Project Portfolio-Level KPIs for Effective Management of Financial Performance [1]

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The performance of a project portfolio should be measured and managed at two levels of maturity. The first level aggregates and analyzes project-level data to create portfolio metrics based on project delivery (i.e., percentage of projects on time/budget). The second level of maturity uses portfolio-level metrics that consider projects as financial investments. In this article, Fernando Santiago presents KPIs defined for this second level, to optimize the allocation of capital based on risk/return.

The purpose of a project portfolio is to deliver value to the organization, through projects from two main categories, based on freedom to invest: non-discretionary VS discretionary. Projects that are considered non-discretionary are needed to maintain and optimize the operation's capability to generate profits. Discretionary projects, on the other hand, are identified to increase the return from the operation through growth, cost reduction, and/or execution of strategy. The financial value of non-discretionary projects is realized in the financial returns from the operation. In contrast, for discretionary projects, value comes from the benefits expected minus the investment required, at an expected level of risk, as documented in a business case.

The first responsibility in managing a portfolio is balancing the allocation of funds and resources between non-discretionary and discretionary investments, as the former tends to increase over time, with new operational needs and regulatory compliance. When managing the funds left for discretionary projects, one needs to ensure that sufficient funding is still available and that these projects maximize return on investment. Value from these projects can come from their contribution to the execution of strategy, as well as from growth or cost reduction projects that are not necessarily part of the execution of strategy. In either case, the approval of a discretionary project should be based on expected return and risk, as in any other financial investment. Taking this to the portfolio level, the collection of discretionary projects is no different than any other portfolio of investments, where the expected return is balanced against the risk of delivering the project and the risk of realizing the expected benefits.

The value of projects that execute strategy can be measured based on the contribution to the development of capabilities identified by the strategy which, in turn, impact business results, usually measured through operational KPIs. This is a higher level of portfolio maturity that comes

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after the initial two levels described in this article. The discussion of the measurement of impact on operational KPIs will be the topic of a future article.

The first level of maturity in portfolio management focuses on delivery at the project level, by coordinating resources across projects, and defining when projects can, or should, start, in order to create the deliverables that the operation needs. Measurement at this level is based on project metrics: schedule performance, cost performance, quality metrics, and customer satisfaction are examples. These metrics use, in many cases, KPIs that can be based on the well-known indexes defined in Earned Value: SPI and CPI, schedule, and cost performance indexes.

The KPIs defined in Earned Value measure actual performance against a target. If actual performance is right on target, the value of the KPI is 1, above 1 means actual performance is better than the target, and below 1 means it is worse than the target. The interpretation of these KPIs does not require the knowledge of the target or the actual performance. The indicator has an absolute meaning. If, in addition, thresholds are defined (i.e., yellow below 0.95), the method provides a scale to map and compare projects. These metrics provide the portfolio with a visual representation of how all projects are performing, which is very easy to understand for most stakeholders.

As portfolio management maturity increases, metrics have to focus on the generation of value for the organization. The overall return on investment from discretionary projects is a logical first step. This requires setting a target return on investment and calculating an actual return of all discretionary projects in the portfolio, at a given point in time. A KPI can be defined for this: Internal rate Performance Indicator, or IrPI, which is calculated by dividing the current return by the expected return. If right on target, IrPI equals 1, better than target above 1, worse, less than 1. As simple as this looks, it still requires the organization to have a defined expectation of return from discretionary projects, which should be higher than the return from the operation. This expected rate should not be confused with the hurdle rate (minimum rate of return projects should yield, based on the cost of capital). It also requires some governance to define rules around the calculation of an aggregate return at the portfolio level (i.e., projects close to completion should not be considered, as most of the investment is sunk and they are almost non-discretionary).

The values behind this KPI can be represented visually, as in Fig 1.

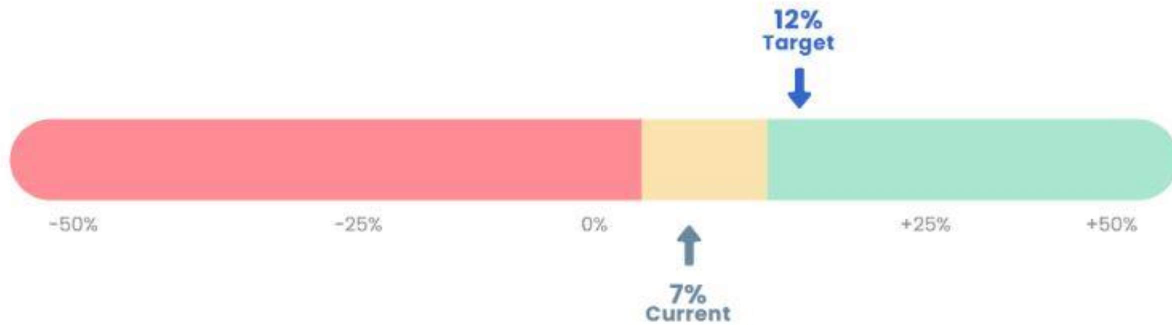

Fig 1 – IRR current VS target

To track the balance between the allocation of investment in non-discretionary and discretionary projects, another indicator can be defined. The target should be the percentage of investment in discretionary projects, as this is the value that should not go down, so AdPI (Allocation in discretionary Performance Indicator) can be calculated. Similar to the previous KPI, AdPI requires a target for the split, and some governance is needed to define the calculation of the current value. The comparison of current VS target values can be represented visually, as in Fig. 2.

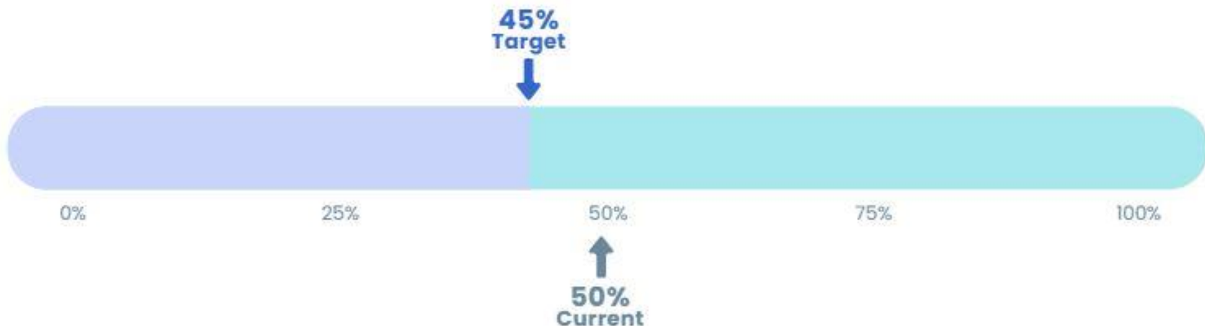

Fig 2 – Current VS target split

The budget allocated to discretionary projects should be distributed based on risk and return, like in any financial portfolio. The exposure of the investment to projects with poor performance should be minimized and for this, a KPI that measures investment in projects that do not have critical performance (i.e., performance not red) is compared to a target that, in theory, should be close to or at 100%. A new KPI, PePI (Performance exposure Performance Indicator), can be calculated for overall, time, and cost performance, as in Fig. 3.

Fig 3 – Exposure of investment to project performance

Finally, exposure of investment to risk should be an obvious concern for the portfolio manager. For this indicator, delivery risk (not delivering to objectives of time, cost, and quality) and benefit risk (not realizing the expected benefits) are combined to define a "critical area" in a 3x3 matrix. A new indicator RePI (Risk exposure Performance Indicator) measures the investment in projects that are not critical (i.e., combined delivery and benefit risk is not red) against a target that should be close to or at 1. Investment in projects that are not critical should be measured against a target close to or at 1. This KPI can be calculated for combined, delivery, or benefit-risk, as shown in Fig. 4.

Fig 4 – Exposure of investment to risk

Measurement that is based on data at the portfolio level focuses on the value of the investment and provides information to manage the exposure of investment and make decisions on projects with poor performance and/or high risk. As with any KPI, these indicators can be tracked over time and integrated into a dashboard that summarizes the information needed for decision-making. Since these metrics are based on targets established by each organization, they can be used to benchmark the performance of a portfolio against other portfolios in the organization, as well as in other organizations of similar size, in the same industry, or region.

"What gets measured gets done" is a quote attributed to Peter Drucker (1909-2005), that captures the main tenet of this article: if all we measure is project-level data, we will focus on delivery, and this is the logical place to start in the road to maturity. As this level is achieved, the definition of metrics at the portfolio level, which considers projects as investments, will widen the focus of management to include maximizing financial returns from the portfolio, which come from growth, cost reduction, and execution of strategy.

References

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