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Portfolio realignment
A business imperative

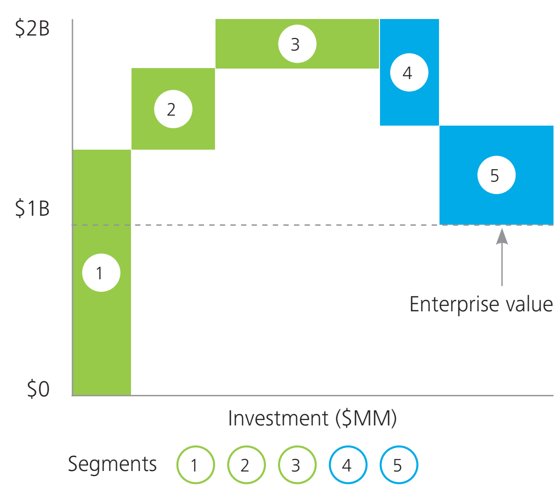
Companies are increasingly looking for opportunities to better understand which parts of their businesses are driving or destroying shareholder value, and to realign their portfolio accordingly. In addition, rising shareholder activism amid the perception that management is not doing enough to boost shareholder value is generating pressure at many companies to thoroughly evaluate their portfolio of businesses.

Recent examples of divestitures and spin-offs include Northrop Grumman's spin-off of its shipbuilding business, Huntington Ingalls Industries, Inc.[1]; Sara Lee's separation of its North American meat business (Hillshire Brands) and European coffee business (D.E. Master Blenders 1753);[2] Kraft's split of its global snack business and North American grocery business and hedge fund Third Point's pressure on Sony to spin-off its entertainment arm[3]. Among other apparent market catalysts, the pool of able and willing acquirers has been expanding as credit has become more readily available; corporations are seeing increasingly healthy balance sheets; leverage rates are at historic lows; and private equity firms are once again, looking to put investor money to work.

Many corporate portfolios, when disaggregated, exhibit a surprisingly wide range of contributions to shareholder value (Figure 1). While the majority of segments may perform well, certain ones may consume a large amount of corporate assets while making little or no (and sometimes, negative) contributions to overall value. Often, this is because they perform poorly as measured by returns on capital (ROC), a metric that is central to many capital-intensive industries such as manufacturing, energy, oil & gas, and consumer products and has been shown to have high correlation to shareholder value.

Figure 1: Value contribution

Disaggregating portfolio — allows the creation of a picture of a picture of portfolio segments creating value and eroding value and an understanding of investment in solutions.



1 "Northrop Grumman Completes Spin-off of Huntington Ingalls Industries, Inc." Northrop Grumman, March 31, 2011, http://investor.northropgrumman.com/phoenix.zhtml?c=112386&p=irol-newsArticle&ID=1544584&highlight=Huntington Ingalls. Accessed July 16, 2013)

2 "Sara Lee splits, takes Hillshire name for N.Amer business," USA Today, June 6, 2012, http://usatoday30.usatoday.com/money/companies/story/2012-06-06/sara-lee-hillshire-brands/55416180/1. Accessed July 16, 2013

3 "U.S. Hedge Fund Calls for Sony Entertainment Spin-Off," UK- Reuters, May 14, 2013, http://uk.reuters.com/article/2013/05/14/us-sony-thirdpoint-idUKBRE94D0A320130514. Accessed July 16, 2013

Portfolio realignment is becoming a business imperative for several reasons. Some companies that did not retool their portfolio prior to the recession have been unable or unwilling to dispose of their value-destroying businesses; today these companies may be finding their growth and profitability hampered by overly complex operations, uneven performance, and the need for fundamental improvements in business quality. Certain companies sold underperforming assets to raise cash during the recession but ineffectively utilized the resulting proceeds; today these organizations may be discovering that they are not well-positioned to address changing economic and credit conditions. Finally, some companies view portfolio realignment as part of a broader, ongoing revitalization process of adding new and shedding old assets to address globalization and value migration, or to align with a fresh corporate vision.

Figure 2: An Advantaged Portfolio is:

1 Strategically sound	2 Value-creating	3 Resilient
• Weighted towards competivie advantage • Carries an optimal innovation mix • Creates synergy	• Maximizes intrinsic value • Aligns with value-maximising ownership • Addresses key capital markets value drivers	• Effectively weighs feasibility and risk • Is robust across future scenarios • Creates optionality
+ Tailored criteria based on owner's goals and aspirations		

Steps to build an advantaged portfolio

A company's portfolio realignment process should begin with a view of the end-game — what an optimal grouping of assets might look like. We believe that this "advantaged portfolio" should be tailored to a company's goals and aspirations, and balance three characteristics, being strategically sound, value-creating, and resilient (Figure 2).

So how can a company create an advantaged portfolio? There are four major steps:

1	Analyzing/disaggregating the portfolio and disposing of value-destroying businesses and/or "cash hogs" that are not long-term strategic businesses.
2	Structurally improving the profitability of other established businesses according to their portfolio roles (e.g., cash generator, growth engine).
3	Growing new businesses through internal development and/or mergers & acquisitions (M&A) to support long-term vitality and to align with the company's strategic vision.
4	Evaluating/re-evaluating the new portfolio's fit with advantaged portfolio criteria.

The first step in portfolio realignment is an important part of a "self-funding" approach (e.g., generating cash for reinvestment) to unlock value and increase investment potential among core portfolio segments. Improving the core begins by assessing and understanding the current and potential future position of each business, and then defining its appropriate role. During this process, executives should address both the strategy and the structure of each business to help identify drivers/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 strategy create value? Is the strategy clearly articulated and understood?
- Which assets, customers, markets, and products create value?
- Are the company's sources of growth and innovation engines clearly defined?
- How should segments be redefined to work with strategic and transaction planning?
- Which segments currently are creating or destroying value?

By disaggregating its portfolio in this manner, a company can develop a picture of how individual segments are creating or destroying value, and better determine its investment solutions going forward (e.g., rationalizing an investment in legacy solutions to strengthen the core and create growth options). As Figure 3 illustrates, this company's portfolio assessment reveals the need to both eliminate value drags and to develop or acquire new businesses in the growth/high-return quadrant.

Figure 3: Portfolio segmentation

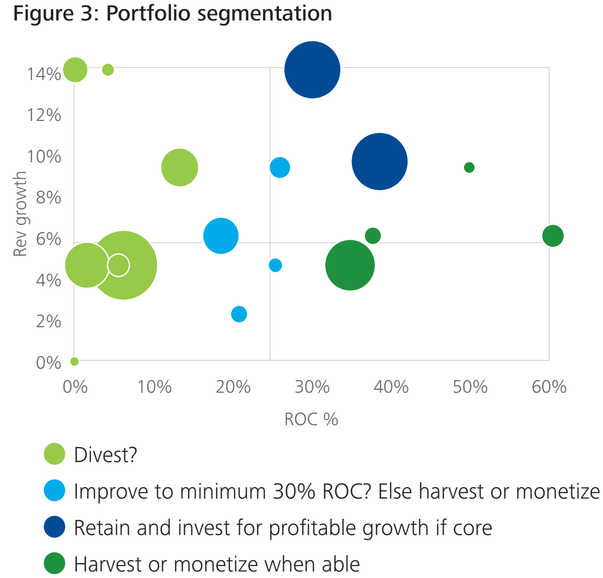
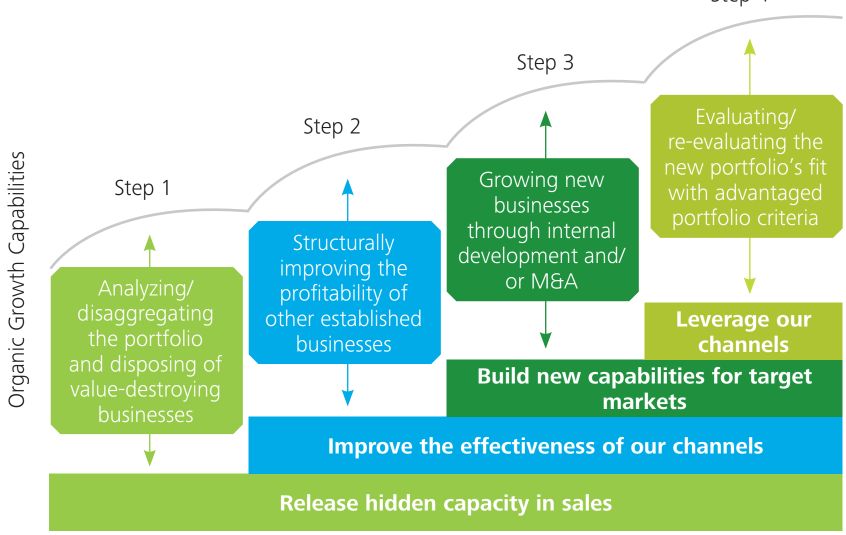


Figure 4: Establishing a sound set of capabilities for growth



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. Growing businesses with existing impediments 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. For example, a changing competitive landscape, maturing markets, or large, outdated assets in the wrong part of the world can make transformation a difficult task that consumes precious management attention and resources that could be better applied elsewhere. In such cases, the business should be considered a growth impediment and be removed.

When considering options to cull poorly performing businesses from the portfolio, a company's goal should be to maximize recovery rather than take the easy way out. A suggested approach is to either divest outright or to spin-off into a joint venture any business units which are unlikely to be transformed into drivers of increased value – extreme cases may even warrant shuttering a business that is a cash and/or management drain and that cannot be sold. It may be tempting to bundle several businesses that might not have logical buyers or that demonstrate widely varying financial performance; however, this action may sub-optimize the total price that could be recovered. Separate sales of several businesses may often net higher proceeds than a bundled sale.

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

Once an organization completes the portfolio clean-up and improvement stages, it should be in a better financial and operational position to pursue the remaining two stages of realignment — growing new businesses through internal development and/or M&A (Figure 4); and evaluating/ re-evaluating the new portfolio's fit with advantaged portfolio criteria.

The direction and goals of new business growth should be focused on the aforementioned portfolio analysis questions as they pertain to organic and M&A-fueled growth opportunities. Creating an advantaged portfolio requires as much discipline when growing businesses as when evaluating divestiture candidates. Growth solely for the sake of growth consumes critical corporate cash and management attention and can lead to value destruction rather than value enhancement. This same lens should be employed when evaluating M&A opportunities. One tactic to help screen M&A candidates is to evaluate them against designated criteria that include factors such as geographic location, innovation, and management oversight needs, among others. These factors may help executives gauge the relative risk and corporate focus required to manage the investment as compared to other opportunities. Finally, a realigned portfolio's segments, including new businesses, should be regularly evaluated to determine their fit with advantaged portfolio criteria and their contributions to enterprise value.

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:

1. Employing a holistic, top-down approach and enlisting strong executive leadership are essential since asset ownership issues are involved as well as specific elements of corporate strategy.
2. Securing an unbiased, external, industry-specific perspective can prove helpful. Dispassionate data analysis is critical...there should be no "sacred cows"; no "lemonade stands" (small assets). Preconceptions, personal history and bias typically are impediments to success.
3. 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.
4. Utilizing informed estimates may be necessary for strategic decision-making. Precision is not consistently possible, so expect multiple iterations to get the data both "right" and representative. Providing demonstrable examples of the effectiveness of each recommended solution can add strength to the proposal.

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

Case study: Chemical company

Deloitte's value analysis of a chemical company's unreported business segments identified a sizeable opportunity for portfolio restructuring:
A business unit {"BU") for a chemical company was generating 28 percent of the company's EBITDA, but still destroying value. A return on capital analysis uncovered an opportunity to raise enterprise value by selling the BU, as the analysis suggested as much as $7.70 per share in value was lost due to owning the BU's operations.

Results:
When the sale of the BU closed, the parent company's share price rose by significantly (approximately $7 per share) despite the fact that EBITDA dropped 30 percent and a book loss was announced at the time of the sale; the value increase was nearly identical to the estimated value lost by holding the business.

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