Strategy & Corporate Finance Practice

Why you need to keep changing your company's business mix

Because the market is always moving, a static portfolio of businesses tends to underperform.

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Sean Brown: From McKinsey's Strategy and Corporate Finance practice, I'm Sean Brown, and welcome to *Inside the Strategy Room*. One of the perennial questions corporate leaders ask is which businesses their company should be in? Our recent article, "Why you've got to put your portfolio on the move," suggests that regularly changing your portfolio mix in response to market trends is the surest path to outperformance. At our European M&A conference in London that took place earlier this year, I spoke with two of the article's authors about their research on portfolio transformation, which analyzed detailed financial results of more than 1,000 of the world's largest public companies. Andy West is the global leader of our M&A practice. And Sandra Andersen is an associate partner in our New York office and a leader in our M&A practice. Sandra, Andy, welcome.

Andy West: Thanks, Sean.

Sandra Andersen: Thank you, Sean.

Sean Brown: So Andy, your presentation today was around portfolio transformation. Can you start by just sharing a little bit of the background on what drove the research and what underpins the conclusions that you came to?

Andy West: Yeah, you know, about a year, year-and-a-half ago, on the back of some really interesting examples of companies making major divestitures and major acquisitions and actually being fairly handsomely rewarded in the market, we started asking, "What is the role of portfolio overall? What is the way that strategy, market strategy where and how to compete, how does that translate actually into M&A? And what's the link between the two?" And is there, you know, something there, are there rules of thumb that people should apply to bring strategy and M&A together to actually better explain what's happening in the market and actually get better returns going forward?

Sean Brown: So let's talk a little bit about what the basis for the research was.

Andy West: Yeah. So what we basically did was, you know, on the back of our global 1000 work, which is something we've published over the last ten years around programmatic M&A and the importance of systematic deal making, we took that research, combined it with our beating-the-odds work based on a book that was released last year that looks at how companies create economic profit over long periods of time, so really our M&A data set plus our strategy beating-the-odds data set, we actually built a new data set, right, which actually looks at portfolio over time. And right now it's around 200 companies and growing, where we actually said, "What if we had an apples-to-apples view of the businesses a company was in from 2007 to 2017? What would that tell us about our portfolio?" Now, actually, that last bit is actually quite hard because if you think about changes in reporting, if you think about acquisitions, divestitures, reorganizations, we've had to rebuild all of those financials. But what we've tried to do is marry those three data sets and say, "What does it tell us?" What does it tell us about the portfolios that people are in, how much need to change and refresh their portfolio, where they should invest, and how M&A can be a tool in driving some of those components of portfolio transformation?

Sean Brown: So, what were some of the ways that you defined portfolio moves?

Andy West: Well, we looked at portfolio from a few different ways. One, we looked at it from a strategic point of view where we looked at a thing called refresh rate. And, basically, that is just simply how much revenue moved from one industry classification to another over a ten-year period. Right? The second thing we did is look at the thing we called momentum, which was basically saying how did your exposure to market momentum or market tailwinds change over a ten-year period and what impact did that have on your overall value or your valuation? And those are largely strategy levers, right? Then we applied M&A to that to say, given your refresh rate or given your market momentum or your ability to move towards market momentum, how is M&A used as a tool to actually deliver that value and did it accelerate or decelerate or detract from that journey? And then finally, we try to look at context, right? Because it's very important to note all of these things are very, very context specific, meaning where you started from in terms of your overall industry exposure and value creation, the different levers you pulled, the industries that you're in, all of those things matter. So we tried to apply a context lens as well.

Sean Brown: Let's double click on that refresh rate in the research that you did, were there any defining characteristics of companies that really refreshed more than others?

Sandra Andersen: Yes, a refresh rate was actually one of the first things we looked at when we analyzed our data set. Refresh rate is actually a pretty simple concept, but a very important one. It is the rate at which you change the sources of revenue in your company. It means the industries that are actually driving the bulk of the revenue that you're looking at. One of the example companies switched from being exposed to three different industries and having three major drivers of revenue to just two. So they used to have exposure in 2007, to logistics, to e-commerce and parcel delivery and retail banking, but by 2017, they'd actually narrowed that down to just two. They'd fully exited the retail banking and their revenue was actually sourced from just two places. The refresh rate was 16 percent, because that 16 percent was the part that used to be dedicated to retail banking, but then went to zero.

Andy West: Yeah, refresh was actually surprising to me because I didn't expect to get much of a result because all we're looking at is revenue movement from A to B. It doesn't really dictate where you moved it or how you moved it. And a few things came out of the research. One, most people don't move. Fifty-three percent of our sample moved less than 10 percent of their revenues over a ten-year period. We call these people "ponds," by the way, just kind of as a metaphor for you're in kind of a stagnant body of water. We then also looked at a category called "rivers," which is companies that moved around 10 to 30 percent. And by the way, we slid these ranges up and down and 10 to 30 seemed to be a really interesting range. We call those rivers. And then obviously, there's "rapids"—so people who really moved a lot of their portfolio, greater than 30 percent of their revenue from one industry classification to another over a ten-year period. So that's how we actually looked at the refresh rate overall. Interestingly enough, when you look at it, you find that despite ponds making up 53 percent of the total sample, the average annual TRS performance was relatively close to the global market average, right, at around 7.7 percent. And when you contrast that with rivers, which made up around 23 percent of the sample, the annual average TRS performance there was around 11.7 percent, by far, the highest, right? So people who were able to move revenue simply from A to B outperformed. We looked at rapids. That was another 23 percent of our sample. Their performance is only 5.1 percent—well below the global market average. And so there is something here about the sweet spot around moving revenue from one point to another that somehow seems to be related to overall market performance.

Sean Brown: Thanks, Andy. Let's talk a little bit about how it seems to relate to market performance and a related question, did you double click on any of the individual companies within each one of those groups to sort of see what was driving that performance?

Andy West: Yeah, just from a refresh rate point of view, when you actually start talking to individual companies, what becomes clear to me is that the outcome, this 11.7 percent, three rivers category, is not a function, so much of just moving revenue, because that kind of doesn't make sense, but it is a function of focus.

Sean Brown: Okay.

Andy West: If you think about what's required, in a boardroom, within a management team, within a company, to move that much revenue over a ten-year period, it requires a tremendous amount of fortitude, alignment, perseverance, I think all of these things, this conviction around where you're headed, is probably the substrate from which a lot of these benefits come. But it is an interesting question, if you're not moving that much, why not? Right? And what does that mean? And can we learn anything from maybe some of the things that are holding us back in terms of actually having that kind of conviction around you know where to go and how to migrate revenue over time?

Sean Brown: Can you talk a little bit about what the performance metrics were?

Andy West: One of the things that we did on refresh rate then as we combined these data sets was to look not only at the TRS performance, but the TRS performance applied to an M&A style, or an M&A program. Right? And so remember that 11.7 percent of folks who are a river, we said, "Well, what kind of M&A did they do to affect that river?" Were they programmatic? Meaning they did quite a few deals over this ten-year period that accrue to a meaningful amount of market cap around 15 percent. Were they selective kind of hobbyists in M&A? Were they organic, right? And we looked at that, and we actually saw quite a big difference between programmatic, where you look at the TRS of somebody who did rivers with a programmatic strategy, that was around 13 percent. Selective was much more closer to the global market average at 9 percent. But if you're actually organic, you're able to move 10 to 30 per percent of your revenue without doing M&A. You're at about the average; you're about 11 percent. So nothing wrong with being organic. It's just actually quite rare. So most companies, if you actually have to, you know, get in the river and start moving your revenue, programmatic seems to be the best strategy overall.

Sean Brown: So momentum is something you also talked about and the disparity between leaders and laggards. Can you talk a little bit more about that, please?

Sandra Andersen: Yeah, momentum is a really interesting concept. Principle investors tend to talk about tailwinds and headwinds in the industries that they play in. The concept of momentum is just the underlying energy effectively behind the industries that you are exposed to. The company that we looked at in the refresh rate example had three industries that they were exposed to—logistics, post, and banking. The logistics example was interesting. Because of the rise of Amazon and other delivery services, you actually saw major tailwinds in that industry, because everything you order needs to get delivered. That industry drives $67 million in incremental economic profit per firm that has exposure to it, which is actually quite impressive. Post stayed relatively flat. This is sort of your run of the mill, sending a letter or paying a bill. But banking, as most of us also experienced from the consumer perspective between 2007 and 2017, took a major hit. $590 million were at stake for folks who were exposed to banking. The power of changing your exposure to momentum is pretty impressive. The example company that we looked at that changed their refresh rate, also changed their exposure to different industries in a meaningful way, and changed their momentum profile. They increased, in 2017, their exposure to logistics. Their post-exposure seemed relatively flat, but they actually fully exited banking. Just by doing that they actually grew their economic profit by $99 million. They gained $94 million in incremental economic profit just by exiting an industry that actually had headwinds instead of tailwinds.

Sean Brown: They cut their losses, in other words.

Andy West: Yeah. And I think this is a really interesting illustration of the value of divestitures. We struggle as advisors, too, to materially describe the value of exiting a business. Usually we do it in terms of managerial focus, the ability to change your strategy, the ability to better apply resources to businesses that are not alike. All of these things are absolutely true. But in some cases, it also means you're just fundamentally changing your exposure to areas that have real headwinds. And sometimes there are better owners just for companies with a headwind. But it is an interesting question that's often overlooked and rarely quantified. And so I think this concept of momentum is a really important one for managers as they think about their portfolio going forward.

Sandra Andersen: The context around momentum is really important. And it actually changes a lot over time. So something that used to be a tailwind, may be a headwind, and vice versa, and it's not entirely cyclical. So when you look at the industries that had positive tailwinds in 2007, they changed materially by 2017. The most interesting thing about that is that there's a major cost to pay for standing still. So if you were standing on the edge of a decision in 2007, and use the same framework to think about where you get your tailwinds and headwinds in 2017, there's a really good chance that you'd be wrong. And when you look at 2017, the industries that outperform and underperform relative to 2007, were actually very difficult to predict for people who didn't make changes or make decisions in that space.

Sean Brown: So keeping things moving is sort of more important than knowing where things are going, I guess?

Andy West: I think it means that staying still or assuming that tomorrow is going to look like today is a real fallacy, right? Especially when you look at a ten-year time horizon. And yet every single day managers need to make decisions that are going to move them towards tailwinds. Right? So how do you break this day-to-day bias, this impossible cycle of, "Well, let's just put that off till tomorrow, or the headwinds aren't affecting me today." You actually have to be very, very active in terms of how you think about it. The one other thing I would add just around momentum in general—and there's a big difference between strategic buyers and, typically, private equity or other investors—which is the amount of time diligence in an asset is very, very high when you do M&A. The amount of time diligence in a market that you're already in is typically very, very low. I think everyone would recognize their market's going to face headwinds, or they may have challenges over the next ten years, but nobody really focuses on getting aligned on that particular market and those particular assumptions, which is very, very different. In a private-equity firm, they have very rigorous, healthy, regular debates about market exposure, and in some ways that helps them manage this risk.

Sean Brown: Would you mind commenting just on some tips and tricks that folks who are thinking about taking a more active look at headwinds and tailwinds can employ?

Andy West: It is probably the most important part of being an effective portfolio manager or trader I think because the number of biases that exist, that prevent management from acting, are extremely high. Whether it's stability biases, things like the status quo bias thinking that where you are today is going to be where you are tomorrow, whether it's a short-term bias around, you know, you're solving for short-term gains at the expense of the right answer for the long run. Right? Whether it's interest biases, thinking about your individual incentives as opposed to company incentives, or misalignment on corporate goals like, "What are we here to do and achieve?" Or whether it's just selective hearing, right? That's another bias that we hear, which is just placing more importance on relevant and available information. This is what I know. So this is what I'm going to act on as opposed to maybe compelling information you're not as comfortable with, right? So in terms of what you do, you've got to cut through this noise. There's a tremendous amount of noise. What we see companies do that do this effectively are a few things. I think one, they really focus on alignment, right? Meaning market and momentum alignment. They take the time to build the fact base around industry trends, industry forces, growth themes, how those things are going to affect their business, so they can constantly evaluate their portfolio as opposed to doing a snapshot or even worse, an incomplete snapshot, once a year or every three years as part of a strategy review. They're very, very clear also about boundary conditions. Because if you need to go from A to B, right? If you need to be in a river, right? Or if you actually need to move a meaningful amount of your capital, it is actually pretty easy to do the math to see how much capital you have to redeploy. Just putting a number on it and understanding, is that in line with the amount of cash we have? Is that in line with investor expectations? Is that in line with what the board expects? Those kinds of things are really important to understand, and yet people typically don't do it. So I think just being honest around some of these boundary conditions and getting alignment is probably the single most important thing to drive both your refresh rate and get focus on momentum.

Sean Brown: Sandra, anything you'd like to add there?

Sandra Andersen: I think there are actually two things that distinguish the experience for a strategic versus for principal investor that are interesting to talk about as well. One is that there is an expectation that strategic players know their industry inside and out. They've been in it for a long time. They've worked in it in a long time. They've created value in it. And so it is difficult for those leaders to overcome the urge to say, "I know it very well," and say, "I'd actually like to ask some questions." And pretty basic ones like, "Do I still want to be in this space?" By contrast, private-equity investors reinvent that every single week, and they can reinvent it for a fund or for a deal. And I think we can actually take something and learn it from the principal investor perspective, and apply it to the corporate lens, which combined with the long-term lens that corporates have is actually a very powerful tool. The second thing that's different is that our corporate leaders have to rally a lot of different stakeholders when they get alignment around a certain idea or concept or a potential change. They have investors, they have their day-to-day managers, their board. Those are a lot of people with a lot of divergent views. Principle investors have it by comparison quite a bit easier. And so I think that there's actually power in the conviction and strength of your opinion that you have to have as a corporate or strategic player versus a principal investor that's worth exploring.

Sean Brown: Let's talk a little bit just about the value of changing lanes and how do leaders of companies do it most effectively.

Just to anchor us in an interesting data point. Companies that are in the fast lane and stayed in the fast lane of momentum, had excess TRS, have almost 12 percent, which was double what the TRS was for the global average. Very impressive. So you really see the effect those tail winds have. But the number of companies in that bucket is actually quite small. So it's less than a third of the total companies that we looked at. The other two thirds have some changing of lanes to do. The question as to what's the cost of doing nothing? Companies that are stuck in the slow lane have TRS of about 4 percent, quite a bit lower than the average globally. But companies that changed lanes, added 7.7 percent of TRS.

Andy West: And when you then take that, those three categories, right—start in the fast lane, change lanes, stuck in the slow lane—if you look at those companies that did manage to change lanes, the way that they did it with M&A, again, was programmatic. That 7.7 percent for folks who went and did programmatic M&A, again, M&A that accrues to meaningful amount of their market cap, that actually does a couple of deals plus a year, they do it systematically, that 7.7 percent goes to 9.4 percent. If you did it selectively, meaning you just did M&A as a hobby, it was only about 6 percent, right? So if you just think about M&A and using it as an engine, it's really important. If you did it, by chance, via a large deal, you actually dropped to

5.5 percent, which is the risk that you sometimes see in these large transactions, right? They just inherently have a wider spread of performance. So again, the message here is if you're changing lanes, and you need to change lanes how to do it programmatically?

Sean Brown: Well speaking about programmatically, how does a company go from not having any kind of a focus on lots of smaller deals to being able to execute on lots of smaller deals? I guess that would imply that you'd have to cast a much wider net.

Sandra Andersen: It's a great question. And one of the questions that we're hearing a lot from executives is, "How do I decide between doing one big deal or doing ten small ones?" A lot of the time, it's the smaller deals, that acts, that give me access to more growth than the big deals. Some companies are used to doing a big deal every two years and that's sort of the rhythm that their investors are on and that they're used to. And they have to change the way that they think about the markets that they're in and the deals that they're going to execute. A big part of it and being successful in this is being able to empower the people in your organization to have a mindset that's open to M&A, but that's also open to value drivers and really internalizes a way of thinking that says, "There's a lot that we can do organically, but what's even possible is we also think inorganically?" And empowering people in functions that traditionally don't have a strong role in M&A to play a bigger role.

Andy West: And along with that, I, you know, you mentioned casting a wider net, I would say, almost casting a deeper net, right? And the reason why I make that distinction is precision actually drives a lot of creativity. So, if you can give, if you can unleash your organization, not on doing more deals, because that just adds a tremendous amount of noise to the system, but also on doing deals that fit the following criteria that have a very, very specific theme. This is the industry trend that we're betting on. This is how we're going to add value to the industry trend. This is the type of deal that we're looking for in terms of its size, and its overall, maybe, geographic location, what we're able to do, and this is how we're going to add value. If you can get specific on those things, you can really unleash people to be creative and identify good, privileged deal flow. I would also add the other problem you have is the M&A value chain, the funnel, is pretty broken in most companies. If you're doing project-based M&A you can muscle anything through. But if you're talking about M&A as a function that's going to drive growth and outperformance, just like operations, just like R & D, just like sales, you need to treat it as such, right? The process from strategy to deal making to integration and operations supported by the governance that goes along with that needs to be optimized, and it needs to be resourced appropriately. So, companies need to have a hard look at their ability to get done what needs to get done over long periods of time. And if they're serious about it, make some of those investments up front to make sure that that process is not only properly resourced, but actually effective, effectively governed and effectively managed.

Sean Brown: So you need a great blueprint and you need the execution capabilities to then follow it.

Andy West: Very well said.

Sean Brown: Any final thoughts you'd like to share before we close out our session today?

Andy West: If you're going to take anything away from the podcast and the work that we've done, I would say it's three things. One, taking an apples-to-apples look at your portfolio over time is really, really interesting. For most companies this is actually a shock. But it actually helps people really understand how, you know, either mobile or immobile, they've been over time. This linking strategy to M&A, the M&A blueprint, M&A understanding at a very granular level, how you're going to enable strategy with M&A is really important. I would say 90 percent of the companies we talk to, that link is still broken. Right? And then, as you just mentioned, building your capabilities is extremely important. You've got to take it seriously and be methodical.

Sean Brown: Anything else you'd like to add, Sandra?

Sandra Andersen: I think we're at a very interesting intersection where a lot of our clients are very worried that one of the reasons that premia are getting pushed up in the deals that they're looking at is because of private equity. One of the most insightful conversations that I recently had with the CEO was actually oriented exactly around that. His executive said, "It's really hard for me to create value. I'm competing with all these private-equity players who have a ton of dry powder to put to work." And he thought about it, and he reflected, and he said, "That's great. But why don't you compare your returns to that private-equity player as well and think about what's possible?" And I think it's a great mindset. So I think that the peer set that we now compare ourselves to as corporate strategic M&A players is actually quite a bit broader, and we can learn a lot from our broader peer set that includes private equity, permanent capital, and other investors who are also in it for the long run. I think the comparison has to go through to the value creation that you can achieve over a longer time period. That includes some of the bolder M&A moves, like step out M&A, and materially changing your exposure.

Sean Brown: It's been a pleasure speaking with you today. Thank you. Thank you also to our listeners for joining us inside the strategy room. We hope you enjoyed today's podcast. And if you'd like to read more about this topic, you can find related articles on McKinsey.com. If you'd like to receive updates, featuring our latest insights on strategy, including M&A, you can sign up for email updates at the bottom of every article, or follow us on Twitter at McKStrategy, or connect with us on LinkedIn by entering "McKinsey strategy and corporate finance" in the search bar to visit our practice page. Thanks again for listening. We look forward to having you join us again soon inside the strategy room.

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