Gartner for Finance

A New Role for CFOs in Capturing Value

Commit to funding competitive differentiation

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Only 31% of large organizations earn returns above their cost of capital — and how CFOs invest resources and manage profitability may be to blame.

For the past 15 years, Gartner has studied how organizations create value by growing the top line, increasing profitability and reinvesting efficiently. Our research reveals this lack of long-term value generation is an evergreen, urgent problem.

CFOs are strategic enablers — stewards of the resources that fund certain initiatives and defund others. They most often make those decisions based on business cases they can comfortably measure. Most of the CFOs we talk to are trying to help their organizations become more adaptive to their competition (and other external factors), but the current environment is too high-change to adapt effectively. As a result, they chase fleeting opportunities and fail to deliver value systematically over time.

Instead of focusing their efforts on being adaptive, our research shows, CFOs should focus on competitive differentiation — which increases resilience in high-change environments by building competitive barriers and enabling a strategic filtering of unexpected events. It may seem counterintuitive to suggest that becoming more adaptive in today’s environment won’t translate into value. But as organizations reset business strategy post-COVID-19, our research shows that CFOs need to drive investment in competitive differentiation to create long-term value.

In fact, differentiation increases the odds that organizations realize value from investments by over 42%, translating into a full 6 points of excess return over a three-year period. CFOs have an outsized opportunity to refocus their organizations on the sources of value, leveraging their influence over the entire cost structure to promote long-term value realization.

Jason Boldt
Senior Director, Research

Nearly 100 finance executives surveyed
120+ CFOs interviewed
1,000+ public companies’ financial results analyzed
Creating Long-Term Value Is a Struggle
Many companies grow revenue but destroy long-term value

Over the past decade, top-line growth has come at the cost of long-term value, which reflects profit margins and reinvestment efficiency in addition to revenue. By 2018, just 31% of the world’s largest companies earned returns above their cost of capital, down from 38% in 2010.

Underlying this challenge is a lack of consensus across the organization on how to achieve long-term value. CFOs are uniquely positioned to guide management teams in prioritizing and deploying investment.

Although they must react to the priorities and goals of other functional and business leaders, they have an opportunity to drive long-term value through how they allocate costs and resources.

The question is, are they focused on the right things?
CFOs are too focused on what’s going on outside

In disrupted and high-change environments, CFOs (like all business leaders) are urged by everyone — from the media to internal peers — to be more agile and adaptive. That often means trying to match competitors.

Business leaders convince each other, for example, that launching new products and services or moving into new geographies will secure top-line growth. CFOs fall in line, and use that business case to prioritize and deploy investments and funding.

But if you only do what your competitors are doing, you won’t earn excess profits. And yet companies, enabled by their CFOs, fall into this trap over and over again.

<table>
<thead>
<tr>
<th>Outside factors</th>
<th>Approach to structuring costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size of addressable markets</td>
<td>Prioritize growth investment for large addressable growth opportunities</td>
</tr>
<tr>
<td>Industry growth rate</td>
<td>Allocate as much cost as needed to maximize top line growth</td>
</tr>
<tr>
<td>Competitor capabilities</td>
<td>Invest to match or surpass competitor capabilities</td>
</tr>
</tbody>
</table>
Managing outside factors doesn’t create value

Impact of cost structure on long-term value realization
Relative impact of moving from 10th to 90th percentile

The relative impact of moving from the 10th percentile to the 90th — that is moving from mediocre to superior performance — on structuring costs around outside factors has zero impact on value realization.

0%

n = 55 CFOs
Source: Gartner CFO Cost Structure Survey
Note: Long-term value realization is a measure of an organization’s ability to realize value over a 3-year period: expanding margins as much as possible, fully translating growth bets into profitability, taking on enough risk, creating capacity to pursue growth opportunities and pursuing growth without creating excess complexity.

In a world where agility has become a hallmark of good management, it’s shocking to discover that being adaptive isn’t necessarily productive — because being adaptive focuses the organization on what others are doing.

Our research shows that however good you get at investing or managing profitability based on outside factors, you won’t create more value. A focus on improving your current outside-view approach has zero impact on your ability to realize long-term value.

Decision making itself might be more agile with an adaptive mindset, but it’s also more likely to lead to herd behavior and scope creep. Case in point: unprofitable expansion into additional industries, business lines or footprints in pursuit of growth — sometimes at any cost.

In these cases, the adaptive approach creates a sense that the organization is acting boldly and keeping pace with competitors, but it’s not creating value — and may actually be destroying it.
It’s Time to Focus on What Differentiates the Organization
Instead, focus on the organization’s uniqueness

A differentiating approach, by contrast, focuses on creating, acquiring, developing, and funding unique assets and capabilities.

CFOs can help drive value by investing in and protecting costs related to points of differentiation for the organization:

- **Assets.** May or may not show up on a balance sheet, but are the foundation from which business leaders launch and capture growth opportunities (for example, patents or fixed manufacturing resources that enable scale and continuous improvement).

- **Alignment.** Midlevel and senior managers have a shared view on which costs need to be protected to capture opportunities and realize value.

- **Capabilities.** Things competitors would struggle or fail to create if they tried and which enable a company to develop enduring value propositions for customers and employees (for example, unique intellectual property and knowledge beyond that needed to simply expand an existing product or service).

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<tr>
<th>Intangible and tangible assets</th>
<th>Align costs to differentiated opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management alignment</td>
<td>Protect costs that support points of differentiation</td>
</tr>
<tr>
<td>Differentiating capabilities</td>
<td>Invest to create differentiated capabilities</td>
</tr>
</tbody>
</table>
Differentiation focus is more likely to drive value

Moving from the mediocre bottom quartile of performance to the superior top quartile of performance on the differentiation approach results in a 42% increase in long-term value realization.

This approach enables CFOs to drive long-term profitable growth at returns above the cost of capital: Over 6 percentage points of excess return compared to competitive peers.

Differentiation provides a foundation to weather unexpected events, while constant “sense and respond” makes an organization more fragile.

Impact of cost structure on long-term value realization

Relative impact of moving from 10th to 90th percentile

- 42%
- 30%
- 15%
- 0%

Structuring costs around differentiating factors

n = 55 CFOs
Source: Gartner CFO Cost Structure Survey

1 Long-term value realization is a measure of an organization’s ability to realize value over a 3-year period: expanding margins as much as possible, fully translating growth bets into profitability, taking on enough risk, creating capacity to pursue growth opportunities and pursuing growth without creating excess complexity.
Challenges for CFOs building a view on differentiation

Implementing a differentiation approach to investment and costs is especially challenging for CFOs today when entities are highly matrixed and costs are interdependent.

**Lack of clarity on costs**
- **Which costs** and investments create or enable a point of differentiation?
- CFOs who categorize and prioritize spending in a silo may inadvertently harm a point of differentiation when they (re)allocate resources.

**How much** should I invest in a point of differentiation?
- Overinvesting harms the efficiency of reinvestment and reduces shareholder returns. Underinvesting makes it easier for competitors to replicate and eliminate the advantage.

**When** should I accelerate, reduce or eliminate investment?
- Ultimately, all points of differentiation evolve or are eliminated by market forces, but until then, it's a risk to abandon prematurely or to entrench unprofitably in business lines, products/services or parts of the industry value chain.
Steps CFOs Can Take Now
Reimagine the CFO role as resource broker

The differentiating approach to investing and managing profitability requires a different kind of CFO leadership — maximizing the role as a steward of resource allocation by enabling business leaders to realize long-term value.

If effective, CFOs build resilient organizations by disproportionately investing and managing profitability to build and protect points of differentiation, and pushing back against the pursuit of top-line growth alone. CFOs should develop guardrails that guide business leaders to invest in and protect sources of differentiation.

**Two steps CFOs can take now:**

1. **Unravel complex interdependencies between costs.**
   - Leverage business expertise to score costs by complexity and materiality. (Highly interdependent costs that create a point of differentiation are the most critical.)
   - Map how costs affect points of differentiation or functional value, support customer and stakeholder needs, and impact margin and financial strategy.
   - Make sure strategic cost categories directly tied to points of differentiation have a business owner who protects and advocates for those resources.

2. **Surface productive spending limits, rather than absolutes on investments and costs.**
   - The lower limit represents the minimum spend on critical costs before the project breaks (e.g., at which point the observable metrics can't even validate the proof of concept).
   - The upper limit is the maximum productive spending you can invest in a given initiative before you start to see declining or no returns (e.g., the point at which you could release new products but the market couldn't absorb them).
Uncover operational constraints in differentiating projects

Illustrative

Establishing the pace and amount of investment in a point of differentiation should be a test-and-learn exercise rooted in operational constraints and market feedback, not assumptions.

Ask business leaders what they would do with 10% of or 10 times their proposed project funds. The exercise helps finance identify the minimum and maximum the business could productively spend on the initiative so they can reallocate funding to protect differentiated initiatives that are at risk and accelerate initiatives with high upside potential.

“Any lower than that, and we wouldn’t be able to validate customer adoption rates ...”

“What if you only had 10% to spend ...”

Minimum productive funding: Locate the minimum spending on critical costs before the project breaks.

“‘We can still do the proof of concept at 90%. Any lower than that, and we wouldn’t be able to validate customer adoption rates ...’”

1x – Proposed funding

Maximum productive funding: Locate the maximum point at which additional funding creates diminishing or no returns.

“‘We’d be able to release two additional products. The overall market can’t absorb more in the short term ...’”

Source: Adapted by Gartner from client case study
What CFOs need to do more — and less

Do more

Promote collaboration across the business
- Instigate an operating review with senior management to explicitly discuss and agree on the company’s points of differentiation and which investments drive that differentiation.
- Ensure each point of competitive differentiation has a business “owner” who creates the business case for investments required to transform or innovate processes as needed.
- Facilitate best practice sharing across cost category owners.
- Encourage adoption of optimal cost strategies developed by business leaders
- Ensure cost optimization is resourced with the right expertise.

Evolve financial processes to reinforce points of differentiation
- Eliminate historical assumptions misaligned to current strategic priorities.
- Ring-fence costs in budgets that drive points of differentiation.

Prepare to build more adaptive governance mechanisms so you know when to accelerate, reduce or eliminate investment.

Keep doing

Model the trade-offs between saving and investing
- Ensure cost reduction initiatives drive positive margin impact.
- Evaluate to what degree strategic investment needs consume cost savings.
- Communicate cumulative cost savings and investment needs to investors.
- Educate and encourage business leaders on how to remove unproductive costs.
- Provide sufficient resourcing to transform organizational processes.

Do less

Generate cost-saving strategies or ideas for the business
- Avoid dictating how the business should change its cost structure.
- Avoid direct finance ownership of any costs outside the finance budget or finance-owned companywide expense items (e.g., travel & entertainment).
- Focus on overall cost-saving targets and positive contribution by each business.