A PRACTICAL APPROACH TO BUSINESS UNIT HURDLE RATES, PORTFOLIO ANALYSIS AND STRATEGIC PLANNING

Joseph Calandro, Jr. (joseph.calandro@us.pwc.com), † David Gates (david.gates@us.pwc.com), *
Anup Madampath (anup.madampath@us.pwc.com), † and
Francois Ramette (francois.ramette@us.pwc.com)

Structured Abstract

Purpose: Many firms employ some form of business or strategic planning process to determine how their capital should be allocated over some given timeframe. These processes have, over the recent past, been stretched due to the influx of capital may firms have experienced as a result of the easy money policies enacted in response to the 2007-2008 financial crisis. Many corporate finance executives are using this situation as a catalyst to thoroughly reevaluate their planning processes, and the analyses that inform them, particularly in the areas of business unit hurdle rates and portfolio analysis.

During the course and scope of our work as both corporate finance advisors and researchers we have encountered a number of executives who struggle with their current methods of: estimating business unit hurdle rates and evaluating business unit portfolios. For example, a number of executives subjectively pick a hurdle rate--many times between 10 and 15%--without engaging in any form of analysis (or worse, some employ formal analysis merely to "back into" a desired hurdle). To address situations like this, we have adopted a well-known financial model and modified it for use in a business unit context through the use of a strategic "accounting beta." Significantly, we also recast (and simplified) the mathematical expression of the model, which served two purposes: First, it provides a level of transparency to the model that makes it easier for corporate executives to understand and therefore use. Second, it facilitates portfolio analysis by leveraging the variables used in the hurdle rate model thereby linking the two analyses (hurdle rate estimation and portfolio analysis), which practically enables business planning in an integrated way.

Design/methodology/approach: Our approach emerged out of: (1) our consulting work where we have been retained to advise various corporate finance clients on business unit hurdle rates and portfolio analysis as part of comprehensive reviews of their planning and capital budgeting processes, and (2) our formal research of how certain successful investment methodologies could be employed in a corporate finance context. Our research methodology began with detailed literature reviews and then proceeded to interviews with executive managers (from both corporate finance and strategy) as well as professional investors, after which we developed, prototyped and put into production the solutions that are described in our paper.

† Managing Director at PwC and Fellow of the Gabelli Center for Global Investment Analysis at Fordham University

* Director with PwC
Findings: We have found that by providing transparency to business unit hurdle rate estimates a greater level of managerial discussion and questioning--from both strategic and financial perspectives--is enabled. Significantly, our approach also facilitates a practical form of portfolio analysis, which can be used in conjunction with various capital budgeting methods to both question certain strategically significant assumptions, as well as to inform and direct more detailed forms of analysis. Finally, the linkage between the two approaches (hurdle rate estimation and portfolio analysis) was found to be useful in formal planning processes where--in order to secure the requisite funds to execute a business strategy--the objective is to show how a business unit could meet (and hopefully exceed) a given hurdle rate.

Originality/value: Our hurdle rate model was inspired by a popular enterprise-wide financial model, but our reformulation of the model, and use of it in a business unit rather than enterprise-wide context, is unique to our paper. Similarly, our portfolio analysis approach was inspired by other such approaches, but the specific criteria, formulation and output of our approach are original to our research. Finally, the integration of the two methods of analyses is also unique to our research, which corporate finance executives both domestically in the United States and internationally have found useful in practice.