

Where Should Our Next Operations Dollar Go?

The hardest capital-allocation decisions are rarely between good and bad projects. They are between competing uses of capital that each solve a real problem, create different kinds of value, and cannot all be funded.

Executive Operations Insights | Saša Cibula

Every operating plan eventually reaches the same uncomfortable point: there are more credible uses for capital than there is capital to deploy. One site needs capacity. Another has a compelling automation case. A third is carrying aging equipment that threatens reliability. Supply-chain leaders want redundancy around a vulnerable source. Technology leaders want the data and systems required for the next generation of AI-enabled operations. Each proposal can be rational. The portfolio cannot fund them all.

That is where capital allocation becomes an executive discipline rather than a budgeting exercise. The question is not whether a project is worthwhile in isolation. It is whether this project is a better use of the next dollar than the alternatives available to the enterprise - and whether committing the dollar today is better than preserving the ability to make a different decision tomorrow.

For operations leaders, this distinction matters more as automation, resilience, sustainability, capacity, maintenance, and growth compete for the same pool of capital. McKinsey's 2026 work on the COO role makes the tension explicit: capital allocation increasingly determines which operating initiatives move forward, forcing COOs and CFOs to align on tradeoffs rather than treat capital spending as a collection of functional requests.

Capital Allocation Is Not Project Approval

The traditional finance tools remain indispensable. Net present value estimates the value a project is expected to add after discounting future cash flows. Internal rate of return expresses the project's expected return relative to its investment. Return on invested capital helps leadership judge whether the enterprise is earning attractive returns on the capital already deployed. CFA Institute's current capital-allocation guidance treats NPV and IRR as core project-evaluation tools while emphasizing that management must consider projects relative to other opportunities and to the company's broader strategic objectives.

The mistake is using those tools as though a positive business case settles the allocation decision. A positive NPV means a project is expected to create value. It does not mean the project creates more value than another proposal competing for the same dollar. A high IRR can make a small, fast-payback project look more attractive than a larger investment that creates substantially more absolute value. ROIC can reveal capital productivity at enterprise level, but it does not by itself tell leaders whether to add a production line, automate a process, replace an aging asset, or preserve cash.

Capital allocation is therefore a portfolio problem. Senior leaders are not choosing between 'good' and 'bad' projects; they are deciding which combination of investments best advances strategy while protecting the economics and resilience of the existing operation. That is why investors pay attention to the discipline behind the process. In McKinsey's 2026 investor survey, 63 percent of respondents identified ROIC discipline as a hallmark of a high-quality capital allocator, while 54 percent looked for a clear allocation framework.

The Highest Return Is Not Always the Highest-Value Decision

Operations capital does several very different jobs. Some spending protects the base business: replacement equipment, reliability work, safety systems, or compliance investments. Some improves economics through automation, yield, energy, labor productivity, or process redesign. Some creates growth by adding capacity. Some buys resilience by reducing exposure to suppliers, infrastructure, or network failures. Some creates capabilities that may have modest standalone returns but unlock future investments.

Those categories are difficult to compare because they create value differently. A reliability project may prevent a low-frequency but severe loss rather than generate visible new revenue. A resilience investment may look unattractive in a conventional payback calculation because its value appears primarily when something goes wrong. A digital platform can look weak as a standalone project even if it becomes the foundation for multiple future use cases. A capacity expansion may show an excellent NPV under the base demand forecast while exposing the company to expensive underutilization if that forecast proves wrong.

The executive task is not to force every project into the same narrative. It is to make the economics comparable without pretending the economics are identical. NPV should remain the anchor for value creation, but leadership also needs to understand risk, timing, reversibility, strategic dependence, and the opportunity cost of consuming capital that could be used elsewhere.

Uncertainty Changes the Value of Waiting

This is where real-options thinking becomes useful. Avinash Dixit and Robert Pindyck argued that conventional investment analysis can understate the importance of irreversibility, uncertainty, and timing. A major capital commitment is rarely just a forecast of cash flows. It is also a choice about when to commit, how much to commit, whether the investment can be staged, and what flexibility remains if conditions change.

Timothy Luehrman later translated that logic into an executive framework he called 'option space.' The idea is that an investment should be judged not only by value relative to cost, but also by how much uncertainty remains and how much time management has to learn before committing. That creates more choices than the traditional invest-or-reject decision. Leaders can invest now, stage an investment, defer while gathering information, or abandon the opportunity.

REAL-OPTIONS LOGIC FOR CAPITAL ALLOCATION

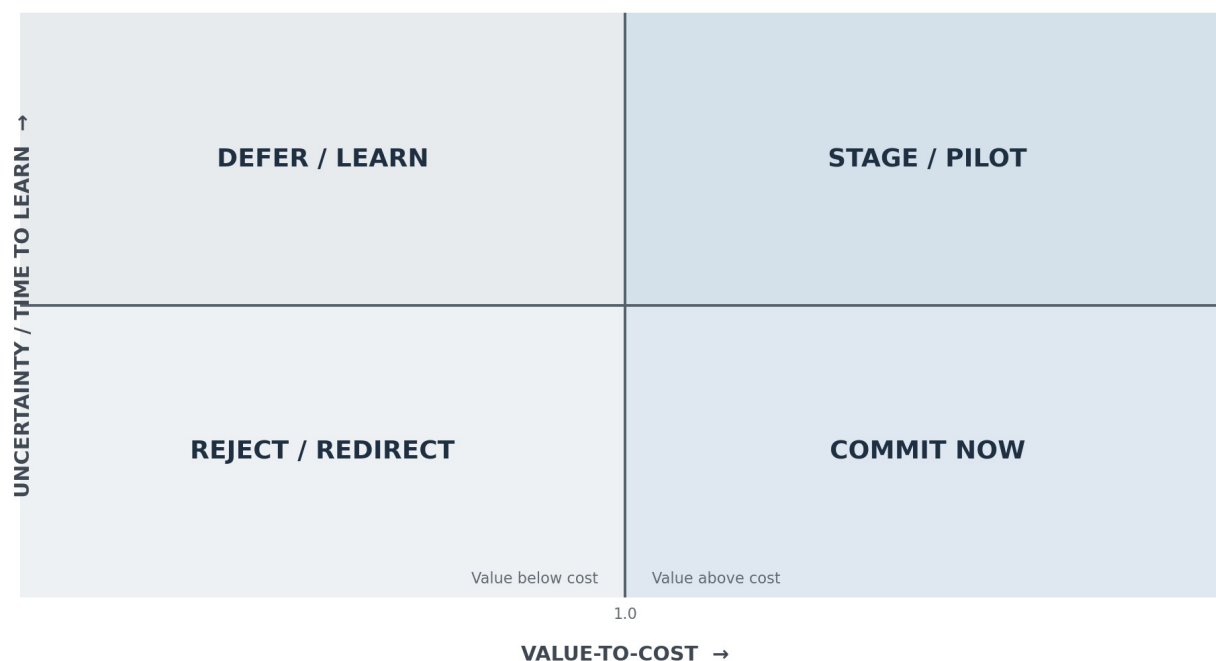


Figure 1. Real-options logic for capital allocation. Simplified executive adaptation of Luehrman's option-space framework; categories are used here to illustrate operating-investment sequencing, not to reproduce the original six-region model.

The practical implication is important. A high-value project under low uncertainty may deserve commitment now. A potentially high-value project under significant uncertainty may be more valuable as a staged investment: spend enough to learn, preserve the right to scale, and avoid locking the enterprise into a large irreversible position too early. A weak project with little strategic option value should not survive simply because it has a sponsor, a budget line, or a history.

Real-options thinking does not replace NPV. It extends the decision when management has meaningful flexibility. CFA Institute's capital-allocation framework makes the same distinction: real options can affect the timing, size,

operating capacity, and other future choices embedded in a project. In operations, that can mean piloting automation before network-wide deployment, buying land or completing engineering before constructing capacity, building modular capability instead of a full-scale asset, or qualifying an alternate supplier without immediately shifting the entire volume.

A Practical Example: Five Good Projects, One Capital Pool

Consider an illustrative operating network with roughly \$50 million available for discretionary capital and more than \$70 million in credible requests. A \$28 million capacity expansion has a strong NPV if forecast demand materializes. A \$16 million automation program offers an attractive IRR and could reduce unit cost. A \$12 million reliability program would replace aging critical equipment before failure risk becomes unacceptable. A \$10 million resilience proposal would reduce dependence on a vulnerable supplier and logistics route. An \$8 million data-and-capability investment would modernize planning infrastructure and enable future AI applications.

The wrong executive conversation is to ask each sponsor to defend the business case and then fund the proposals with the strongest presentations. The better conversation is to examine what each dollar does to the portfolio. The reliability program may deserve priority because the downside risk threatens the earnings base that supports every other investment. The automation program may be stageable, allowing the company to invest in one process or site, prove the economics, and preserve the option to scale. The capacity expansion may warrant design, permitting, or modular preparation now while the full construction commitment waits for a clearer demand signal. Resilience may be targeted at the few failure points where the financial consequence of disruption justifies the carrying cost.

That sequence can create more value than either extreme: funding every positive-NPV proposal or starving the business until certainty arrives. The portfolio is improved not only by choosing better projects but by changing the timing and size of commitments. Capital allocation becomes a way of managing strategic flexibility.

Three Behaviors That Weaken Capital Discipline

Treating last year's budget as an entitlement

Capital often becomes sticky. Business units, sites, and functions expect an allocation because they received one previously. That turns the process into negotiation over shares rather than competition for future value. McKinsey has repeatedly argued for portfolio-level comparison across growth, productivity, maintenance, and other categories rather than isolated bottom-up budgets. Recent productivity research makes the same point more broadly: dynamic reallocation is more valuable than a 'past plus' approach when the environment is changing quickly.

Allowing project sponsorship to shape the economics

Project sponsors naturally understand the benefits of their proposals better than the alternatives they do not own. That creates predictable optimism around demand, implementation speed, cost, and risk. McKinsey's work on capital portfolios notes that competition for funding can contribute to overly optimistic and overly precise estimates, trapping capital in projects whose true risk was understated. The executive process has to normalize assumptions across the portfolio, not simply compare business cases prepared under different levels of optimism.

Mistaking fairness for allocation discipline

Equal treatment can feel responsible and still destroy value. BCG's 2026 capital-allocation research argues that outperformers are selective and actively move capital toward areas with greater future value-creation potential rather than spreading resources mechanically. For an operations executive, that can mean one site receives substantial investment while another receives very little, or one technology program is accelerated while another is paused. The question is not whether the allocation is even. It is whether the enterprise can explain why the marginal dollar creates more value in one place than another.

The Counterargument: Not Every Operations Dollar Should Be Financialized

There is an important limit to financial frameworks. Safety, legal, environmental, and regulatory obligations cannot always be treated as optional investments competing for the highest return. Some expenditures are conditions of operating. Others protect trust, license to operate, or downside exposures that are difficult to model credibly.

Even then, capital discipline still matters. The obligation may be nonnegotiable, but the design, timing, technology, scope, and delivery approach usually are not. Executives can still ask which solution meets the requirement at the lowest life-cycle cost, which risks need to be eliminated rather than insured, and whether a phased approach preserves flexibility.

Real-options analysis also has its own failure mode. The concept of strategic flexibility can become a convenient way to justify weak projects with speculative future benefits. MacMillan and van Putten warned that real-options logic can encourage overinvestment when managers assign generous value to uncertain opportunities. The safeguard is straightforward: option value should complement disciplined cash-flow analysis, not rescue a project whose economics are poor and whose future choices are vague.

The Decision

So where should the next operations dollar go? Not automatically to the project with the highest IRR, the shortest payback, the loudest operational pain, or the strongest executive sponsor. It should go to the use of capital that creates the greatest incremental enterprise value after considering the alternatives, the risk to the existing business, the timing of the commitment, and the flexibility the investment creates or destroys.

That requires COOs and CFOs to look at operations capital as a portfolio rather than a queue. Some investments should be accelerated. Some should be staged. Some should be deferred while the company buys information rather than assets. Some should be stopped even after significant work has been invested in them. And some lower-return investments should be funded because they protect the platform on which higher-return opportunities depend.

The most important discipline is opportunity cost. Every dollar committed to one operating model, asset, facility, technology, or risk position is a dollar that cannot be used elsewhere. Capital allocation is therefore one of the clearest expressions of strategy because it converts priorities into irreversible choices.

Executives do not merely allocate money to projects. They allocate the future operating capacity of the enterprise.

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Editorial standard: established frameworks, executive application, practical tradeoffs, selective sourcing.