Unearthing the sources of value hiding in your corporate portfolio

Executives who rely on high-level metrics to manage will miss potential sources of value creation. A finer-grained look can help.

Marc Goedhart, Sven Smit, and Alexander Veldhuijzen

The senior leaders of a diversified global industrial company recently got a major shock when they took a more fine-grained look at corporate performance. Rather than viewing the company through the usual lens of the top-line growth, economic profit, and return on invested capital (ROIC) of its four divisions, the members of the top team broke things down much further—into 150 business segments. Two-thirds of those segments were falling so short of their economic-profit targets that they alone would have made the company overall miss its targets by 40 percent. The rest, however, were outperforming by enough to skew the averages for the company and each division, giving the appearance of only a 7 percent shortfall. Recognizing the performance disparities helped the company identify a more significant set of opportunities to reallocate resources and stimulate value creation than anything that had been on the table previously.

The problem of averages hiding outliers is a common one, and it frequently undermines the corporate center's ability to take a strategic look across the organization and make selective course corrections or trade-offs between investments. That companies struggle with this is clear from the typical annual budgeting process, when many routinely allocate their capital, R&D, and marketing budgets to the same activities year after year, regardless of their relative contribution to performance and growth. The cost is high, since those that more actively

reallocate resources generate, on average, 30 percent higher total returns to shareholders.[1]

Companies are unlikely to enjoy these returns absent finer-grained insight into pockets of value creation[2] at the level of individual businesses and market segments. It's also crucial to develop a strong understanding of the reasons those activities perform as they do and of the alignment between their potential for value creation and corporate investment priorities. Armed with this information, executives—particularly the CEO and CFO—become better able to adapt performance targets, differentiate where to drive growth or ROIC across the portfolio, and monitor performance. They also are better positioned to overcome resistance from managers, who may be protective of the people and activities they manage and resistant to what they see as micromanagement. The best antidote, in our experience, is fostering a shared commitment to value creation as the decisive metric for decisions on strategic priorities, business targets, and budgeting.

Identifying pockets of value creation

The mechanics of identifying opportunities at this level of detail are not new. Efforts typically involve a standard discounted-cash-flow valuation or analysis of economic profit but for far more business units than most companies currently look at—often as many as 50 to 100 (see sidebar, "Finding pockets of value creation"). Managers who find that their companies lack the necessary financial data, such as revenue, operating earnings, and capital expenditures, will probably also find that they rely too heavily on averages when setting strategic priorities, financial targets, and resource budgets. Those who have the data will find that a finer-grained perspective reveals more opportunity to create value, as it dissects average performance and growth across the portfolio.

For example, when we analyzed four divisions within a corporate group in a consumer-durable-goods company, we found that all were generating returns well above the company's cost of capital and at fairly similar levels, between 12 and 18 percent. But at the next level of business units, returns were much more widely distributed—and even in the division with the highest returns, there was a unit earning less than its cost of capital. At the level of individual activities within business units, the improvement potential was much larger than expected, with weak performers even in the strongest units.

The aggregate impact can be significant, and analyses of both potential value and current value are useful. Analyzing the potential value projected by the business plans of around 100 business segments in another large company's profile, we found that more than 60 percent of the value improvement would be generated by less than a third of its product or market segments. This was the case even though they had contributed less than 40 percent of the company's current value (Exhibit 1). Once executives identified those segments, they were able to selectively evaluate the underlying strategic rationale for each, determine whether its business plan was grounded in concrete, viable initiatives, and assess whether it had sufficient corporate resources to be successful.

Understanding why an activity creates value

It's important to understand why an activity creates value when making decisions on pushing growth or earnings—or both. Executives at one consumer-goods company, for example, had long considered growth to be the key to value creation and set incentives for management that rewarded growth. Yet a detailed analysis of the business plans of over 150 segments in the company's corporate portfolio found that more than 60 percent of expected value creation

Finding pockets of value creation

Learning which activities create the most value and understanding why they hold promise for growth and return on capital is no small endeavor. It takes a certain degree of investment and commitment to ongoing research and analysis, and not every company will have access to the level of data needed. For those that do, here are the key steps:

- **Define the scope.** Identify which segments to analyze separately, trading off the costs and data needs of doing the analysis with the increased insights offered by more granularity. One rule of thumb is to continue dissecting segments as long as the underlying subsegments show significant differences in growth and returns on capital and are material in value relative to the company as a whole. Each segment of a company to be tracked will require a forward-looking, three- to five-year business plan. For a typical S&P company, this usually results in some 50 to 100 business segments.

- **Value business segments.** For each segment identified, perform standard financial analysis and two discounted-cash-flow (DCF) valuations for each segment: one under a scenario of constant margins and growth at current levels and another according to the assumptions of current business plans.

- **Identify pockets of value.** Rank all segments based on how much they currently contribute to DCF value, which is the baseline, and how much additional value they might create, as projected by their business plans.

- **Understand value drivers.** Determine what factors contribute to the potential value improvement for each segment, relating them to underlying business characteristics and management initiatives. Be sure to determine the impact of the most important factors affecting returns at least at the level of earnings margin and capital turnover, and those affecting top-line growth at least at the level of market growth and market-share growth.

- **Review resource allocation.** Analyze the productivity of all resources, including capital and R&D investments as well as, for example, brand advertising, both as a whole and for each resource type separately. The ratio of DCF baseline or business-plan value divided by resource spending over the next three to five years provides a measure of resource productivity for each segment and a starting point for discussions on whether to reallocate resources.

would come from increases in earnings margin. The plans did foresee acceleration in growth for most of the portfolio's segments, but it ultimately had far less impact on value, and the company's incentives were misaligned.

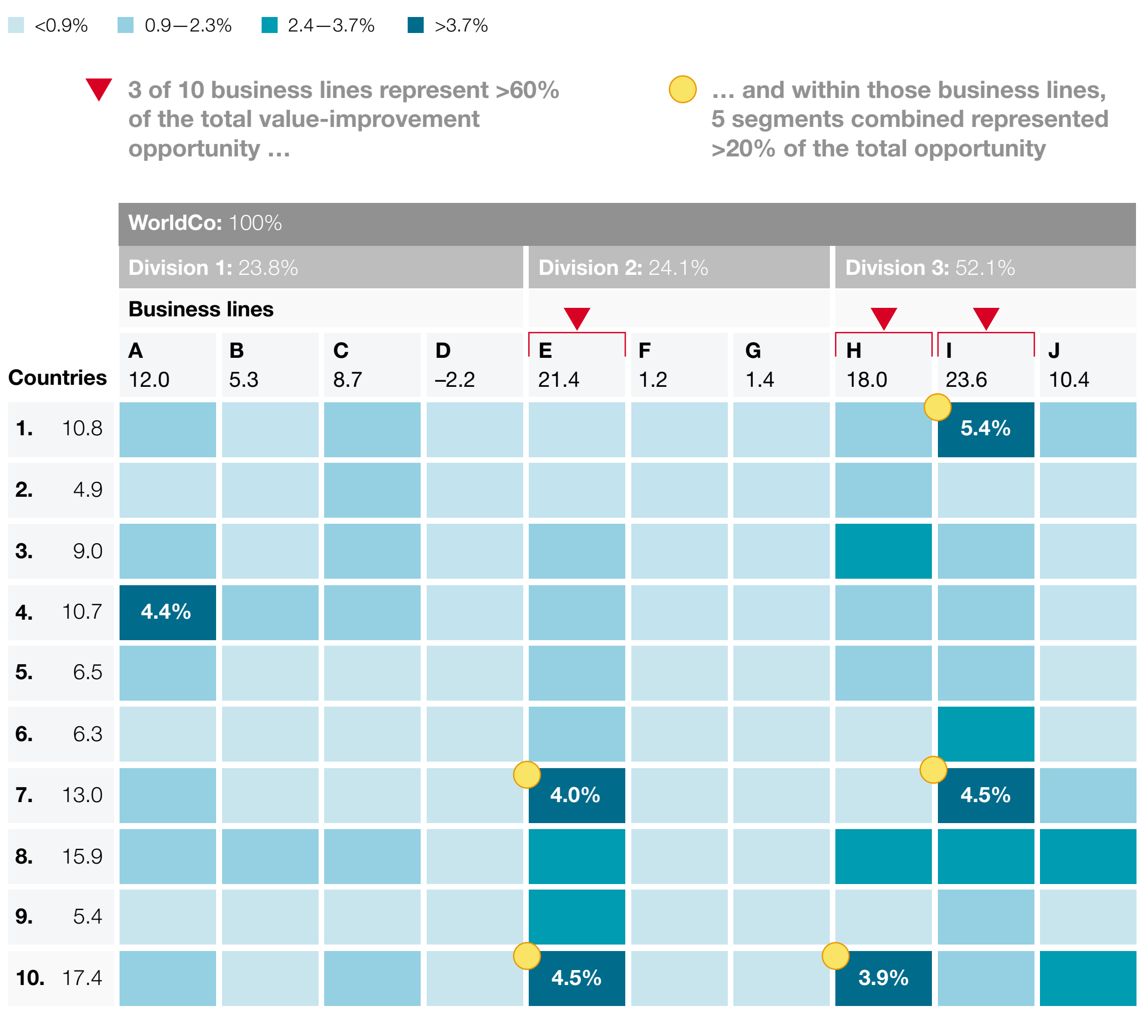
The most useful insights won't come from the kinds of high-level metrics executives usually use to assess a business's value-creation potential, such as ROIC, economic profit, and top-line growth. Such metrics don't reflect the underlying causes of value creation and can be unreliable indicators of value in the long term. For example, a business might see a near-term increase in ROIC or earnings margin by lowering its advertising budget. But it will also likely destroy value in the long term by weakening its market position.

Top-line growth, too, can be misleading. Executives at one global company, for example, considered a consumer-goods business in Asia to be the most successful in the company's portfolio because it consistently delivered double-digit growth. However, a more detailed

Exhibit 1

Among 100 business segments in one industrial company, a handful represented the greatest opportunity for value improvement.

% of total value-improvement potential[1]



[1]Total value-improvement potential is defined as business-plan value divided by base-case (business-as-usual) value minus one.

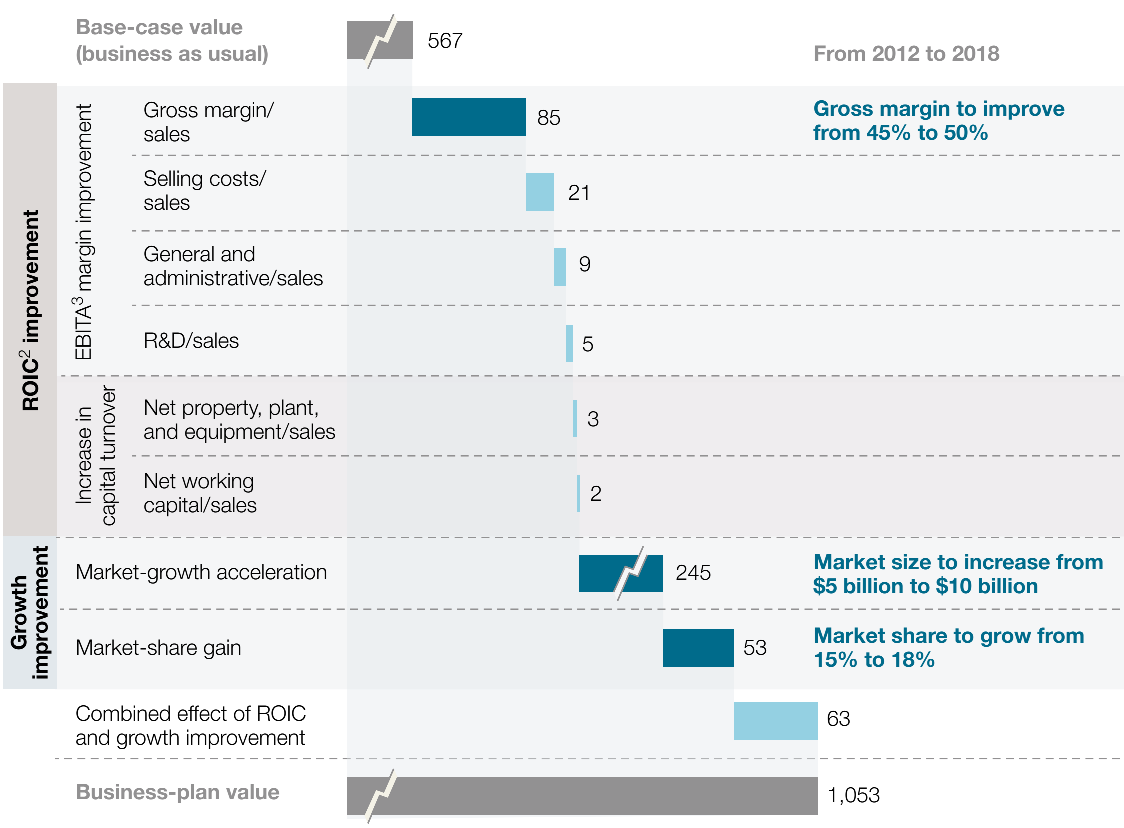
analysis revealed that this business was losing market share because the relevant local markets were growing even faster—which would almost inevitably lead to lower value creation in the long term.

Instead, successful intervention requires executives to understand the more important leading indicators of growth and returns that are often overlooked. These include the growth of the relevant market, in size as well as in market share; changes in pricing and gross margin; and R&D and sales, general, and administrative expenses. For the large company described in Exhibit 1, this would show that its most promising segment offers its strong value improvement

Exhibit 2

Examining the business assumptions behind high-potential segments reveals where the value will come from.

Value-improvement potential, by source,[1] $ million
Example: WorldCo, Division 3, Business H, Country 10



[1]Value-improvement potential is defined as business-plan value minus base-case (business-as-usual) value.
[2]Return on invested capital.
[3]Earnings before interest, taxes, and amortization.

When they intervene, executives should budget resources in line with expected value creation at the level of individual business segments, since that's where the opportunities to create value are.

off the tailwind of a doubling of local market demand. On one hand, this may call for a confirmation of that aggressive market outlook, given that this is what mostly drives the segment's value improvement. On the other hand, it may trigger a question about whether such growth could offer opportunities for capturing additional share beyond the three percentage points projected in the business plan (Exhibit 2). Having insights on underlying drivers could also reveal inconsistencies in the plans. Consider, for example, the experience of one high-tech company, where the executive board found that the business plans for a segment in a maturing market implied a value improvement of more than 40 percent. At first glance, this might not be an unreasonable target for a fast-growing company in that sector. But a closer look revealed an underlying assumption that the business could realize 10 percent annual top-line growth over five years, even as its relevant markets were shrinking. As this implied almost a doubling of its market share at stable prices, the board asked the business to revise its plans.

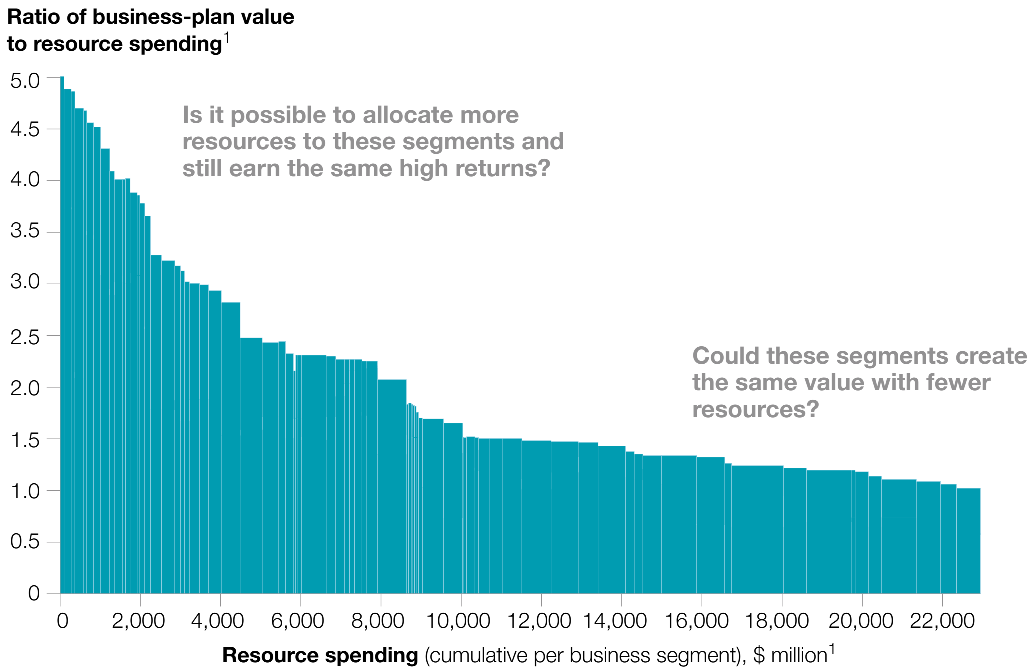
Evaluating the allocation of resources

Armed with detailed insights into what drives value creation in which segments across the portfolio, executives can more successfully intervene in the planning process and budget allocations, challenging and revising business plans and resource requirements for key segments. This could involve interventions in decisions on specific launches of new products or entries into individual markets, or even in individual R&D projects, if the value at stake for the company is significant. And all strategic resources should be considered, not just investments in physical capital—especially in companies where investments in R&D and brand advertising exceed capital investments by a wide margin, for instance, in sectors such as consumer packaged goods, pharmaceuticals, and high tech.

When they intervene, executives should budget resources in line with expected value creation at the level of individual business segments, since that's where the opportunities to create value are. For example, one consumer-goods company analyzed the allocation of all its strategic resources by following the plans of close to 100 business segments (Exhibit 3). Plotting the resource investments against the expected value of each segment's business plan in a resource-productivity chart, executives found that some segments with very strong value potential were allocated very limited resources, while some of the largest investments were made in segments that returned much less value per dollar of resources spent. How much of their resources should be reallocated to the more productive segments depends on how much those segments can invest at the same attractive returns—and whether lower investments in the less productive segments might lead to

Exhibit 3

The activities where companies allocate the most resources aren't necessarily where they create the most value.



[1]Resource spending is the sum of brand advertising, R&D, and capital expenditures over the next 5 years.

significantly lower or negative returns. But a company's executives should be aware of such large differences in resource productivity and investigate whether a reallocation of resources could lead to higher value creation for the company as a whole.

Gaining acceptance for intervention

Naturally, executives will need to explain the benefits of selective intervention to skeptical line managers—it creates more value for the company as a whole and enables a more fact-based and meaningful dialogue about planning and performance. By turning the conversation away from one largely about changes in growth and earnings to one that includes concrete initiatives and their impact on market share, gross margin, and capital turnover, managers will have more opportunities to develop new businesses, exit less attractive markets, and initiate promising R&D projects on their true merits.

One of the benefits of doing this well is that it allows line managers to fully understand where their businesses create value and how much they create relative to other businesses and activities in the company. When managers can see which trade-offs are being made and why, it's easier to get behind allocation and budgeting decisions—and harder to be defensive. It's also easier to see that this kind of selective intervention doesn't mean executives are micromanaging the company's businesses; when confronted with detailed information from so many business segments, micromanaging would hardly be feasible anyway, and it certainly would not be productive. What counts is that information is transparent so that executives can intervene when and where needed.

A second advantage of managing at this level of detail is that it allows managers to tailor a package of incentives and compensation that reflects what each unit is expected to accomplish. Instead of rewarding just top-line growth, they can combine measures of growth with, for example, increases in market share. Instead of rewarding just earnings targets, they might consider earnings growth combined with targets for specific components, such as gross margin or R&D spending.

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Executives who manage at the level of a few divisions are more likely to be blinded by averages of top-line growth, economic profit, and ROIC. A more fine-grained review of what drives performance and growth at the level of 50 or more business segments can help.

[1] For additional research on this topic, see Stephen Hall and Conor Kehoe, "How quickly should a new CEO shift corporate resources?," mckinsey.com, October 2013; Mladen Fruk, Stephen Hall, and Devesh Mittal, "Never let a good crisis go to waste," mckinsey.com, October 2013; and Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," mckinsey.com, March 2012.

[2] This is similar to what we have elsewhere called "value cells"; see, for example, Massimo Giordano and Felix Wenger, "Organizing for value," *McKinsey on Finance*, Number 28, Summer 2008, pp. 20–5.

Marc Goedhart (Marc_Goedhart@McKinsey.com) is a senior expert in McKinsey's Amsterdam office, where **Sven Smit** (Sven_Smit@McKinsey.com) is a director and **Alexander Veldhuijzen** (Alexander_Veldhuijzen@McKinsey.com) is an associate principal.