COMMENTARY

THE WHERE OR THE HOW

NEW EVIDENCE ON THE LINK BETWEEN PORTFOLIO DECISIONS AND PERFORMANCE

Neal Kissel, Joseph Poore

September 2013

Marakon

Management consulting at Charles River Associates

What is more important – where you compete or how you compete – portfolio or operations? Marakon finds evidence that portfolio matters more, and in some industries explains up to 65% of performance. Executives should give portfolio decisions the attention they deserve.

Introduction

What is more important – where you compete or how you compete – portfolio or operations? Will operational excellence deliver as much as playing in the best geographies, product categories, or asset types? Our hypothesis was that so long as a company met a minimal level of operating performance (the "hygiene factor") a company's decisions on portfolio composition drive the majority of outperformance. In other words, market economics is worth more than competitive position – certainly a provocative thought.

Looking at companies actions and time allocation by senior executives would suggest the opposite to our hypothesis. Companies tend to place much greater emphasis on driving operating performance from their current businesses rather than working to achieve the right of mix of businesses or optimal portfolio shape – not surprising when you digest the fact that the majority of new CEOs appointed this year among FTSE 250 companies have strong operating backgrounds. Indeed, executives tend to be promoted on the back of operational delivery vs. strategy or experience in portfolio management.

For most companies, the response to the recession has been a reduction in acquisitions and disposals rather than an increase. Uncertainty tends to result in protecting the status quo, which is generally aligned with human nature, but not necessarily good for value creation or shareholders.

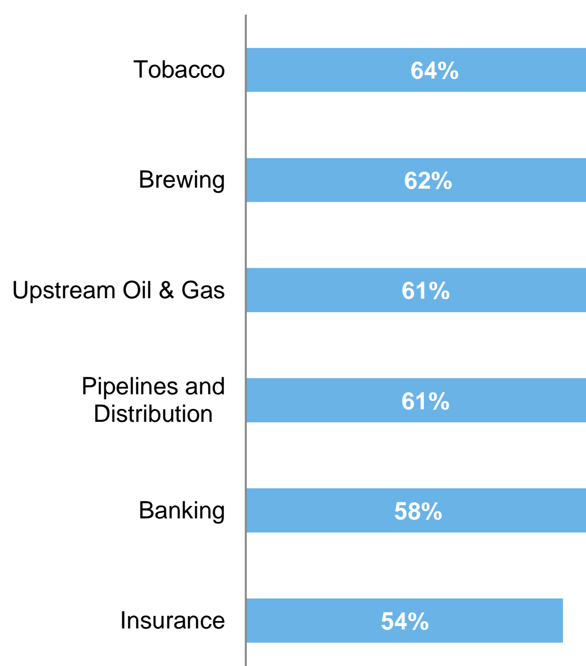
While management are aware and conscious about the need to be in profitable, high-growth, low-risk markets, an overwhelming amount of time and investment is spent on optimizing and improving performance of existing operations, spreading capital spending across divisions to avoid uncomfortable debates, and feeding slow-growth businesses for fear of bruising executive ego. Even worse, poor investments are justified under an outdated portfolio management framework as "cash cows" or "undecided".

The evidence in this article should give CEOs and top executives pause next time they stand up to give those quarterly reports with an opener like "when you normalize for our portfolio, we have outperformed our competitors". Aren't chief executives and their management teams responsible for managing the portfolio shape and ensuring capital is allocated to the highest-value businesses?

New Evidence

Recent analysis conducted by Marakon estimates the importance of portfolio shape to overall performance of an enterprise. The results while perhaps not surprising, have deep implications for how executives at the top of any company should think about their roles. The study showed that in all the industries sampled, a larger amount of performance can be explained by *where* each company competes vs. *how* it competes. The results suggest that, dependent on industry, between 55% and 65% of performance can be attributed to portfolio shape.

Market-to-Book Explained by Portfolio Shape (R^2)



Methodology

To undertake the analysis, a database of 500 companies across 6 industries was constructed. For each industry, a set of meaningful "portfolio pieces" were established based on how the companies in each industry typically report their participation.[1] For each company, data was then collated to determine the weight of each portfolio piece in the overall corporate portfolio.[2] The weights were then regressed against overall company performance (as measured by the market-to-book ratio).

Looking at the R^2 of the regression indicates how significantly different the economics of each portfolio piece are. To explain this further, if there were only pure play companies, and all the companies in Portfolio Piece 1 had a market-to-book of exactly 3x and in Portfolio Piece 2 had a market to book of exactly 1x, the R^2 would equal 100%. Performance would therefore be fully explained by where each company participated. On the other hand, if the companies in Portfolio Piece 1 or 2 had a random distribution of market-to-book ratios, the R^2 would be close to 0%. Performance would therefore be unrelated to participation.

The analysis therefore looks at the difference in implied performance in each portfolio piece – if the range is small (R^2 > 50%), market fundamentals are more important, whereas if the range is large (R^2 < 50%), competitive effects within the market are more important.

Within the industries included in the study, the range of implied performance by portfolio piece was the largest in Insurance and smallest in Tobacco. The variance of implied performance in each portfolio piece was low enough to suggest portfolio was more important. Similar analysis conducted at the company level revealed comparable results.

While the approach has some limitations (e.g., the number of industries looked at, the definition of portfolio pieces and boundaries, and the time horizon of the study), the results are robust enough to provoke serious enquiry.

Importance for Management

The data gives an interesting and revealing picture on the importance of getting portfolio choices right, and about whether management is putting adequate time and attention into portfolio and resource allocation decisions.

When it comes to strategy, cost efficiency and differentiation are certainly important, but too often the bigger needle movers available to the CEO are put in the "too hard box", or overlooked as "fixed". Portfolio decisions are hard, and in many instances harder still to execute. But good resource allocation, and portfolio shaping does not have to be based on bold moves only.

The best portfolio managers tend to systematically look to the future and ask themselves why is our portfolio better then the next best alternative. Asking this "simple" question will open up the debate not only around choices, but also around what information, process, and view of the future is necessary to better inform resource allocation. Knowing where you want to be in 5 or 10 years' time is critical to achieving a better portfolio shape.

Decisions on participation deserve as much, if not more attention than operations from senior management. Portfolio shape can be managed. Executives should give portfolio decisions the attention they deserve.

---

[1] For Insurance, Banking, and Pipelines & Distribution, the portfolio pieces were based on product type and geography (e.g. UK Life Insurance, Asian Retail Banking, West Coast Natural Gas Pipelines); for Upstream Oil & Gas the portfolio pieces were based on geography, resource maturity and resource type (e.g. Asian Late-Life Oil); and for brewing and tobacco portfolio pieces were based on geography (e.g. Latin America).

[2] For Insurance and Banking, portfolio weights were calculated using estimated or reported capital employed by portfolio piece; for Pipelines & Distribution weights were calculated using reported or estimated total assets; for Upstream Oil & Gas weights were calculated using P2 reserves using reported data and industry datasets; and for Brewing and Tobacco weights were calculated based on revenue using reported data and industry datasets.

About the Authors:

Neal Kissel is a managing director at Marakon, and serves as the European practice head. He has more than 20 years of experience working with senior executives in the Americas, Asia and Europe in an advisory capacity. He has advised clients extensively on enterprise strategy and portfolio coherence. He has been a guest lecturer at the London Business School, authored several articles, and been a contributor to the Financial Times and Telegraph on topics of Management.

Joseph Poore is a Senior Associate in Marakon's London office.

Key contacts:

Neal Kissel
nkissel@marakon.com
+44 207 664 3700

About Marakon

Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

We help clients achieve their ambitions for sustainable profitable growth through:

- Stronger strategies and advantaged execution based on:
  - A better understanding of what drives client economics and value
  - Insight into changing industry dynamics and the context in which clients need to succeed
  - Better portfolio shape and resource allocation
- A stronger management framework to generate better ideas and link decisions and actions to value
- A stronger organization with a more focused top management agenda and well-aligned resources
- A more confident and effective leadership team that's focused, decisive, and strategic

We have supported many companies in driving performance through portfolio. We bring a clear framework based on value creation, not traditional portfolio roles; a toolkit and proven methodology; thought partnership and a collaborative model; and an understanding of the complexity of the issue. Our clients have systematically outperformed their peers on shareholder returns.