Editors’ note: for companies managing a portfolio of businesses, investment decisions are seldom clear-cut—especially when different logical rationales conflict. This excerpt, adapted from the new book Strategy for the Corporate Level: Where to Invest, What to Cut Back and How to Grow Organisations with Multiple Divisions (Jossey-Bass, June 2014), examines some of the ticklish questions and trade-offs that those harder cases bring up.

Managers typically make portfolio decisions based on a series of logical justifications. The choice to invest, cut back, buy, or exit is ideally guided by the strength of a business’s structural attractiveness (business logic); the potential to improve the business or create synergy with other businesses (added-value logic); and the state of the capital markets—whether they are likely to over- or under-value the business relative to the net present value, or NPV, of its future cash flows (capital-markets logic).

These three logics are each important for making good portfolio decisions. The decision is easy if the three logics all point in the same direction. When they don’t, decisions can get complex. For example, if a business is likely to sell for more than it’s worth, there is little reason to buy and good reason to sell—unless the business would perform much better under your ownership or it adds something to another business you own. If
a business is structurally less attractive because it is in a low-margin industry and has a significant competitive disadvantage, you are likely to want to sell or close it—as long as the price you can get is more than the value of continuing to own it. But you may also want to keep the business if you can improve its competitive position or if it strengthens your position or adds capabilities in a related segment.

The trick is to make informed trade-offs among these different reasons for buying or selling businesses. It is important to give weight to all three logics and avoid letting momentum build up around one so that the others have little influence or are ignored. Too often, we encounter executive teams that decide what to buy first and consider how to add value only as part of the valuation or integration process—or that commit to hold onto an underperforming business without considering whether it might attract enthusiastic buyers. But this article is not about those who fail to use the three logics. It’s about tricky cases where the logics suggested different paths forward—and how managers came to the conclusions they did.1

**You can add value, but the business is structurally less attractive**

Most management teams try to avoid businesses with low returns, weak positions, and limited growth prospects, especially those in complex industries. But what if you’re good at adding value to these businesses? The default answer is to focus on what you’re good at.

Consider the case of Grupo Bimbo, a $14.1 billion Mexican baking giant, the world’s largest bread-manufacturing company. It operates in a tough business: bakery products. These products have notoriously low margins, partly because customers are price sensitive. Some competitors, such as Hostess Brands, have gone bankrupt, and others have been in gradual decline. However, Grupo Bimbo’s stock price has gone up 700 percent since 2000, and revenues have nearly doubled in the past five years.

Grupo Bimbo’s secret is that it adds a lot of value to the bakery businesses it owns. It has a strong focus on operations. For example, it’s particularly skilled at managing delivery routes for its trucks. The company makes three to five deliveries per week across more than 52,000 routes to 2.2 million points of sale in national, regional, and local networks. Each truck carries a computer to help the optimization process.3 It’s also skilled at optimizing oven utilization in its 100 plants. And the company has complementary skills. Much of the machinery used in its factories is developed and manufactured in its industrial division. It also produces a significant portion of the plastic packaging used on its products. Finally, the company’s focus on operations includes an emphasis on producing high-quality bread in some of the most advanced facilities for baking. Combined, these capabilities allow Grupo Bimbo to adapt to local tastes and needs on a global scale, with operations in 19 countries across four continents. Through organic growth in its core countries and through aggressive acquisitions, including Weston Foods (Sara Lee’s American baking operations), sections of Hostess Brands’s bread business, and most recently Canada Bread, it is today one of the largest bakers in the world.

Acquiring businesses in complex, low-margin industries is not a strategy to recommend lightly. One risk of buying or holding structurally unattractive businesses is that they typically don’t provide a reasonable return on incremental investments. Hence decision makers, like Grupo
Bimbo, must juggle all three logics. How difficult is the industry? Can they add enough value to compensate for the low underlying returns? Can they buy assets at a discount or without paying too large an acquisition premium?

**You can’t add value, but the business is structurally attractive**

Every manager likes an attractive business, one with high margins that has a competitive advantage. But what if you’re not good at adding value to this business? The default answer is to learn how to add value, and to do so quickly.

When Rolls-Royce acquired the marine business of Vickers in 1999, it acquired a number of different businesses, one of which was the Ulstein offshore ship business. This small Norwegian business made components and systems for vessels used to supply oil rigs—a technically demanding environment in which ships, in the middle of very heavy seas, have to remain within a few meters of the rig. Rolls-Royce could see that, from the perspective of business logic, this was a structurally attractive business. The value of such a vessel to an oil company is very high, and there were few competitors able to design and build them. Unfortunately, Rolls-Royce would be unlikely to add much value to Ulstein in the short term. Ulstein needed to broaden its products, add niche technology capabilities, and build its capability to sell globally. While Rolls-Royce had some seemingly relevant capabilities, such as global sales in aerospace, a strong balance sheet, talent, and a well-known brand, managers recognized that these might not be appropriate in such a different industry.

Rather than sell Ulstein, Rolls-Royce took care to build some new capabilities that would enable it to add value in the future. The company hired a new head for its marine businesses. Drawing from Ulstein and other marine businesses, both within and without Rolls-Royce, he built a team that could exploit what Rolls-Royce had to offer and do more. The key was to understand the difference between selling systems, such as complete drive systems with electronic controls, and components, such as diesel engines. The team was then able to draw on those capabilities in Rolls-Royce that fit. For example, the team drew on lessons learned in civil aerospace and defense to offer long-term service support to ship operators. The result? Rolls-Royce’s marine business grew from about £750 million in revenues in 2000 to more than £2.5 billion in 2010, and today it’s a leading competitor in this segment. But to get there it had to develop many of the ownership skills needed to turn the vision into a reality.

It’s easy to presume that a company will be able to learn to be a good owner, especially when the business is attractive, but developing new skills at

The trick is to make informed trade-offs among these different reasons for buying or selling businesses, giving weight to all three logics.
the corporate level is not easy. It often requires significant changes in people and a willingness to let go of past habits and processes—and failure to do so is common.

You can add value to a structurally attractive business, but it’s overpriced

When you find an attractive business that you can add value to, your instinct is to acquire it or hold onto it. But what if you own a business for which the price in the capital markets is higher than the NPV—for example, if the business is in a hot sector and competitors are vying for a few prizes? Should you sell? If you’re considering acquiring, should you withdraw from bidding? The default answer depends on whether you’re looking to acquire or whether you already own the business and whether the reason for the overvaluation in the capital markets is likely to be temporary or permanent.

If you’re looking to acquire, the default answer is either to change the strategy so that you don’t need to buy the business or to wait until the capital markets correct themselves. However, there are tactics that you can employ if you want to be more proactive. A common one is to hedge the risk of overpayment. If both your company and the target are trading at high multiples relative to historic levels (and especially if your multiple is particularly high), you can make the acquisition with equity rather than with cash, or issue new shares and use the cash to buy the acquisition. This results in paying for an overpriced asset with overpriced equity.

Another tactic to cope with high prices is to structure the deal to reduce the risk of overpaying—for example, by using an “earn-out formula.” This can work if the seller believes the business is worth more than the buyer does. An earn-out allows both parties to see the deal as attractive due to different assessments of its future prospects. In the event that the business performs to the seller’s expectations, both sides are happy. In the event that it performs to the buyer’s expectations, at least the buyer is happy.

If you’re already a superior owner of a business and are offered a price that is higher than its NPV, the default answer is to hold. You should be wary about allowing your strategy to be buffeted by the vagaries of the capital markets, especially if you believe the overvaluation is not justified by the superior abilities of other companies to add value. Even then, you should still consider selling under some conditions—if the premium offered by the buyer is too big to ignore, for example, or if the cash overcomes a shortage of funding to invest in other parts of your portfolio.

You own a structurally unattractive business and are subtracting value, but buyers are not offering a fair price

Managers with unattractive businesses to which they cannot add value will normally sell. But what if you cannot sell a business at a price that matches the value of retaining it? Many companies will simply keep such a business and wait until they can offload it at a better price. But there are some tactics that sellers can use to increase the price buyers will offer. Which tactic is most appropriate will depend on the reason for the low price—be it a lack of buyers, the nature of those buyers, the information they have about the business, or the deal process.

For example, a mining company wanted to dispose of a combined smelter and cast house (a facility in which the metal from the smelter is cast into semifinished products). Few buyers were
interested in the combined offer—in part because the smelter had committed to buying electricity at a fixed high price from the local power utility for a 20-year period. To solve the problem, the company unbundled the business into three separate parts, turning it into a more salable proposition and improving overall NPV. The cast house could now be sold to a company that wanted to use its own metal as an input. The power contract for the smelter was bought back from the utility. And the smelter was left as an independent asset that could be sold or, if the reserve price was not met, shut down.

Another way to increase price is to redesign the deal process. For example, when Tesco divested its Japanese operation to Aeon, it divided the deal process into two stages. In the first stage, it paid Aeon to take 50 percent of the business off its hands. The remaining 50 percent will be sold off at a later date. This allowed the buyer and seller, which had different views about the value of the business, to reach an agreement. If the business performs well, Tesco will be able to get a better price for the remaining 50 percent share.

What to do also depends on the risks of subtracted value. If the current owner neither adds nor subtracts much value, the business is “ballast.” Retaining it awhile is unlikely to reduce its value so the sale process needn’t be rushed. For example, a natural-resources company owned an aluminum business—for which it was not a particularly good owner. Aluminum, at the time, was also not an attractive business due to global overcapacity, and better parent companies had their own challenges, so the business
could not be sold at a sufficiently attractive price. Fortunately, the business was part of a joint venture, operated by the company’s partner, which also acted as the parent company. That left little chance that the natural-resources company would subtract value, so it decided to hold onto its share and look for an opportunity to offload the investment in the future.

If the current owner is already subtracting value, the pressure for an urgent disposal is high. Retaining the business means it will sell for less in the future and it will demand attention from parent-company managers that distracts them from more productive work. Getting rid of it speedily—using whatever tactics available—is likely to be the least bad solution.

In each of these cases, leaders were able to make wise choices only by using all three logics together. By facing up to the conflicts among the logics, they were able to find tactics that enabled them to succeed. Financial analysis is an important aid to this process. It can help managers define how big a premium a company can afford to pay or how much value needs to be added to turn an unattractive business into one that offers good returns. But financial analysis cannot substitute for strategic judgments about the attractiveness of the business, the ability to add value, and the reasons for over- or undervaluations in the capital markets. It’s these judgments that are critical to making good portfolio decisions.

Andrew Campbell is an alumnus of McKinsey’s London and Los Angeles offices and a director of Ashridge Business School’s Strategic Management Centre, where Jo Whitehead is also a director.

Reprinted by permission of the publisher, Jossey-Bass, from Strategy for the Corporate Level: Where to Invest, What to Cut Back and How to Grow Organisations with Multiple Divisions, second edition, by Marcus Alexander, Andrew Campbell, Michael Goold, and Jo Whitehead. Copyright © 2014 by John Wiley & Sons, Ltd. All rights reserved.