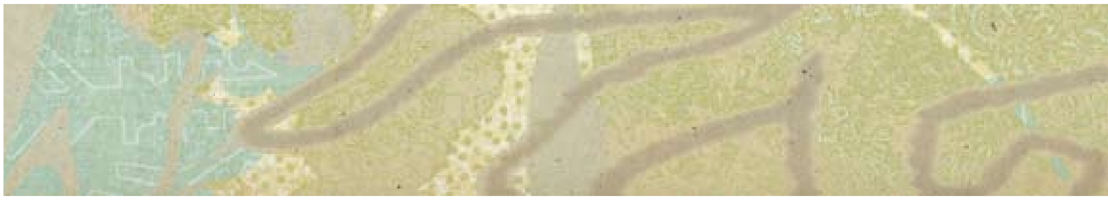
McKinsey on Finance

Perspectives on Corporate Finance and Strategy

Number 23,
Spring 2007

McKinsey&Company



The new dynamics of managing the **corporate portfolio**

As investors demand that companies actively manage their business portfolios, executives must increasingly balance investment opportunities against the capital that's available to finance them.

Lorenzo Carlesi, Braam Verster, and Felix Wenger

Early in 2006, the Dutch media concern VNU announced that it would accept the €7.6 billion takeover bid of a private-equity consortium, which, together with activist shareholders, had criticized a large planned acquisition and instead suggested a review of the company's portfolio of businesses. In January 2007, the British aerospace technology company Smiths announced the sale of its aerospace business to GE after shareholders steadily criticized that unit's performance relative to peers. A month later, the London-based hedge fund TCI called on the Dutch bank ABN Amro to "actively pursue the potential breakup, spin-off, sale, or merger of its various businesses."

In a buyout market where suddenly it seems that everything is for sale, companies throughout the world face mounting pressure to actively manage their portfolio of businesses. A new breed of investor, among private-equity firms, hedge funds, and activist shareholders, is aggressively looking for opportunities to create value from portfolio moves in companies the investors regard as too passive. Complicating matters further, companies that do actively manage their portfolios are finding that the traditional "rebalancing" logic of portfolio management—invest free cash flows in more attractive businesses, preferably with synergies to existing ones, and look to build a strong position—often creates little value. Given the breadth and pace of today's global markets, companies must constantly compete for acquisitions across the world and pay a hefty premium for highly attractive businesses. Often, merely reinvesting free cash flows makes little difference to the portfolio's value.

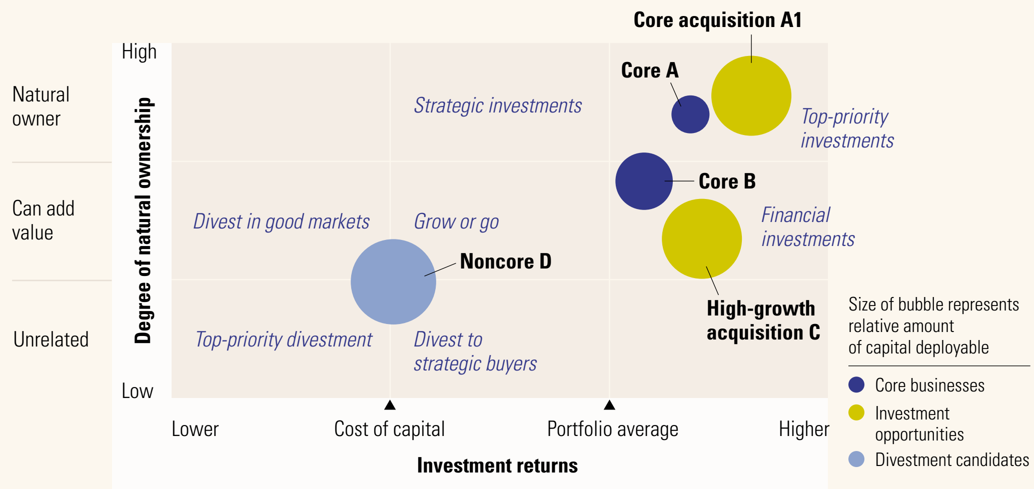
Concepts and approaches that might help boards and management teams go beyond the conventional wisdom of portfolio management are often loosely defined and difficult to pin down analytically, so there is a tendency to make ad hoc decisions grounded more in gut feelings than actual

Exhibit 1

Finding the ideal portfolio

Portfolio strategy assesses investment and divestment options and their implications for capital.

Disguised example



data. However, in our experience, managers can quantify several of these concepts of portfolio strategy and bring them together in a more cohesive approach. Portfolio strategy, at its core, is about being or becoming the natural owner of businesses and balancing investment opportunities against the supply of capital, given the predicted returns of current and potential investments (Exhibit 1).

Becoming a natural owner

Natural ownership isn't a new concept, but it is now more important than ever. In today's liquid markets, companies face so many competitors around the globe that the companies adding the greatest value depress returns for owners that are not distinctive. The most important factor is not the absolute level of returns but the difference a given owner can make in a business. High-performing consumer goods companies, for example, typically excel at marketing and distribution, so they are natural owners of other consumer goods businesses, whose products they can sell through the same channels and to a similar customer base.

Companies can be natural owners in several ways, depending on how they add value to a business. Operational synergies, for instance, may let them use the same technology, produce in the same plants, or distribute to the same channels where business systems overlap. In specific situations, such as emerging markets, natural ownership can include superior access to capital and talent—one of the reasons emerging markets still have conglomerates with a broader business mix than we find in more developed markets.

Corporate skills also can be a source of natural ownership. The skills of any company are the product of its culture and history. Thus, one might argue that certain oil companies know how to foster operational excellence in refining; these companies have repeatedly created significant value by acquiring refining assets from other oil companies and improving their performance. Finally, natural ownership can come from corporate skills that generate proprietary insights for insiders in certain sectors and geographies. Proprietary information on the potential upside in new markets or the downside of a mature business, for example, will improve investment and divestment decisions. At any given time, only one or two broad themes define a company's natural ownership of a business.

A company that isn't the natural owner of a certain type of business can decide to become one by building a large enough position and striving for distinctive performance in key areas. When many universal banks acquired investment banks in the 1990s, they worked to become natural owners in a very attractive business segment. Many failed, but some of the most successful global banks built their position in this way.

Measuring natural ownership isn't straightforward but does provide an important point of comparison among portfolio options. The comparison starts with the amount of overlap between the business systems of two companies—their products, channels, and customers. The greater the overlap, the greater the potential for synergies and shared skills. However, the overlap must translate into performance superior to that of other companies in the same field. Managers should consider how their businesses compare with rivals against such value-correlated performance indicators as returns on invested capital (ROIC), earnings margins, and top-line growth. A well-known example is GE, which seems to achieve a significant performance advantage in most of the businesses it operates, because it is a good owner and an aggressive manager of performance.

The best test for natural ownership is whether a different owner would ascribe a higher value to a business. Measuring this point is difficult and subjective, but managers can do so for an existing business by valuing their plans assuming realistic performance levels and then comparing this value with the price the business would command if it were sold, using either private equity–style valuation models or recent M&A multiples. For M&A opportunities, managers can compare the price they could rationally offer with the likely bids of others—keeping in mind that other offers aren't always rational.

Balancing opportunity with capital

Even if a company is the most natural owner of all its businesses, merely investing free cash flows in the most attractive ones may not be the best approach for generating maximum returns. Companies must consider that almost all businesses can be bought or sold and that capital can (within sound limits) be raised or returned to shareholders. Therefore, managers must constantly examine a company's entire portfolio of businesses and opportunities as if they were planning to reinvest all its capital (see sidebar, "Activity is not enough").

The notion of capital balance starts with the mix of investments in new and existing businesses—the mix that creates the most value. More often than not, the amount of capital a company has for investment doesn't equal (is not in balance with) the amount of capital required by all of its opportunities. Companies with more investment opportunities than capital, such as a fast-growing technology company with interesting intellectual property, tend to look for more capital. These companies will be more aggressive on divestments, impose higher hurdle rates on investments, and ponder raising more capital through additional (and maybe temporary) debt or equity issues. Companies with more

Activity is not enough

A company's portfolio mix may be the biggest determinant of shareholder returns, but that doesn't mean it is enough just to divest underperforming businesses and aggressively reinvest in better ones. Our analysis of the world's 400 largest companies shows that, across industries, shareholder returns and portfolio structure and activity differ widely—but are not correlated (Exhibit A). Evidently, the advantage of mere portfolio activity is discounted by the fair pricing of investments and divestments.

A closer look does reveal some patterns, though. In underperforming industries, for example, diversification is an advantage. The opposite holds true for overperforming industries, which have an advantage: focused players beat their more diversified peers (Exhibit B).

capital than investment opportunities, such as a successful company in a mature market, tend to accept lower returns from new opportunities, are more reluctant to divest, and look for ways to return cash to shareholders via buybacks and dividends. Calculating capital balance requires a clear understanding of the current portfolio, investment and divestment opportunities, and available capital and financing.

Most companies we know raise capital only for transformational opportunities. When they have smaller capital shortages, they usually adapt the hurdle rates of investments or divestments. From a theoretical point of view, this means that they forgo some value they might have created. However, capital is not always readily available and disposable in any amount. In practice, managers should evaluate, on the one hand, the cost of raising capital and the various signals that such efforts might send to investors and, on the other, the forgone value. We suggest that companies use the concept of capital balance to be more explicit about these trade-offs among investments, divestments, and real-world capital constraints.

In analyzing the capital balance, managers should distinguish among three types of capital decisions:

1. *Capital deployed in existing businesses.* Almost all businesses require a certain rate of reinvestment—for example, to develop new products or keep production facilities up to date. While the current rate of reinvestment may create the most value for a mature business, a higher rate may be necessary to gain market share or expand into new markets.

2. *Capital deployed in larger investment opportunities.* Big opportunities include completely new investments, such as an acquisition or a market entry, and dramatic shifts in current businesses. An example of a dramatic shift could be a decision to transform a company from a technology provider into a service provider that owns and operates its technology.

3. *Capital gained by exiting existing businesses.* Exiting some businesses, such as those that have scarce assets—say, mobile-phone businesses in markets with a limited number of licenses—often brings a company a premium above the current value. In other businesses, an exit won't necessarily generate a price that reflects the business's true economic stand-alone value; in many transactions in the chemical industry, for example, potential buyers discount the price they're

Exhibit A

No advantage

Across industries, focus and performance are not correlated.

400 leading global companies[1]

Industry	Industry performance: Median TRS,[2] 2000–05, %	Level of diversification: Focus index,[3] 2000; index: greatest focus = 100, %	Intensity of portfolio activity: Transformation index[4] (higher figure = more activity), 2000–05, %
Energy	23	62	28
Utilities	14	49	57
Industrial goods, services	11	46	36
Health care	9	96	11
Financial services	8	49	52
Materials	7	43	72
Consumer goods	6	76	9
Telecom	–4	58	65
IT	–9	53	42
Combined median of sample	8%	58%	28%

[1] Among top 700 US and foreign companies with American depositary receipts, by market capitalization, 1995–2005.
[2] Total returns to shareholders.
[3] Hirschfield-Herfindahl Index of reported business unit structure.
[4] Sum of absolute changes in share of revenues of all business units.

Exhibit B

Where focus counts

In overperforming industries, more focused companies took the advantage; in underperforming industries, those with more diverse portfolios did better.

400 leading global companies[1]

Industry	Industry performance: median TRS,[2] 1995–2000, %		TRS advantage: change in TRS[2] of focused players vs less focused (more diversified) players within given industry, 2000–05[3]
IT	32	In overperforming industries,[4] focus pays off	7
Financial services	30		2
Health care	27		5
Consumer goods	20		5
Energy	20		1
Telecom	17		2
Utilities	17	In underperforming industries,[4] diversification pays off	0
Industrial goods, services	16		–3
Materials	12		–8
Combined median of sample	19%		3%

[1] Among top 700 US and foreign companies with American depositary receipts, by market capitalization, 1995–2005.
[2] Total returns to shareholders.
[3] Focused players = companies in top half of Hirschfield-Herfindahl Index of reported business unit structure for given industry; diversified players = companies in bottom half of focus index for given industry.
[4] Overperforming industries achieved median TRS performance above median TRS performance of the sample from 1995 to 2000; underperforming industries' median TRS performance from 1995 to 2000 was below that of sample.

willing to pay by assuming a worst-case economic scenario. Certain businesses are too interlinked with other operations or the corporate identity for divestment to be practical. Some involve government or other stakeholders that put a sale beyond a company's control.

In all situations, managers who understand the elements of capital balance can make better-informed decisions. These managers have to arrive at a number of judgments on the relative merits of investments and divestments, such as trade-offs between strategic fit and short-term value creation or whether to modify hurdle rates. After one US niche services company had calculated its current capital balance, for example, it realized that it could create further value in its core business but would be better off diversifying into adjacent businesses with a superior long-term outlook and uncorrelated risks.

Assessing future investment returns

To allocate capital among various opportunities, management has to understand the future economic returns that potential investments will generate, but assessing future returns is challenging and often poorly executed. Many management teams still focus on accounting returns, such as profits on book capital, ignoring the fact that the market value of an existing business is higher than the book value if its returns are above the cost of capital (and lower if its returns are below the cost of capital). Likewise, the value of new businesses must account for any goodwill paid to acquire them. Managers often compare the book returns of existing businesses with the net value creation from new ones; the result is an unfortunate bias toward keeping lackluster businesses and shying away from new opportunities that require the payment of goodwill or entry costs.

Calculating the net returns of a portfolio of investments can be complex, as actual returns may differ markedly from accounting ones. The most accurate approach is to decompose net returns into the underlying future returns of the business, minus entry costs and plus synergies. Managers can estimate this value by using simple proxies; for example, they can usually derive a good estimate of future returns from long-term returns on invested capital, which are surprisingly stable in many industries. Note that long-term growth heavily influences future returns; at typical levels of profitability, growth at twice the rate of GDP generates returns that are two to three times higher than growth at GDP.

The main reason many companies fail to create value when they change their corporate portfolios is that managers have misjudged the exit or entry costs, such as acquisition goodwill or start-up losses. Again, managers should consider external proxies. In the case of acquisitions, executives know the premiums paid for past transactions, and premiums for new businesses can be justified by synergies even if they are assessed only approximately. In the case of a divestment, a substantial loss of value can result from the loss of synergies, and while few companies bother to quantify the synergies among existing businesses, that oversight can lead to unpleasant surprises at the moment of a divestment. When a large UK financial institution tried to divest its asset-management business, it found that more than a third of its value depended on captive business, which buyers would exclude from a stand-alone valuation. As a consequence, the company had to grant extensive guarantees in order to sell.

One proxy for future returns that is often used—but should not be—is short-term growth in earnings per share. This approach

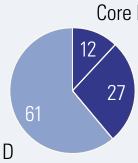
Exhibit 2

Looking for superior returns

Managers can calculate the net return from all portfolio moves under consideration.

Disguised example

Portfolio 'as is'
Total equity = €7.4 billion



Investment opportunities

1. Add to core businesses A and B through acquisitions.
2. Expand into high-growth adjacent business C.

Divestment options

3. Divest business D.

Portfolio scenario	**Net return,** %	**Implied long-term growth in profits,** %	**Portfolio value,** € million
'As is' portfolio	11	1.4	8.9
'Value-maximizing' (opportunities 1 and 3)	17	1.9	12.5
'Best strategic fit' (opportunities 2 and 3)	15	2.5	11.0
'Value-maximizing with additional capital' (opportunities 1, 2, and 3)	18	2.3	13.1

does not adequately account for the amount of capital needed to acquire or maintain an investment, so it tends to favor acquisitions even if they will destroy value.

As a practical approach, we suggest that managers calculate the net return, typically over the next five to ten years, from all portfolio moves under consideration: keeping a business, investing in step changes or new businesses, or selling businesses (Exhibit 2). Managers should always calculate returns relative to the current value of a business, existing or new. Coincidentally, this metric resembles the approach taken by private-equity firms. It lets managers easily link the results of portfolio strategy to a business's medium-term targets for growth and returns. In that sense, only investments that give a company some form of advantage sufficient to pay back the costs of entry and exit are likely to generate sufficient returns on capital. Here, the connection to natural ownership becomes clear: the ideal investment is one where natural ownership leads to superior net returns. The ideal portfolio is one with enough such investments to deploy all the available capital at rates clearly above the cost of capital.

The right approach

Given the complexity of portfolio decisions, how should managers go about defining a portfolio strategy? Here are four useful hints, drawn from a broad range of portfolio projects, for companies wanting to apply a more rigorous methodology.

1. *Understand the context and objectives.* Approaches to portfolio strategy can vary considerably, depending on the context. One company may want to determine which businesses it can divest with minimal loss of value and strategic coherence. Another might want to assess the range of investment options for cash flows generated by its current, maturing businesses.

2. *Manage agency issues.* Operational managers do not have the best position for making portfolio decisions: they are

often inclined to favor the businesses they are currently responsible for, so they are reluctant to recommend reallocating capital to new opportunities. To overcome such agency issues, a company should charge people who are independent of the operating businesses—typically, the board, advised by the CEO and the CFO—with the responsibility for making all final portfolio decisions.

3. *Apply analytical rigor.* Any rational portfolio decision depends on a true understanding of a business's performance and upside. Managers often claim they have all the data, although those data are purely internally focused. To analyze a portfolio, a functional team, led by the CFO, should rigorously and quantitatively benchmark the returns and growth of individual businesses as compared with those of their peers. The team also needs to challenge internal plans by comparing them with the historical performance of the business or that of peers.

4. *Keep capital discipline.* Even the best portfolio strategy cannot adequately account for all future developments. Investors do not expect a company to predict the future, but they do expect it to show discipline once projected returns do not materialize.

The more private-equity firms, hedge funds, and activist shareholders step up the pressure on companies to generate value, the more it makes sense for them to be selective about creating a truly distinctive portfolio of businesses. MoF

Lorenzo Carlesi (Lorenzo_Carlesi@McKinsey.com) is a consultant in McKinsey's Rome office, **Braam Verster** (Braam_Verster@McKinsey.com) is a consultant in the London office, and **Felix Wenger** (Felix_Wenger@McKinsey.com) is a partner in the Zurich office.