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Active portfolio management: Interview with Andy West

Senior partner Andy West discusses the latest trends in M&A in light of several recent high-profile divestitures.

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In this episode of the *Inside the Strategy Room* podcast, McKinsey senior partner Andy West speaks with global director of communications for strategy and corporate finance Sean Brown about recent trends in M&A and the importance of aligning your transaction strategy with your overall strategy. (For more conversations on the strategy issues that matter, subscribe to the series on iTunes.)

Sean Brown: From McKinsey's Strategy and Corporate Finance Practice, I'm Sean Brown. Welcome to *Inside the Strategy Room.* Today we have Andy West joining us. Andy is a senior partner in our Boston office and global leader of our Transactions service line. We sat down with Andy to discuss trends in conglomerates and divestitures in light of several recent high-profile divestitures. Andy, welcome. Thanks for joining us today.

We'd like to start off with, what's driven the existence of conglomerates historically? And how have some of those dynamics changed over time?

Andy West: Most conglomerates have been around for quite a while. When you think of traditional conglomerates, they tend to be companies that have been around for 20, 30, 50, and sometimes 100 years. They've evolved for a variety of reasons. A lot of times, these companies were born out of economies of scale. They were simply able to produce more efficiently—obviously you go all the way back to auto manufacturing and large industrials and the ability to put large factories in the ground and make things more efficiently.

You also see regulation playing a role. There are certain economies, especially economies that are growing, where it's hard to get into a market and manufacture something if you're an outsider. Typically if you've got a manufacturing base, you've got institutional relationships in the market, and it's just a lot easier to expand than it is for a new player to get in.

There are other reasons that conglomerates exist and have existed over time. Capital efficiency is probably another—so the ability to invest, take proceeds, invest over long periods of time, invest in new businesses. Certainly a lot of innovation has come out of conglomerates. New industries have been created often by their ability to take capital from one part of the business and invest in something new.

And then you've got economies of scope. This is probably a more modern phenomenon—and an interesting one. Are there inherent capabilities that a company might have? I just talked about the ability to shift capital. But also, shift R&D, and shift technology. There are other ones that have many businesses but also have invested in true R&D capabilities. You could argue that some of the more modern conglomerates, if you'd call them that, they also have invested a lot in talent and digital capabilities. You can take a basic capability and apply it to many different businesses or use that capability to grow.

Sean Brown: When you talk about why conglomerates have developed, what trends have changed? You mentioned capital, for example.

Andy West: If you look at what's happening in the modern economy, a lot of the rationale for conglomerates existing is going away.

If you take them piece by piece, if you think about capital efficiency, you'd argue that markets are pretty capital efficient. There's a lot of capital out there these days. It's relatively affordable. I do think that longevity of capital—and whether the market has the patience that maybe a private investor would—is an interesting reason why some conglomerate-type activity may exist. But markets have become much, much more efficient over time.

I think economies of scale is actually a very interesting one too. I think there are really interesting things happening from a scale point of view. You've got a rise in technology, which is allowing you to outsource and communicate more effectively—to shift content and knowledge across borders without having to shift people. That's decreased the need to have everything in house or in one large office building somewhere. Also, you just see scale. Companies are getting bigger. You see industries consolidating. Many companies are at scale, or minimum efficient scale, for a lot of these activities. I don't think that's as salient as it used to be.

Regulation is a very interesting one. You see a general opening of markets over the last 50 years in a pretty aggressive way, particularly over the last 20 to 25 years. You might see some of that coming back. You see more companies, more markets, and more countries being a little bit more isolated in their mind-set, but it hasn't really manifested itself in trade arrangements or things like that yet. So I think that that's probably changed quite a bit.

And then we get to the economies-of-scope bit. That's to be determined. I think about that in a way almost like capital, where you have to have a very clear capability that is applied across businesses to warrant that. And all of that has led investors—whether it's boards, activist investors, or just management—to take a much harder look at their portfolio. These times are changing, and frankly it's hard for companies to actually shed assets. So maybe companies are finding themselves behind the curve on a few of these trends.

Sean Brown: What are some of the challenges of shedding those assets? Have some of the factors that have been holding that back changed as well? Has it become easier?

Andy West: I think it's become more necessary, and sometimes necessity leads to decision making and an acceleration of some of these things. There is something real happening in the market, particularly in the US, but it's now happening in Asia and Europe, where activists are just taking a hard look at your portfolio. And if you're sitting with assets that don't look like they make sense or are mathematically trading at some sort of discount, clearly it's observable—and it raises a lot of questions. That greases the skids a bit.

But the reason why it's hard is it's just getting rid of a business. How do you know it's the right time? It's hard to time the market, it's hard to understand value, and it affects people. And managers understand that. Leaders don't want to disrupt their organization. They don't want to destabilize their strategy. Sometimes it actually calls a lot of things into question. They may not know what to do with that money.

There are a lot of reasons why companies would be very cautious about making the decision to break up a company or to sell an asset. Not to mention the fact that there are very few strategy processes—or very few companies—that look at the portfolio in terms of getting rid of assets in the same way that they look at, for example, acquiring assets. You don't have a systematic plan to shrink the businesses. You don't have a systematic plan to break things up. Most companies don't. Some companies do, but most of them don't. It's just not ingrained in decision-making and strategy processes, budgeting, et cetera.

Sean Brown: Are there any factors that are making it easier? Such as, if you spin off a business, it's still possible to have an arm's-length relationships between those two businesses after they've spun off. Has anything in terms of technology made it a little bit easier if you're trying to spin off a business or divest of it in both the near term and the longer term?

Andy West: Yes and no. It's a very industry-specific question. With certain businesses, there may be a need to collaborate. For example, a company that's vertically integrated: that could be very easy to continue to collaborate. I don't need the assets on the books for the sales component of the channel. I don't need the bottling component of my business. I don't need all of the auto-parts making. You could argue that, in more vertically integrated businesses, there's a lot of commercial incentive to spin that out and then continue to collaborate. Sometimes you're creating a natural competitor. Or sometimes you're just getting out of a business. If you look at pharma companies that are getting out of either therapeutic areas or a different area, like animal health: I mean, there's just no need to really work together.

Once you get rid of those arrangements that you might have as part of the spin-off for cooperating, once those are done, there's really no need to collaborate. But certainly, you could argue that technology, transparency, some of the trends I described earlier around the ability to outsource—and get rid of certain corporate functions and not have to own those—are making the separation process a bit easier. And certainly, if you need to collaborate after that, you could argue that that's gotten easier as well.

Sean Brown: Are there any companies that have gotten really good at both M&A and divesting? What have they put in place to get good at it?

Andy West: When we look at M&A performance over long periods for large companies, typically the best strategy—if you control for a lot of things, like industry context—is to be a relatively active acquirer and a semiactive divester. We call it "active portfolio trading." And I think companies that have a very clear link between their strategy and what makes them successful, their sources of competitive advantage—and they're constantly moving their portfolio to reinforce that, both in terms of their own capabilities but then also being in the markets that matter—you see those companies, on average, being quite successful.

We talk a lot about modern economy and technology. And I do think you see a pace of decision making and a pace of collaboration that are ever quickening. Your ability to organically be in the right place with the right technology with the right offer at the right time with the right customers: it's just getting harder and harder without actually being in the market and having to acquire some of those capabilities. And then when you are no longer the advantaged owner of a particular business, then you're shedding that and getting the managerial focus on what matters. So I do think that, overall, companies that have the capabilities to do this active trading are going to be better off.

Now specifically, what does that mean? I think that means a few things. One I mentioned is having this very clear link between who you are and the markets that matter and how you allocate your resources and stay in the business. You have to have an active management dialogue that's clear and consistent. I think one thing that people who are quite successful do is, they make this very clear link between their general strategy and their transaction strategy—both on what they're acquiring and what they might be divesting.

There are a few other things that are really important. If you have that active process, if you have that precision, you are able to generate a much more proactive deal flow. I think being reactive to the markets is probably not a great way to add value. What you're presuming then is someone else is going to understand your strategy well enough to come to you with the right opportunity. And a lot of companies still do that. So company position begets proactive outreach and being able to build relationships, including commercial relationships with a company that may be the natural owner of one of your assets, or a company that you eventually want to acquire. So how are you using joint ventures, alliances, or commercial relationships to further relationship building and the migration of assets over medium to long periods of time?

The hardest thing to do—and what companies struggle the most with—is the governance around this process. The idea that you have to have alignment at the top, including with the board, around what businesses you want to be in and why. That's actually usually when you ask five board members and five management-committee members what they think the natural source of advantage is for a company and where they need to go, and you'll get at least two or three different answers, even from a very well-aligned management team. If you're going to migrate capital, that has to be aligned.

Then you have to turn that into some actual deals, whether it's something you're going to acquire or a boundary condition around some assets that you want to sell. And that also requires real work and can be quite complicated. You then have to turn that into a fair market price. You then have to turn that into an entire plan, whether on the separation side, dealing with all of the separation activity, or obviously on the acquisition side, turning that into integration. And that whole process has to be pretty well aligned.

Managing the strategy to the concept—to the deal, to the actual value—is a lot of work, and the governance around it is typically very poorly articulated. It bounces between the board, managers of different business units, executive management, corporate development, strategy, and obviously all the back-office and corporate functions and operating functions that need to enable it. It is not easy. I mean, it's a real capability. The good news is that if you can figure this out, if you can crack the code, it can actually be a source of competitive advantage. It's hard for others to emulate positive deal flow. It's hard to emulate a mind-set around shedding assets and doing that efficiently. Companies that can crack the code can be quite successful.

Sean Brown: Who is it that you're seeing as typically driving the portfolio rebalancing? Where have you seen it work really well?

Andy West: At the end of the day, the corporate portfolio is the CEO's job. And it is one of the areas of activity that requires significant CEO involvement: because the board's involved, because your most important shareholders are involved, because the constituents—your business units or whoever else reports up to you—are all going to be involved, but somebody's got to decide. And that usually clears with the CEO. Many times, it's a very close relationship between the CEO, the CFO, the head of corporate development and strategy, because usually the work is being done in the corporate-development-strategy function.

Usually the CFO is acutely aware of what's going on with investor relations: what the capital position looks like, what's happening in the markets. And obviously the CEO needs to have his or her eyes on the strategy. So a collaboration between that team is usually extremely important. But if you're going to get over all of the hurdles I mentioned earlier, it's got to be something where the CEO really has conviction and makes it his or her agenda item.

Sean Brown: Is this something that a CEO would spend 20 percent of their time thinking about? If you thought of broad brushstrokes, and you're the CEO, how should you be thinking about where you're investing that mind share?

Andy West: For a CEO, if it's not part of your agenda, I think the right question is to ask, "Why not?" And if it's because of all the reasons I said before—because it's hard, because there's a lot of uncertainty, because you're afraid you're going to attract attention from the market—then ask again because that's not a healthy place to be. If your organization's firing on all cylinders, you understand what your strategy is, and it's just a matter of simple execution that you can outsource to other parts of your business, then I think it's fine.

Sean Brown: Are there any specific support mechanisms that you've seen exceptional organizations put in place to help support programmatic M&A and divestiture?

Andy West: It's just got to be core to what you do. It depends on how you govern, but typically this portfolio question should be an active part of strategy setting. It needs to be linked to budgeting and whatever FP&A [financial-planning-and-analysis] process you have because as the business changes, your portfolio may need to change along with it. I'd embed it into those kinds of processes.

The biggest problem is, strategy becomes an aggregate of many small plans. Or budgeting becomes a bunch of microdecisions that largely focus on incremental reallocation of capital as opposed to taking a look at the whole picture on a fairly regular basis and saying, "Is this who and where we want to be?" It really depends on your starting point. If you don't feel like you've got a clear view of the businesses you're in, a clear understanding of why you're in them, a clear link between your overall strategy and how that's going to drive transactions—either buy-side or sell-side transactions—you should do that work. And then you should also take a look and make sure that all of your decision making isn't being too incremental. We talk a lot about big moves as a company. And it's the same concept. A lot of small moves typically add up to an indirect strategy or, you know, not being in the right place at the right time. I think it's just the same mind-set. "Am I thinking big enough? Am I thinking holistically enough about the portfolio?"

Sean Brown: Andy, you've made it really clear that it's important to be able to get good at this in terms of thinking about portfolio reallocation, resource reallocation. But for some companies, they may just be subscale in terms of having those capabilities to be able to do them on a regular basis. Are there any tips that you can offer our audience in terms of how to establish that capability in a way that it is good for the long term?

Andy West: A few ideas: one is, you do have to invest in your ability to transact and do these deals, like you would any other function. If you need to grow through M&A, if you need to grow the top line by 10 percent for M&A, well, if you're to grow the top line by 10 percent in your sales function, you wouldn't balk at hiring salespeople. If you needed to innovate, you wouldn't balk at hiring a few more R&D people. Yet, people aside, companies often decide they want to allocate sometimes billions of dollars in more capital, and you've got …

Sean Brown: One person.

Andy West: … yeah, your one person there—and a strategy guy. And they're going to go off and somehow make magic happen. Right? You need to solve that problem. And you can solve that problem by building up your corporate-development function. I think there's a minimum scale. I don't think it needs to be hundreds of people, but you need to invest in it seriously. You need to professionalize it. It needs to have real tools. It needs to have metrics. People need to be compensated with the right incentives. You have to take it as seriously as your aspiration. There are a lot of ways to virtually do that too.

I was talking to a client, and they called it the "national guard." I mean, you've got a national-guard strategy, where you have people who are trained and capable but deploy when needed. I do think that that's also important. Whether it's a finance person or an IT person or an HR person who's actually got to go do the integration work or participate in diligence or do the separation work, practice matters. It really does matter. Have folks, the same folks, participate. And making that part of their job descriptions, their titles, their expectations, so every time you have a deal, you're not negotiating with them about their time, you're not negotiating with their boss, or you're not getting a different person every time, I think is also another way to do it.

The other thing I would say—and this is going to sound a little self-serving, but people do underestimate how important it is—is to shift your capabilities and your insights when you shift your M&A strategy. You're going from an adjacency, a business. Maybe it's digital. Maybe it's a new market. If you don't know anything about it, you've got to get that insight. You've got to find a way to do it. If you're going to invest a lot of money, you better make sure that those insights are good. I say it's self-serving because typically the answer is to hire a consultant or come in and partner with somebody to do it. But I do think companies blindly often go into M&A strategies, and they really suffer because they know they don't have the expertise, but they also don't take the step to go get it until they have a live target or a live deal. And you can imagine that when you think about the implications of that, it doesn't really make sense. You're never going to have the conviction to actually go after the strategy if you don't trust the people's advice who are giving you the suggestions.

The last thing people typically struggle with—and you may have been going there with your next question—is, OK, so you go into an adjacency, how do you actually get comfortable? Whether it's a multiple evaluation, it just seems extraordinarily expensive, extraordinarily risky.

Sean Brown: On how much you're going to pay?

Andy West: How are you going to pay? How are you going to do that? And that is a really good question. And as you see digital—in particular, in strategies and ecosystems—is affecting all sorts of businesses, not just high-tech businesses anymore. I do have a lot of clients that struggle with that. And the one bit of advice I would give that's consistent with this whole theme is, if you're going to invest in something, invest in it. Don't invest in a particular deal. M&A is a way to deliver strategy. It's not a strategy.

Sean Brown: Right.

Andy West: If your strategy is to get into an adjacency or to build a new capability, what is the business plan for that? How much money are you going to spend? If you're going to spend $3 billion to do that over the course of five years, and you can do a deal that's going to shorten the time frame, or decrease the risk in a significant way, it might be worth a multiple that you're not used to paying. The key is just understanding that and knowing you're going to spend the money anyway. And then not only just spending it on a particular target but making sure that that target doesn't have to fund the strategy. You know, you buy the company. You start milking it for synergies, and you never get the growth out of it. So how do you actually put the organic investment around the asset and make sure you're truly committed to the strategy as opposed to confusing an individual deal—particularly one in a business you don't know—where the evaluation of that deal often becomes the evaluation of that strategy? And if you're not comfortable with the strategy, it makes the deal very, very hard.

Sean Brown: A couple of final questions. One is, just in terms of putting in place things that help one think about portfolio reallocation, have you seen any clients or companies do red team and blue team, where one-half of the corporate-development team is looking at acquisitions, and the other half is looking at the existing portfolio and saying, "This one really doesn't fit anymore," where it's their job to look at that?

Andy West: One of my favorite questions with senior executives after they come out of a strategy review is, "Did you ask everybody what their top three choices for a divestiture were?"

Sean Brown: Right.

Andy West: It doesn't have to be a whole business. It could be a product line. It could be getting out of a particular market. But what are the three things you'd get out of the fund? And almost nobody asks that question. I think that's a derivative of what you were just saying. I think for divestitures, the method of red team and blue team is very helpful. A lot of companies do that for M&A. I think most companies can get their heads around the risks and the benefits of buying something. There's also a sense of impermanence around an acquisition because once you buy it, you own it. And it can become something else. With a divestiture, once you sell it, it's gone.

Sean Brown: It's gone.

Andy West: It is permanent. And so having somebody say, "We really want to do this," and having somebody else say, "We don't want to do this," and making a very strong case is typically quite helpful.

Sean Brown: Great. My last question is related to technology. What do you see as the modern-day conglomerate, and why?

Andy West: I think it comes down to some of the trends we talked about earlier. I don't think that forming conglomerates or groupings of businesses for regulatory reasons, capital reasons, or economies of scale is the modern way. I'm sure there are examples, but they're becoming fewer and farther between. I think the economies of scope—with the underlying core capabilities, having IP [intellectual property], R&D, analytics, digital assets …

Sean Brown: Data.

Andy West: … and data, exactly, at scale—I think that is meaningful. You continue to diversify. And I don't think it's because they have a lot of cash. I think it's because there's actually something they can add to the markets that they're going into. And it's going to be very interesting to see how that plays out over time.

Sean Brown: Andy, thank you so much for taking the time.

Andy West: My pleasure. Thanks, Sean.

Sean Brown is McKinsey's global director of communications for strategy and corporate finance and is based in the Boston office, where **Andy West** is a senior partner.

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