Portfolio realignment:
Four steps to increase value
Among leading-class companies, the effort to better understand which parts of the business drive shareholder value and which parts may destroy value is an important and ongoing mandate. The need for this kind of review may be particularly important in capital-intensive industries such as manufacturing, energy, chemicals, or consumer products. It may be pushed to front of mind in times of economic turmoil, tighter financial conditions, or increased business uncertainty. But every well-managed organization has an imperative to continually examine the value contribution of individual segments and realign its portfolio accordingly.

This is the process in play when a company such as United Technologies makes the decision to spin off Otis and Carrier and then focus its attention to building its core aerospace business through a merger, or when Johnson Controls sells its automotive batteries business. It leads to Huntsman divesting its intermediate chemicals and surfactants business or ABB divesting a majority stake in its power grids division to Hitachi. We are seeing greater emphasis by corporate leaders on executing their core strategies and using portfolio realignment to sharpen their focus. The market catalysts they need to make this possible include able and willing corporate acquirers with readily available credit and low leverage rates, as well as private equity players that have stockpiles of investor money and a need to put the cash to work.

Many corporate portfolios, when disaggregated, exhibit a surprisingly wide range in how individual segments contribute to shareholder value (see figure 1). While the majority of segments may perform well, certain pieces may consume a large amount of corporate resources while making little or no contribution to overall value—even subtracting value. Often, this is because they perform poorly as measured by return on capital (ROC), a metric that is central to many capital-intensive industries and has been shown to have a high correlation with shareholder value.

Portfolio realignment becomes a business imperative for a number of reasons. Companies that have not retooled their portfolio to dispose of value-destroying businesses may find their stock price performance lagging their peers. Overly complex operations, uneven performance in different segments, and a need for fundamental improvements in business performance can muddy a company’s strategic vision and financial outlook. Even companies that sell underperforming assets to raise cash can often end up using the resulting proceeds ineffectively if they don’t undertake a deliberate realignment process. Such companies may find they are not well-positioned to address changing market and economic conditions. It’s better for a company to view portfolio realignment as part of an ongoing revitalization process that adds new assets and sheds old assets to address changing market factors and value migration—or to align with a fresh corporate vision.
A company’s portfolio realignment process should begin with a clear view of an end state—a vision of what an optimal grouping of assets might look like. We believe that this vision certainly needs to be tailored to a company’s goals and aspirations. But any company’s “advantaged portfolio” should balance three characteristics: It needs to be strategically sound, value-creating, and resilient (see figure 2).

Figure 2. An advantaged portfolio is:

<table>
<thead>
<tr>
<th>1 Strategically sound</th>
<th>2 Value-creating</th>
<th>3 Resilient</th>
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<tbody>
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<td>Weighted toward competitive advantage</td>
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<tr>
<td>Carries an optimal innovation mix</td>
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<td>Creates synergy</td>
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<td>Maximizes intrinsic value</td>
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<td>Aligns with value-maximizing ownership</td>
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<td>Addresses key capital markets value drivers</td>
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<td>Effectively weighs feasibility and risk</td>
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<td>Robust across future scenarios</td>
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<td>Creates optionality</td>
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Tailored criteria based on owner’s goals and aspirations

The process for a company to create an advantaged portfolio can be broken down into four major steps:

1. Disaggregating and analyzing the portfolio and disposing of value-destroying businesses or cash hogs that are not long-term strategic businesses.
2. Structurally improving the profitability of other established businesses according to their portfolio roles. Is a business a cash generator, a growth engine, a driver of innovation?
3. Growing new businesses through internal development, acquisitions, or partnerships to support long-term vitality and to align all parts of the company around a strategic vision.
4. Continually evaluating and reevaluating how the new portfolio measures up against advantaged portfolio criteria.

Analysis, disaggregation, disposal

The first step in portfolio realignment is important as a way to generate cash for reinvestment. This allows for a self-funding approach to unlock value and increase investment potential among core portfolio segments. Improving the company as a whole begins by assessing and understanding the current position, and potential future, for each business you identify in the disaggregated portfolio, then defining its appropriate role.

During this process, executives should address both the strategy and the structure of each business to help identify drivers or destroyers of value, structural costs, and growth opportunities. Important questions include:

- Where is the magic made in the business?
- What does the business do that is different and creates value and profits?
- How does the business fit into the company’s value chain?
- Is the business’s strategy clearly articulated and understood?
- How do the business’s assets, customers, markets, and products create value?
- Does the business interact with its customers and end markets similarly to the company’s other businesses?

By disaggregating its portfolio in this manner, a company can develop an overall picture of how individual segments are creating or destroying value and how they fit the organization’s investment strategy going forward. For example, rationalizing an investment in legacy solutions might strengthen the core and create growth options. Some questions for executives to address include:

- Are the company’s sources of growth and innovation engines clearly defined?
- How should segments be redefined to work with the company’s broader strategic and transaction planning?
- Which segments currently are creating or destroying value?

A portfolio assessment may reveal the need to both eliminate value drags and to develop existing businesses or acquire new ones that have higher growth and higher returns (see figure 3).
Companies should resist the urge to move directly to high-growth opportunities without first removing existing impediments to success. This may include divesting, shrinking, or not growing businesses with low returns. Investments to expand businesses with poor potential for growth and returns may actually accelerate enterprise value destruction and tie up cash needed to support high-growth opportunities. Considerable thought and analysis should be applied when assessing whether an underperforming business can or should be fixed. Not all assets can be improved to the point where they are worthy of inclusion in a portfolio. A changing competitive landscape, maturing markets, or large and outdated assets in the wrong part of the world can make transformation a difficult task. The amount of management attention and resources consumed in managing these businesses could be better applied elsewhere. In such cases, the segment should be considered a growth impediment and be disposed.

When considering options to cull poorly performing businesses from the portfolio, the goal should be to improve recovery rather than take the easy way out. A company might either divest outright or spin off business units that are unlikely to be transformed into drivers of increased value (extreme cases may even warrant shuttering a business that is a cash or management drain and cannot be sold). It may be tempting to bundle several businesses that might not have logical buyers or that demonstrate widely varying financial performance. This action can result in a total price that is suboptimal compared with what could be recovered in separate sales.

**Profitability improvement**

The next step is to make businesses and assets that remain part of the enterprise more accretive to value by improving returns and generating profitable growth. Typical actions might include supply chain or operational improvements, customer and channel enhancements, product and value proposition innovation, new business models (value-priced total customer solutions, for example), asset-light restructuring, geographic expansion, and other organic growth strategies.

Completing the portfolio cleanup and improvement stages should put an organization in a better financial and operational position to pursue the remaining two stages of realignment (see figure 4).

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**Figure 4. Establishing a sound set of capabilities for growth**

![Figure 4](image-url)
New business growth
The direction and goals of new business growth can be focused by paying attention to the same portfolio analysis questions that were brought to bear on existing businesses and assets earlier in the process. These pertain both to organic growth and opportunities that are pursued through acquisitions. Creating an advantaged portfolio requires as much discipline when growing businesses as it does in evaluating divestiture candidates.

Growth solely for the sake of growth can consume critical corporate cash and management attention, which can lead to value destruction rather than value enhancement. This same lens should be employed whether evaluating organic growth or an M&A path. One tactic to help screen M&A candidates is to evaluate them against designated criteria, including factors such as geographic location, innovation potential, and management oversight needs. These factors may help executives gauge the relative risk and corporate focus required to manage the investment as compared with other opportunities.

Evaluation and reevaluation
The process of creating an advantaged portfolio suggests that the process is never entirely finished. Nothing is static. The changes and market dynamics that make portfolio optimization necessary in the first place never really stop. In fact, they are accelerating. That’s why a realigned portfolio’s segments, including businesses that are growing organically and those newly acquired, should be regularly reevaluated. Do they continue to fit with the advantaged portfolio criteria? Do they continue to contribute to enterprise value in the way that was expected when the strategy was set? These are questions that must be revisited on a regular basis.
Critical success factors

Portfolio realignment as part of a broader business transformation can be a complex, gut-wrenching, and time-consuming process. Companies should consider the following as they undertake the process:

- Employing a holistic, top-down approach and enlisting strong executive leadership are essential, since asset ownership issues, as well as specific elements of corporate strategy, are involved.
- Securing an unbiased, external, industry-specific perspective can also be helpful. Dispassionate data analysis is critical: There should be no sacred cows and no lemonade stands (small assets kept for sentimental reasons). Preconceptions, personal history, and bias typically are impediments to success.
- Pursuing transformational versus incremental change is imperative. Portfolio realignment is not just about cleaning up assets; it should be driven by an enterprise-wide strategy for growth and renewal.
- Utilizing informed estimates may be necessary for strategic decision-making. Because precision is not consistently possible, expect multiple iterations to get the data that is both accurate and representative. Providing demonstrable examples of the effectiveness of each recommended solution can add strength to the proposal.

Many companies should consider cleaning up their portfolios to get rid of underperformers and value destroyers. By approaching the process holistically and rigorously, they can be better positioned to improve strategic soundness, operational resilience, and drive value creation.

Chemical sector case study

Deloitte’s value analysis of a chemical company’s unreported business segments identified a sizeable opportunity for portfolio restructuring.

**Analysis:**
The company was performing well, but its stock price performance was lagging many of its peers. One of its business units generated 28 percent of the company’s EBITDA, but had a negative return on capital and was destroying value. The returns analysis uncovered an opportunity to raise enterprise value by selling the unit.

**Outcome:**
When the sale of the business unit closed, the parent company’s share price rose by an amount nearly identical to the nearly $8 per share value destruction estimate made during the review. This occurred despite the fact that cash flow dropped 30 percent and a book value loss was announced at the time of the sale.
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Endnotes

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