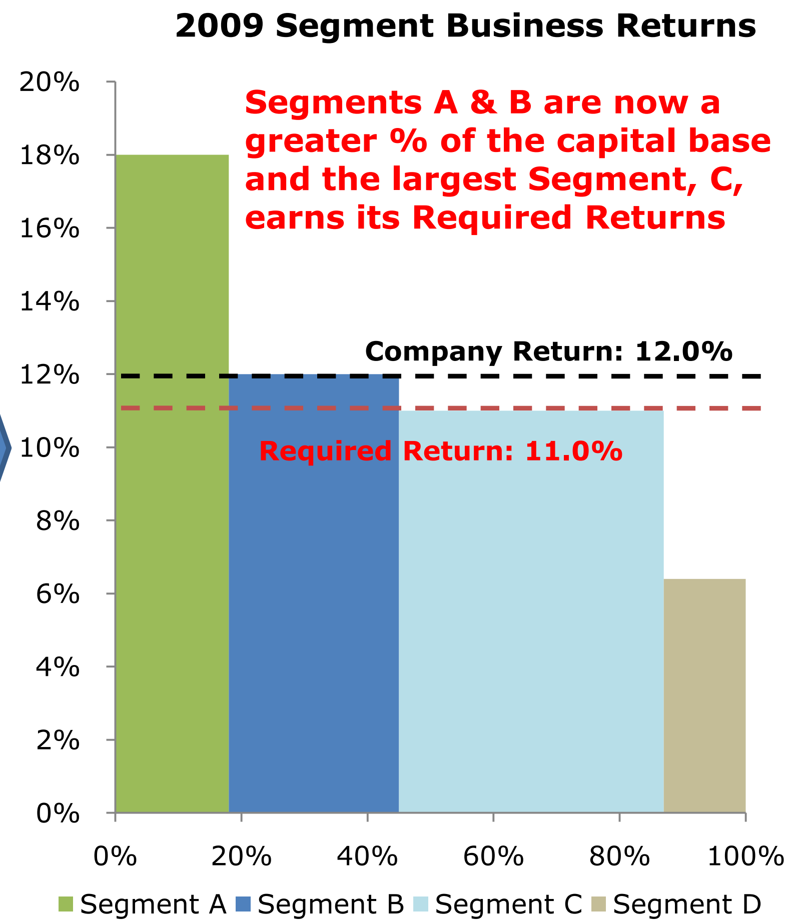
# Portfolio Analysis:
# A Return Based Approach to Capital Allocation




The return based approach creates an "*Internal Capitalism*" system where resources are allocated based on the ability to generate a return on the next dollar of capital.

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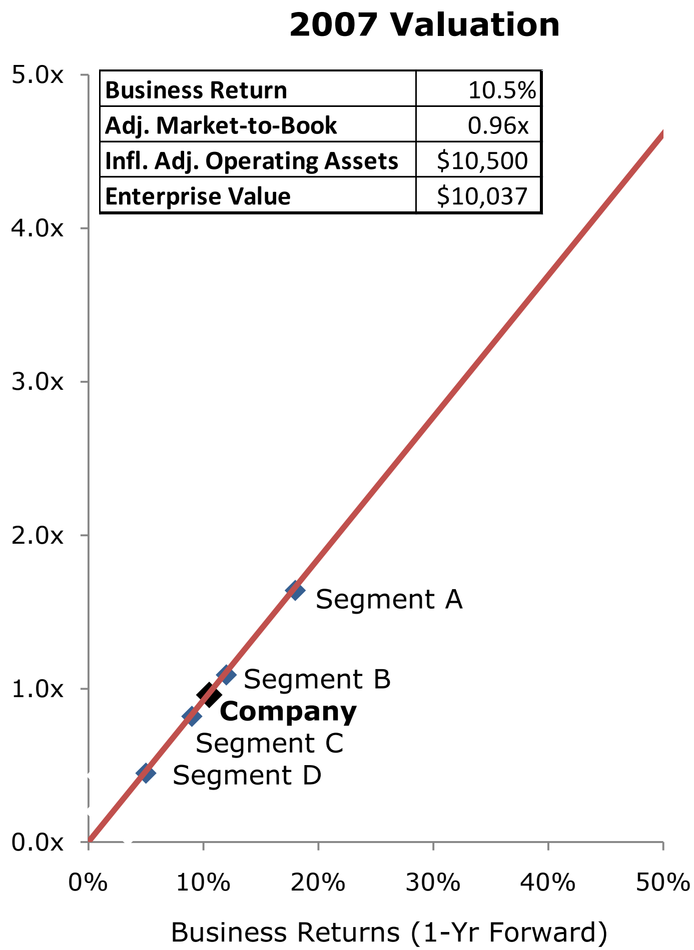
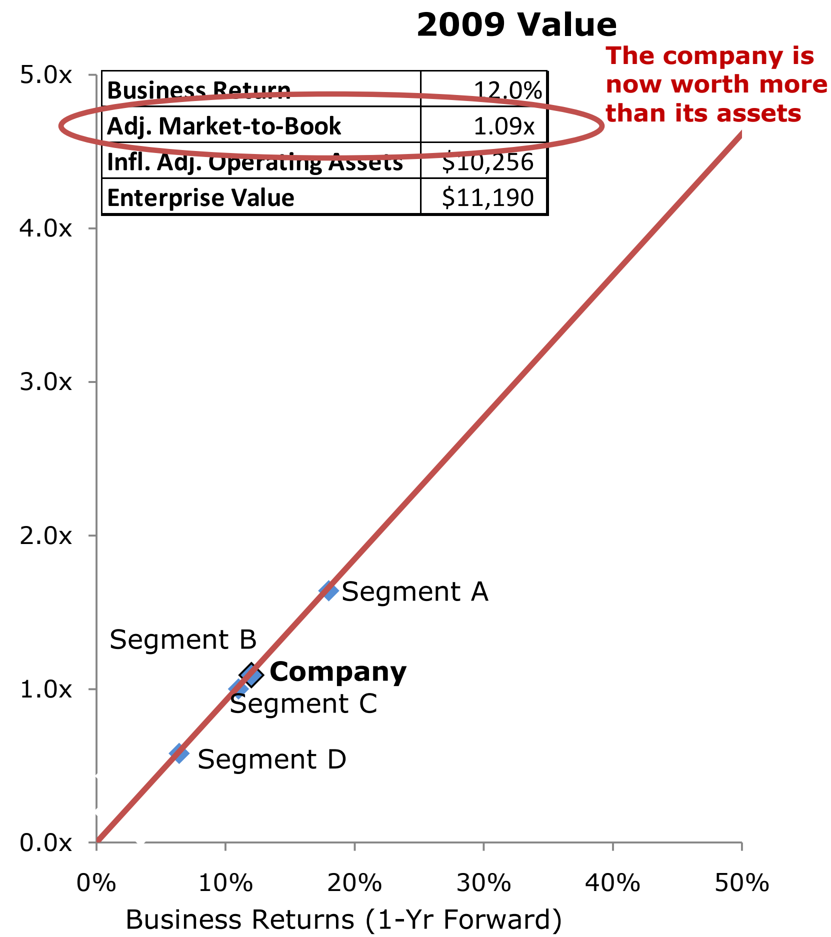
CASE STUDY

# Portfolio Analysis: Better Strategy Drivers Better Results




By allocating the next $500 million based on Business Returns, Residual Income & Growth, the company was able to create nearly $1.2 billion of value.



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