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Strategic portfolio management: Divesting with a purpose

Tying portfolio decisions to a company's distinctive capabilities can help identify which businesses to divest.

Managers are becoming increasingly aware of the relationship between asset reallocation and value creation. They're also growing more attuned to the role of divestitures[1] as a tool for managing corporate portfolios. In our experience, deciding which businesses to sell and which to keep can make as much of a difference to a company's long-term value as which businesses it decides to acquire.

A structured, regular corporate-strategy process can help companies test which, if any, of their existing businesses have reached their sell-by date. The "best" owner of a business is whoever can generate the highest value from it.[2] And even if a parent company's distinctive capabilities stay the same, a business's needs change as it matures and the competitive landscape evolves.

For the past several years McKinsey partner Ruth De Backer has co-led a McKinsey initiative on portfolio management and divestitures, working with leading players in the pharmaceutical, biotechnology, and medical-technology sectors. In her work she's developed a particular interest in the application of the best-owner principle to portfolio decisions. We recently sat down with her to explore how the best-owner mind-set can help companies overcome barriers to profitable divesting.

McKinsey: *How does the best-owner principle help companies make objective, unbiased decisions about divestitures?*

Ruth De Backer: Companies need to ground portfolio-management decisions, including divestitures, in the attributes that make them a better owner of their businesses. Such attributes can include, for example, unique skills, governance, insight, or even connections to other businesses. They can also include access to talent, capital, or relationships.[3]

Tying divestitures to the better-owner principle means companies need to define explicit criteria for what good ownership looks like in each of their businesses. Some of those criteria should reflect a company's strategic intent. If a business unit helps a company meet its strategic goals, such as becoming an emerging-market player or developing a certain set of unique skills, then managers should rate it higher against their strategic criteria. Other criteria should reflect a company's capabilities. A company with a large integrated footprint and high operational efficiency is likely a better owner of products that help fill capacity and contribute to overall scale than companies without those attributes, so managers should rate such businesses higher on the capabilities criteria. And some criteria should reflect a company's current market position. For example, managers of a company with an enviable channel position or leading customer relationships and a great reputation across their portfolio can rate businesses against their ability to leverage the company's position across product lines.

Then managers can use those ratings to assess each of a company's businesses. The intent is to maintain the objectivity of the process, not to make every single business look good. So the scale needs to be consistent from business to business. For example, managers might agree that market position is 20 percent of each business's overall score, capability is 50 percent, and strategic intent is 30 percent. Naturally, the most attractive and valuable businesses will score very high. Those businesses where the company isn't a very good owner will score lower.

McKinsey: *How do the ratings help executives decide?*

Ruth De Backer: That rating process allows managers to have a more dispassionate conversation, because having gone through it, they'll already have nearly diagnosed why their company is or is not a good owner of certain businesses. And when the outcome is visibly a rational, objective, criteria-driven decision, it's much harder for business-unit managers to disagree. That accelerates divesting. Otherwise, it can take two or three years for some managers to accept that the issue is deeper than an unusually bad year or a difficult turnaround and that their businesses don't belong in a company's portfolio—and another couple of years to get the businesses out of the portfolio.

McKinsey: *Do the criteria differ from company to company?*

Ruth De Backer: At the high level, criteria are always about value-creation potential, natural ownership, and objectives drawn from the company's strategic plan. But the details may change from company to company and the focus may change from industry to industry.

In the pharmaceutical industry, much of the value comes from innovation, technology, and intellectual property. So the criteria for a pharma company will be less focused on market position than on the products they offer and related capabilities. These include their intrinsic capabilities as market leaders that make them natural owners of those products over the long term, including a strong knowledge of therapeutic areas in your research-and-development department or existing relationships with physicians, opinion leaders, and start-ups. For example, the more related assets a diabetes company

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can offer, the easier it will be to get access to physicians who specialize in diabetes—and often the better the reimbursement status for the company's product portfolio. However, market position alone is not enough to have a lasting edge, because the relative positions of companies in the market shift based on the clinical benefits of their products. Many of the current leading infectious-disease companies today weren't leading the category ten years ago. When intellectual property or exclusivity runs out, as it does every 7 to 15 years, you get turnover even among the top companies.

Market position is more important for companies in the medical-equipment industry. The top cardiovascular companies ten years ago, Boston Scientific and Medtronic, are still the top companies today. For them, market position is a more important criterion because it means they can pull a lot of new products into their most important channels.

In industrial companies, scale benefits and operational capabilities are more important. Their ability to produce something at a lower cost is probably more important than it would be for the average pharma company, where the gross margin will be high even if they could be a couple hundred basis points more efficient.

McKinsey: *What are the common roadblocks to divesting?*

Ruth De Backer: A CEO who is primarily focused on growth and the size of the organization can be the biggest roadblock to divesting. In a company with a strong, numbers-driven CFO, the case to divest can be quite clear, objective, and grounded in data—but to make the actual decision, you need a CEO who is willing to act.

It's also harder in decentralized companies. In such cases, divesting is often left to individual division managers, who may find it difficult to pivot from building a business to thinking about divesting it. In those cases, you obviously need strong strategy and corporate-development functions looking at the corporate portfolio. Otherwise, those are the companies where assets past their prime will linger the longest.

McKinsey: *How do executive incentives come into play?*

Ruth De Backer: The right incentives can help. If incentives are grounded in sales growth, for example, managers would be working against their own interests to sell a business with $2 billion in revenue. Unless the company were to set a new baseline for incentives after the sale, it would be hard to fill the revenue gap with anything else. A strong CFO and a strong corporate HR officer can help companies better understand how their incentives support corporate strategy—and can also explain them to investors.

McKinsey: *The evidence is clear that Wall Street reacts positively when companies make divestitures, even if those companies become* *smaller.[4] Why would there be a disconnect between the statistics and the way companies believe Wall Street will react?*

Ruth De Backer: On the face of it, executives get a lot of conflicting messages from Wall Street, often emphasizing growth. It takes a lot of courage to shrink, especially for executives who are unaware of the data showing that investors tend to applaud intelligent divestiture programs. Divesting is also counterintuitive to executives conditioned to highlighting revenue and margin growth in quarterly earning calls. Given the pressure they face, explaining a divestiture-driven revenue decline or even a slowdown in revenue growth can be daunting.

McKinsey: *You might expect that from a division leader, but aren't the CFO and CEO more in touch with the way the market reacts to these things?*

Ruth De Backer: Many of them are. The more experience they have at divesting, the more they've seen the market's positive reaction firsthand, the more likely they are to do more and bigger spin-offs and divestitures. The more they do it, the more they take an interest in keeping the portfolio fresh. But companies with CEOs and CFOs who have no experience with shrinking, who frame performance in terms of revenue numbers rather than enterprise value, market capitalization, or shareholder value, find it very hard to divest.

McKinsey: *How much of that is related to their mind-set versus the way they are compensated or their relationship with their board?*

Ruth De Backer: All of the above. For instance, in one company in a high-margin industry, the chairman of the board is from an industry with low margins and low returns. The company was reluctant to sell anything that might dilute margins. The chairman argued that "you can manage true low-margin businesses and make them attractive." And they generate lots of cash, even though a more focused, higher-growth, higher-margin business would have created more value. So boards can shape the dialogue. And if the board always talks about revenue growth, and your incentive system is based on revenue, then it's not surprising that you get CEOs who are very much focused on revenue numbers and growing the pie. The academic evidence is pretty clear that the single most important indicator of a CEO's compensation over a longer period of time is the size of his or her company.

McKinsey: *How can companies get the incentives right?*

Ruth De Backer: Getting the incentives right isn't easy, even for executives. I was working with a company that was really good at setting executive incentives based on the profile of its end markets and the profitability and the strategic objectives of each of the businesses. Executives told managers of the low-profitability, low-growth business in the portfolio not to worry about growth but to maximize their returns on invested capital and profitability instead. And in the end, they earned twice the bonus of managers of the portfolio's most profitable business, whose incentives were grounded in growth. Some people were unhappy and weren't shy about expressing their discontent, even though the incentives were actually aligned with creating shareholder value. Those kinds of incentive systems put a lot of pressure on companies, because they're harder to live by year after year. It's one reason not to keep diverse divisions in the same portfolio, because most human-resources managers and most executives are uncomfortable when everyone's performance isn't measured against the same yardstick. Even when companies do manage to sustain diverse incentives year after year, it doesn't get easier. You don't want to disenfranchise the people who deliver the most value for the company in the long term. But you also don't want to undermine the people in a business that needs to be managed differently, to do what is right from a shareholder-value perspective. ■

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[1] The sale of part or all of a business can take the form of private transactions, including trade sales and joint ventures, or public transactions, including IPOs, carve-outs, spin-offs, split-offs, or tracking stock.

[2] Richard Dobbs, Bill Huyett, and Tim Koller, *Value: The Four Cornerstones of Corporate Finance*, first edition, Hoboken, NJ: John Wiley & Sons, November 9, 2011.

[3] Richard Dobbs, Bill Huyett, and Tim Koller, "Are you still the best owner of your assets?," *McKinsey Quarterly*, November 2009, McKinsey.com.

[4] See, for example, Audra L. Boone and J. Harold Mulherin, "Comparing acquisitions and divestitures," *Journal of Corporate Finance*, 2000, Volume 6, Issue 2, pp. 117–39, pendientedemigracion.ucm.es; James A. Miles and James D. Rosenfeld, "The effect of voluntary spin-off announcements on shareholder wealth," *Journal of Finance*, 1983, Volume 38, Issue 5, pp. 1597–1606, onlinelibrary.wiley.com; Katherine Schipper and Abbie Smith, "A comparison of equity carve-outs and seasoned equity offerings: Share price effects and corporate restructuring," *Journal of Financial Economics*, January–February 1986, Volume 15, Issues 1–2, pp. 153–86, sciencedirect.com; Katherine Schipper and Abbie Smith, "Effects of recontracting on shareholder wealth: The case of voluntary spin-offs," *Journal of Financial Economics*, December 1983, Volume 12, Issue 4, pp. 437–67, sciencedirect.com; Jeffrey W. Allen and John J. McConnell, "Equity carve-outs and managerial discretion," *Journal of Finance*, February 1998, Volume 53, Issue 1, pp. 163–86, onlinelibrary.wiley.com; and Roni Michaely and Wayne H. Shaw, "The choice of going public: Spin-offs vs. carve-outs," *Financial Management*, 1995, Volume 24, Number 3, pp. 5–21, semanticscholar.org.

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