By Tim Becker

A Modern Proposal

Rules for developing better business cases

At the heart of effective leadership is good decision making. And at the heart of successful business is profit. Therefore, most decisions that a business leader makes are driven by economic motives. Accordingly, these choices are—or at least should be—grounded in a formal business case, though often a simple and subconscious one.

For the most important business decisions—those requiring significant investment—an explicit and formal business case is required. It should include some calculation of return on investment (ROI) and be developed using a financial model, often a spreadsheet. I have created more of these models than I'd care to admit. Spending time as a "spreadsheet jockey" is somewhat of a rite of passage for consultants. Fortunately, I rarely create spreadsheets these days. However, like most business executives, I still supervise and review quite a few business cases each year. Following are some guidelines I have found to be useful.

Don't overdo the analysis. There is a tendency, particularly among MBA types such as myself, to strictly adhere to the admonitions of our finance professors: "Payback analysis is heresy." "Internal rate of return (IRR) works most of the time, but has flaws and should generally be avoided." "Net present value (NPV) is the only prudent method of computing ROI." "Plus-NPV calculations are sure to impress the corporate brass."

Executives operate in the real world, where payback analysis is fine 90-plus percent of the time. It is easy to compute and easy to understand. The rest of the time, IRR usually will work. Only in unusual, murky, or high-stakes situations—those with oddly distributed cash flows, for example—is NPV analysis a necessity.

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For less impactful, simple, obvious decisions—in other words, the majority of decisions that we make—payback analysis is fine. However, for high-impact, complex, or less-clear investments, it's necessary to compute IRR and NPV in addition to payback. While these kinds of decisions may be few in number, they account for a majority of investment dollars a company lays out. Most of the guidance that follows pertains to these more complex investment analyses.

Consider and model several viable investment options. Avoid the temptation to focus on the acceptable option, one that merely clears corporate hurdles. Rather, set your sights on finding the option that clears corporate hurdles by the greatest amount. I find that clients often gravitate toward a single solution with a positive NPV to the exclusion of other options with higher NPVs. A good leader identifies multiple options arrayed across the spectrum of risk and return. Be careful not to go overboard with option identification and evaluation. A good rule of thumb is to identify and model the three to five most attractive options via a prescreening process involving a much larger set.

Risk adjust the cost of capital. Most organization leaders have defined a corporate cost of capital based on the cost of equity and debt. This is the basis for the company's hurdle rate and is a rough indicator of overall risk. However, the risk of individual business units can vary considerably, as can the risk of an individual investment. For larger investments, the cost of capital should be adjusted based on the risk of both the specific business unit and the individual investment itself.

Build additional conservatism into the business model. This often is referred to as contingency. Risk adjusting the cost of capital is done to account for known risks, while contingency is risk adjustment for the unknown risks inherent in almost all investments. Even in the most mundane of capital projects, I have witnessed the erosion of ROI because of unanticipated factors or events. It's common to hear of investments that fall short of predicted ROI, but rare to hear of investments exceeding ROI. This highlights the importance of including contingency costs. The amount of contingency depends on a number of factors, including the complexity of the investment and company experience with similar investments. Projects in which new technologies are applied especially warrant contingency premiums, perhaps amounting to 15 percent of total project costs.

Account for all significant costs and benefits, specifically, those that comprise at least 1 percent of the total. Include soft costs and benefits—

that is, those that are not easily quantified. Many soft costs and benefits can, in fact, be quantified—albeit with less precision than hard costs—if creativity and effort are applied. Where quantification truly is impossible, identify such soft costs and benefits along with a qualitative evaluation of impact.

Understand and represent the impact on accounting. While an investment might pass muster based purely on ROI, it might have a devastating effect on the business unit from an accounting perspective. For example, classifying costs as capital instead of operating expenses can have a significant effect on financial statements. On more than a few occasions, I have seen financially attractive investments disapproved because of negative influence on a company's income statement.

Perform deep sensitivity analysis. Identify the variables that most affect investment economics, and model the worst and best cases for each variable. Sensitivity analysis often is misunderstood and misapplied. The most common mistake is adjusting the base case value—the most likely value between the best and worst case values—for key variables by the same percentage upward and downward to determine the best and worst case values. Such sensitivity analysis is overly simplistic and therefore of little value.

In a good business case, the best, worst, and base case values for each variable should be calculated individually and each value provided with justification. Seldom will the percentage adjustment applied to base values be the same for the worst and best cases; and seldom should the percentage adjustments to the base values be the same across all key variables. If the same worst case values for multiple variables is a possibility, then your worst case ROI should reflect this worst case scenario. If you find that the worst case values for variables consistently diverge more than the best case values, you may want to assess whether your base case is overly optimistic—it probably is.

Identify key risks and mitigation strategies. A good business case should identify key investment risks, their probability of occurring, and an estimate of their potential impact on ROI. For each risk, detail a mitigation strategy identifying actions to avoid the risk and reduce its effect should it manifest. For certain investments, it may be prudent to devise an exit strategy triggered by the failure to meet specified performance minimums.

These guidelines should put a business leader's investment proposal in a good position for approval. However, the end game is not investment approval, but investment success. Accordingly, a business case should not be shelved once investment approval is achieved.

A business case is not a static, single-purpose tool. Rather, it is a dynamic tool of project management and investment evaluation. A business case should continue to be updated during project planning and execution—and perhaps be modified for better usability. Then it can serve as a reference point for investment evaluation and a tool for performance management.

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