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ARTICLE STRATEGY

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by Michael Mankins, Karen Harris, and David Harding



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**MONEY IS NO LONGER A SCARCE RESOURCE.
THAT CHANGES EVERYTHING.**

**BY MICHAEL MANKINS, KAREN HARRIS,
AND DAVID HARDING**





IN BRIEF

WHAT'S CHANGED?

For most of the past 50 years, business leaders viewed financial capital as their most precious resource. But today it is abundant and cheap.

WHAT DOES IT MEAN?

The skillful allocation of financial capital is no longer a source of sustained competitive advantage. More important is a workforce that can generate good ideas and translate them into successful new products, services, and businesses.

WHAT SHOULD FIRMS DO?

Companies should lower hurdle rates, make numerous small investments in growth opportunities, and pay more attention to managing their human capital well.

FOR

most of the past 50 years, business leaders viewed financial capital as their most precious resource. They worked hard to ensure that every penny went to funding only the most promising projects. A generation of executives was taught to apply hurdle rates that reflected the high capital costs prevalent for most of the 1980s and 1990s. And companies like General Electric and Berkshire Hathaway were lauded for the discipline with which they invested.

Today financial capital is no longer a scarce resource—it is abundant and cheap. Bain's Macro Trends Group estimates that global financial capital has more than tripled over the past three decades and now stands at roughly 10 times global GDP. As capital has grown more plentiful, its price has plummeted. For many large companies, the after-tax cost of borrowing is close to the rate of inflation, meaning that real borrowing costs hover near zero. Any reasonably

profitable large enterprise can readily obtain the capital it needs to buy new equipment, fund new product development, enter new markets, and even acquire new businesses. To be sure, leadership teams still need to manage their money carefully—after all, waste is waste. But the skillful allocation of financial capital is no longer a source of sustained competitive advantage.

The assets that are in short supply at most companies are the skills and capabilities required to translate good growth ideas into successful new products, services, and businesses—and the traditional financially driven approach to strategic investment has only compounded this paucity. Indeed, the standard method for prioritizing strategic investments strives to limit the field of potential projects and encourages companies to invest in a few “sure bets” that clear high hurdle rates. At a time when most companies are desperate for growth, this approach unnecessarily forecloses too many options. And it encourages executives to remain committed to investments long after it's clear that they're not paying off. Finally, it leaves companies with piles of cash for which executives often find no better use than to buy back stock.

Strategy in the new age of capital superabundance demands a fundamentally different approach from the traditional models anchored in long-term planning and continual improvement. Companies must lower hurdle rates and relax the other constraints that reflect a bygone era of scarce capital. They should move away from making a few big bets over the course of many years and start making numerous small and varied investments, knowing that not all will pan out. They must learn to quickly spot—and get out of—losing ventures, while aggressively supporting the winners, nurturing them into successful new businesses. This is the path already taken by firms innovating in rapidly evolving markets, but in an era of cheap capital, it will become the dominant model across the business economy. Companies that practice this strategy will have the edge so long as capital remains superabundant—and according to our analysis, that could be the case for the next 20 years or more. In this article, we outline what it takes to produce great results in this new world. We begin by taking a closer look at the data.

A WORLD AWASH IN MONEY

Many of today's business leaders cut their teeth in a period of relative capital scarcity and high borrowing costs. In the early 1980s, double-digit federal-funds rates prevailed, and corporate debt and equity securities traded at high premiums. Although the required rate of return on stocks and bonds returned to more “normal” levels by the end of the decade, capital

costs remained high. Our research suggests that for most large public companies, the weighted average cost of capital, or WACC, exceeded 10% for most of the 1980s and 1990s.

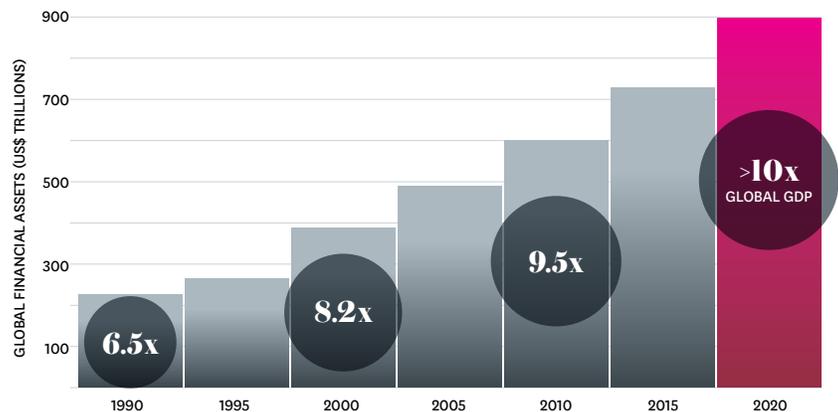
But the world changed following the financial collapse in late 2008. Central bank interventions pushed interest rates in many countries to historic lows, where they remain nearly a decade later, owing to tepid economic growth. Many executives believe that the current interest rate environment is temporary and that more-familiar capital market conditions will reassert themselves soon. Our research, however, leads to the opposite conclusion.

Using public data and proprietary economic models, Bain's Macro Trends Group examined how the quantity and scale of assets on the world balance sheet have evolved over time. We found that global financial assets (which more or less represent the supply of capital invested or available for investment in the real economy) grew at an increasingly rapid pace—from \$220 trillion in 1990 (about 6.5 times global GDP) to some \$600 trillion in 2010 (9.5 times global GDP). We project that by 2020 the number will have expanded by half again—to about \$900 trillion (measured in 2010 prices and exchange rates), or more than 10 times projected global GDP (see the exhibit “Growth in the Global Balance Sheet”). At this rate, by 2025 global financial assets could easily surpass a quadrillion dollars. We see two factors principally accounting for the continuing trend:

- **Growing financial markets in emerging economies.** Although prospects for growth in advanced economies are relatively weak, the financial markets in China, India, and other emerging economies have only started to develop. Our analysis indicates that these nations will account for more than 40% of the increase in global financial assets from 2010 to 2020. And the data suggests that emerging economies will continue fueling growth in financial capital well beyond 2020.
- **An expanding number of “peak savers.”** There are important demographic factors at work that will reinforce the superabundance of financial capital. Specifically, the population of 45- to 59-year-olds is critical in determining the level of savings (versus consumption) in the global economy. People in this age bracket have moved past their prime spending years and make a higher contribution to savings and capital formation than any other age group. These “peak savers” will represent a large and growing percentage of the global population until 2040, when their numbers will slowly begin to decline.

GROWTH IN THE GLOBAL BALANCE SHEET

Worldwide financial assets keep building up—faster than global GDP.



SOURCE BAIN MACRO TRENDS GROUP. NOTE ASSETS AND MULTIPLES OF GLOBAL GDP WERE CALCULATED USING 2010 PRICES AND EXCHANGE RATES. DATA IS ESTIMATED FOR 2015 AND PROJECTED FOR 2020.

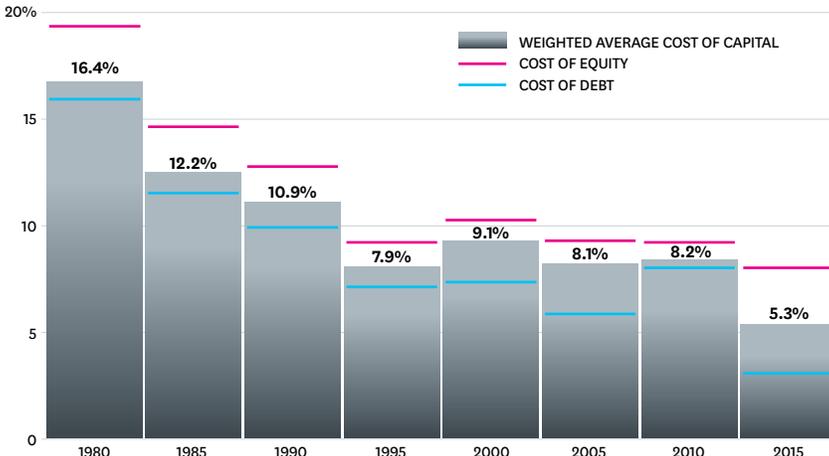
The combination of these factors leads us to conclude that through 2030 (at least), markets will continue to grapple with capital superabundance. Too much capital will be chasing too few good investment ideas for many years.

Moreover, as the supply of financial capital has increased, its price has fallen precipitously. In 2008 the cost of borrowing began to decline in response to central bank intervention. Today, facing a dearth of attractive investment opportunities, large banks have been forced to accept riskier projects as investment grade. Even high-yield “junk” bonds are trading at historic lows. All told, the marginal cost of debt for many large companies is now as low as 3%. This means that the after-tax cost of borrowing is at (or below) the rate of inflation—implying that in real terms, debt is essentially free.

Not only are interest rates low across all classes of debt, but the cost of equity is lower as well. Immediately following the global financial crisis, equity risk premiums—that is, the premium relative to risk-free assets, such as government bonds, that investors demand in order to buy stocks—shot up dramatically. We estimate that in 2007, before the crisis really hit, the equity risk premium was around 3% (versus 10-year government bonds). By 2009, following the

HOW THE COST OF CAPITAL HAS EVOLVED

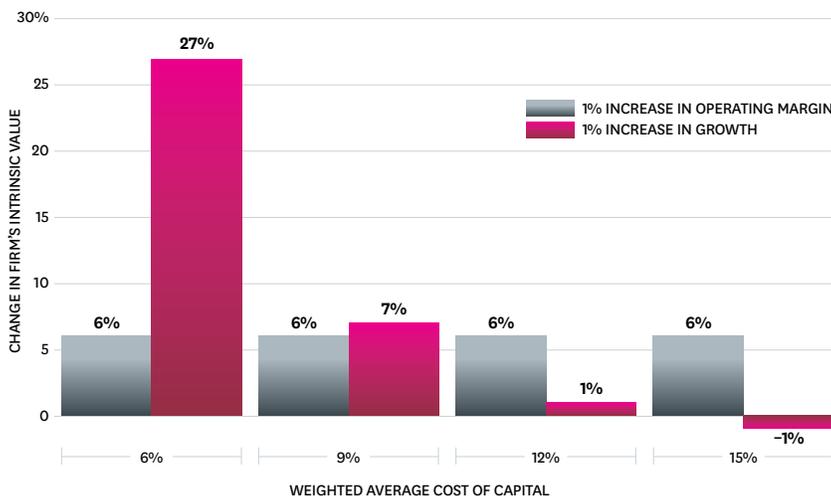
The cost of capital for most large U.S. companies is at its lowest level in decades.



SOURCE BAIN & COMPANY. NOTE DATA IS FOR COMPANIES IN THE VALUE LINE INDEX.

CHOOSING A STRATEGY: PROFITABILITY OR GROWTH?

The value of pursuing growth is highly sensitive to changes in the weighted average cost of capital (WACC), while the value of improving operating margins is stable. At a WACC of 6%, the return on growth investments is extraordinarily high: A 1% improvement in a company's long-term growth rate will increase a firm's value by a staggering 27%, whereas a sustained improvement in operating margins of 1% will boost value by only 6%.



SOURCE BAIN & COMPANY

financial collapse, investors demanded a premium of more than 7% to hold equities. As the economy rebounded, equity risk premiums dropped back to more-normal levels (averaging 4% to 5%). That decline, combined with lower rates of return on risk-free assets, reduced the cost of equity: We estimate that for U.S. corporations, the average cost is currently around 8%, compared with more than 12% during much of the 1980s and 1990s.

The combination of historically low debt and low equity costs (along with the buildup of cash on many balance sheets) has produced very low capital costs for most corporations. We estimate that for the 1,600-plus companies that constitute the Value Line Index, the weighted average cost of capital currently ranges from 5% to 6%. That compares with 10% or more in the 1980s and early 1990s (see the exhibit "How the Cost of Capital Has Evolved").

THE NEW RULES OF STRATEGY

When capital is both plentiful and cheap, many of the unspoken assumptions about what drives business success must be challenged and a new playbook developed. In our work with clients, we have seen a few companies that are already incorporating capital superabundance into the way they think about strategy and organization. The changes they are making—and deriving benefits from—accord with three new rules:

Reduce hurdle rates. Virtually every large company sets explicit or implicit hurdle rates on new capital investments. A hurdle rate is the minimal projected rate of return that a planned investment must yield. Exceed this rate and the investment is a "go"; fall short and it will be scuttled. Ideally, the hurdle rate should reflect a company's WACC (adjusted, as needed, for differential risk).

For too many companies, however, hurdle rates remain high relative to actual capital costs. Research by Iwan Meier and Vefa Tarhan pegged average hurdle rates at 14.1% in 2003. Since then, hurdle rates have changed very little. When the Manufacturers Alliance for Productivity and Innovation (MAPI) surveyed members of its CFO and Financial Councils, it found that the average rate was 13.7% in 2011 and 12.5% in 2016. And roughly half the survey respondents noted that hurdle rates at their companies had stayed constant during that five-year period. Research conducted in 2013 by the Federal Reserve found that companies are extremely reluctant to change hurdle rates even when interest rates fluctuate dramatically. This research dovetails with our own experience as consultants: Most companies that engage with us have not adjusted their hurdle rates significantly in the past two decades.

We estimate, on the basis of the MAPI survey data, that the gap between hurdle rates and the actual cost of capital for most companies is 650 to 750 basis points. The result: Too many investment opportunities are being rejected, cash is building up on corporate balance sheets, and more and more companies are choosing to buy back common stock rather than pursue investments in productivity and growth. Reuters studied 3,297 publicly traded U.S. nonfinancial companies in 2016 and found that 60% bought back shares between 2010 and 2015. And for companies with stock repurchase plans, spending on buybacks and dividends exceeded not just investments in research and development but also total capital spending.

It is important to point out that share buybacks create value for the acquirer only if a company's common stock is significantly undervalued in the market. Under those conditions, share repurchases are akin to "buying low" with the prospect of "selling high" later. However, although executives frequently maintain that their companies' shares are undervalued, our research suggests otherwise. And even when a buyback makes financial sense, the act of repurchasing shares can signal to investors that management has run out of attractive investment ideas—it's the economic equivalent of throwing up your hands and asking shareholders to find good investments on their own.

In the new era, leaders should have a strong bias toward reinvesting earnings in new products, technologies, and businesses. It is the only way for the companies that have bought back shares to grow into their new multiples and for all companies to fuel innovation and accelerate profitable growth. With expected equity returns in the single digits, it shouldn't be difficult for management to identify strategic investments with the potential to generate more-attractive returns for investors. To qualify, opportunities need only be capable of generating a return on equity higher than shareholders' cost of equity capital, which we estimate is a mere 8% for most large companies.

Focus on growth. A lingering artifact from the age of capital scarcity is a bias toward tweaking the performance of existing operations, rather than trying to build new businesses and capabilities. When capital was expensive, investments to improve profitability trumped investments to increase growth. Accordingly, over the past several decades, most companies have employed process reengineering, Six Sigma, the "spans and layers" methodology, and other tools to remove waste and increase efficiency. At the same time, however, the rate of innovation has declined, according to research conducted by the OECD, and since 2010, top-line growth

has been flat (or negative) for nearly one-third of the nonfinancial companies in the S&P 500.

Success in the new era demands that leaders focus as much (or more) on identifying new growth opportunities as on optimizing the current business—because when capital costs are as low as they are today, the payoff from increasing growth is much higher than what can be gained by improving profitability. Take a look at the exhibit "Choosing a Strategy: Profitability or Growth?" It shows that the benefits of investing to accelerate growth (rather than improve profitability) depend a lot on the cost of capital. But at today's WACC of less than 6%, a growth approach clearly trumps an emphasis on profitability (as measured by the average pretax operating margin for the Value Line Index companies). Improving margins by 1% would increase the average company's value by only 6%. By contrast, increasing the long-term growth rate by 1% would drive up value by 27%—*four and a half times* as much bang for the buck invested.

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Shifting to a growth focus requires reevaluating the organizational model, as the case of WPP, the world's largest advertising and marketing services company, illustrates. In addition to optimizing its existing business, WPP has looked for growth opportunities by making dozens of investments and acquisitions outside traditional geographic markets and capabilities. As a result, the company's revenues rose from \$16.1 billion in 2011 to \$19 billion in 2015, and operating profits rose from \$1.9 billion to \$2.5 billion.

A significant part of WPP's success has been an approach to organization that CEO Martin Sorrell calls "horizontality." In the traditional industry model, single agencies compete for a client's global business. By contrast, WPP offers clients an internal market in which they can choose from a wide range of marketing services businesses that are under the WPP umbrella. These businesses then work together in dedicated client teams. Currently there are about 50 such teams, which involve some 40,000 people and account for one-third of the company's revenues. Each team is directed by one of the firm's client leaders, which puts WPP in a position to coordinate the work. That gives clients the benefits of having a partner with a full picture of the business while also giving them the advantages of choice. This approach has allowed each agency to focus on doing what it does best, whether that's digital advertising, public relations, marketing analytics, or something else. Top managers at WPP also have room to develop bold strategies to expand in digital markets, fast-growth geographies, and new fields such as data investment management.

In addition to setting up formal structures that encourage new business ideas, companies can adopt informal processes to reward continuous expansion. 3M is the classic example. For years it has permitted its 8,000-plus researchers to devote 15% of their time to projects that require no formal approval from supervisors. The company also pursues traditional product development efforts in which business managers and researchers work together to create new offerings and improve existing ones. This multipronged innovation process has enabled 3M to generate countless new products—from

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industrial adhesives to Post-it notes—and consistent top-line growth, year after year.

Making continual expansion part of a company's DNA is not easy, and companies have traditionally suffered from losing focus and overdiversifying. But that is not an argument for ducking the challenge. Investment in real growth has always been risky, and executives must learn to accept and even embrace failure. As Bill Harris, the former CEO of Intuit and PayPal once said: "Rewarding success is easy, but we think that rewarding intelligent failure is more important." Leaders in the new era should judge their team members not just by the home runs they hit but also by the learning that comes out of their failures. This implies the need for new performance-appraisal processes and an effort by senior managers to consider how their organizations are gaining knowledge by exploring new avenues of growth—whether those pan out or not.

Invest in experiments. When capital was scarce, companies attempted to pick winners. Executives

SCALE, SCOPE, AND THE FUTURE OF M&A

Abundant capital is rocket fuel for M&A. Low-cost capital has recently facilitated record levels of acquisitions and some of the largest transactions in corporate history. Most of the largest debt-fueled transactions are scale deals—usually some form of industry consolidation. Examples are plentiful in pharmaceuticals, technology, telecommunications, and energy.

Given the low borrowing costs and the opportunity for postmerger synergies—which typically range as high as 5% of combined revenue—scale deals seem like safe bets. And the combined companies typically do hit predicted earnings targets for one, two, or three years after the deal. But over the longer term, their performance is less impressive.

Bain & Company has been tracking deal returns for more than 15 years, and the single most consistent finding is that scale consolidations underperform the market. Almost any other M&A strategy is better than these “big bet” deals, which generate only 4.4% annual total shareholder returns. In fact, doing no deals is better than doing scale ones (sticking to the status quo generates annual returns of 5.7%). So although the required capital may be sitting there available—like the chocolate fountain at the all-you-can-eat buffet—it is not necessarily a good idea to indulge.

But this does not mean M&A is doomed. There's an alternative to scale deals: scope deals, which move companies into adjacent businesses, related services, or new markets and geographies. Our research finds that scope deals generally lead to higher returns, and the more of them a company does, the better the returns. Companies that expand via frequent, smaller deals over many years generate between 8.2% and 9.3% total annual shareholder returns.

Why do scope deals outperform scale deals in the new era? In a word: growth. A move into an adjacency is almost always a move into a higher-growth business, with greater option values. While scope deals may feel expensive and risky compared with scale deals, which quickly generate returns through synergies, scope deals create more value over time, particularly when capital is cheap. And the more deals you do, the better you get at finding and closing the best ones.



needed to be very sure that a new technology or new product was worthwhile before investing precious capital. The consequences of getting it wrong could be dire for careers as well as for strategy. With superabundant capital, leaders have the opportunity to take more chances, double down on the investments that perform well, and cut their losses on the rest. To put it another way, when the price of keys is low, it pays to unlock a lot of doors before deciding which one to walk through.

To win in the new era, executives need to get over the notion that every investment is a long-term commitment. They have to stop trying to prove to themselves (and their colleagues) that they can predict the future accurately and know how a business will perform five or 10 years out. Instead, executives should focus on whether putting money into something could be valuable as an experiment. If the experiment goes south, they can (and should) adjust. Treating investments as experiments frees companies to place more bets and allows them to move faster than competitors, particularly in rapidly changing markets.

Take Alphabet, the parent company of Google. Since 2005, Alphabet has invested in countless new ventures. Some have been highly publicized, such as YouTube, Nest, Google Glass, Motorola phones, Google Fiber, and self-driving cars. Others are less well-known (grocery delivery, photo sharing, an online car-insurance comparison service). While many of Alphabet's investments have succeeded, a few

have not. But rather than stick with those losers, CEO Larry Page and his team have shed them quickly. This has enabled the company to move on, test other investment ideas, and redouble its efforts in promising new businesses. In the past three years, Alphabet has closed the smart-home company Revolv, shut down Google Compare (the car insurance site), "paused" Google Fiber, and sold Motorola Mobility to Lenovo.

During the same period, the company has increased its stake in cloud services and various new undertakings managed by the company's X lab group—including electronic contact lenses and a network of stratospheric balloons intended to provide high-speed cellular internet access in rural areas. Not every investment will pay off, but the "noble experiments" mindset has allowed the company to explore many innovative ideas and create new platforms for profitable growth.

To be sure, Alphabet does have more money than most corporations and is operating in the "new economy," where exciting ideas constantly bubble up. But there is plenty of scope to apply the same approach in traditional sectors. Consumer foods and beverages are a case in point. Every March, aspiring entrepreneurs in the natural and organic foods industry converge on Anaheim, California, for Expo West, a giant trade show. In the past, the kind of small entrepreneur who set up a booth there might have started a business with funding from angel investors or from family and friends. If the company had some success, it might grow large enough to attract venture money or private equity. But large food companies stayed away. They knew the success rate of new products was low, and they funded innovation internally, rather than risk expensive capital on start-ups.

Today those large companies are flocking to Expo West and taking advantage of low-cost capital to form their own investment groups that build portfolios of early-stage food companies. Kellogg has Eighteen94 Capital, General Mills has 301 INC, and Campbell invests through Acre Venture Partners. The companies use these in-house units to fund small start-ups, nurture them, and then cull the flock. When a new product takes off, they buy out the founders and bring the operation in-house. In effect, superabundant capital has made "outsourced innovation" possible for food giants, allowing them to tap into the dynamics of the entrepreneurial economy to solve their biggest strategic issue: growth.

HUMAN CAPITAL: WHERE THE POWER LIES

The economist Paul Krugman famously noted, "Productivity isn't everything, but in the long run it is almost everything." Today productivity requires

working smarter rather than the traditional working harder. Companies increase output by identifying better ways to combine inputs, implementing technological innovations, and adopting new business models.

But all these productivity-enhancing measures require talented people who can bring them to life. In the new era, therefore, human capital—the time, talent, and energy of a company’s people, along with the ideas they generate and execute—is the foundation of superior performance. A single great idea, after all, can put a company on top for many years. Think of Apple’s iPhone, Continental Resources’ introduction of horizontal drilling for oil and natural gas, and IKEA’s re-imagining of home goods. Lots of smaller, everyday good ideas can enable a company to pull away from competitors too.

But great ideas don’t just materialize. They come from individuals and teams with the time to work productively, the skills to make a difference, and creativity and enthusiasm for their jobs. As long as companies continue to focus too much attention on managing financial capital, they will devote far too little to ensuring that the organization’s truly scarce resources—time, talent, and energy—are put to their best use. In fact, most companies lose nearly a quarter of their productive power because they have structures, processes, and practices that waste time and undermine performance. Firms counteract only a small portion of this lost output by making good hires and keeping their workforces engaged.

In other words, human capital has become the fundamental source of competitive advantage, and companies that manage it as carefully and rigorously as financial capital perform far better than the rest. In their book *Time, Talent, Energy*, Michael Mankins (an author of this article) and Eric Garton find that companies that apply real discipline in their management of human capital are on average 40% more productive than the rest. These companies lose far less to organizational drag. They attract, deploy, and lead talent more effectively—taking full advantage of the unique skills and capabilities their people bring to the workplace. Finally, they unleash far more of their employees’ discretionary energy through inspirational leadership and a mission-led culture. The resulting productivity difference is a huge advantage for the best companies, producing operating margins that are 30% to 50% higher than industry averages. And every year, as this difference is compounded, the gap in value between the best and the rest grows bigger.

MOST OF TODAY’S leaders were taught strategy—either in school or on the job—by the old rules, in a time when capital was scarce and expensive. Not surprisingly,



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most large companies still treat financial capital as the firm’s most precious resource and seek to carefully control how it is deployed. Those practices are out of step with what is required to win in the new age. The few “old dogs” that have learned the “new tricks” of strategy—and understand that ideas and the people who bring them to life are a company’s most valuable asset—are building an impressive lead. Their peers who don’t learn these lessons may find themselves irrecoverably behind in the years to come. ☹

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