Cash Flow | June 04, 2013 | CFO.com | US

Is it Time to Prune the Portfolio?

Management shouldn't be too jumpy to sell and buy businesses. They need to carefully evaluate their strengths and competitive advantages.

Gregory V. Milano

Back in 2009 with the stock market sitting at about half the peak it reached two years earlier, a client CFO shared a disheartening story about a divestiture he planned but never made. It seemed he and his CEO decided during the previous downturn that they should sell one of their business units. But they failed to sell it when the time was right.

The business unit didn't strategically fit well with their other businesses and its financial performance was spotty and cyclical. When they decided to divest it, the business was suffering very low profitability and the public peers were trading at dismal valuations.

So they decided to wait until the financial performance and valuations rebounded.

Fast-forward a few years and just as they had hoped the financial performance of the business bounced back stronger than ever and stock market valuations among comparable companies jumped back up as well.

Just when their strategy signaled it was time to sell, they didn't sell. The CFO recalled with a sting that he and the CEO decided "…it's producing decent cash flow so we should keep it."

ANALYSIS

Everyone knows what happened next. A few years rolled by and both the business unit performance and comparable company valuations dropped. In fact they couldn't get 50% of what they once would have easily sold it for. They regretted the decision they made at the top of the cycle.

Are we back at a point where company executives should think about pruning their business portfolio by selling their unwanted business units?

The National Bureau of Economic Research (NBER) publishes data on the time between economic cycles. The duration of cycles does vary but over the 11 cycles since World War II, the average time between economic peaks has been 66 months.

The last peak was in December of 2007 so on average the next peak should be right about now - June 2013. But the last 3 peak to peak cycles have been longer, averaging 106 months. This implies the next peak is over three years away. The point is that sometime over the next few years we are likely to hit an economic peak so it seems worthwhile to evaluate strategic alternatives now.

Another way to consider the business cycle is to examine net income trends. Based on consensus equity research analyst estimates, the expected 2013 net income for the companies in the S&P 500 is about 38% higher than the same companies delivered in 2007. So whether we are at the peak yet or not, financial performance is strong in many industries.

On top of this the stock market is now hitting peaks regularly with earnings multiple valuations still a little bit lower than they were at the last peak but quite high by many standards and certainly in many industries.

For those who think this may be the time to dispose of unwanted business units, there are two key considerations.

The first and most important piece of criteria is whether the business fits from a strategic perspective. The answers to a few key strategic questions can answer this:

- Do the key value drivers of the business coincide with the core competencies of the parent company?
- Do any of the parent company's other businesses possess competitive advantages that help the subject business unit to be an above-average player among competitors?
- Are there any cross-fertilization opportunities between this and other parts of the portfolio?

The second important piece of criteria is whether or not the parent company management believes after an objective strategic analysis that they can add value to the business. It is not enough to decide if a business is a good business with strong growth and high returns or a bad business with weak growth and/or low returns. Can value be added?

Managing a portfolio of businesses is very similar to managing a portfolio of stocks. You want to hold the ones you think will grow in value and not the ones that you don't think will rise in value.

Consider an example. A company may have a business unit that produces a 20 or 30% return on capital with 6 or 8% growth and rightly believe this to be a good business. But if there isn't any room for the company to improve upon the returns or the growth rate of this business, why are they holding it?

Why not sell it for what it's worth given the return and growth profile, and redeploy the capital into business areas where management can invest to increase growth or improve returns by doing something to make the business worth more than has to be invested to buy it?

In fairness, management's shouldn't be too jumpy to sell and buy businesses. They need to carefully evaluate their strengths and competitive advantages. They must assess each business in the portfolio in absolute terms and against peers. They must decide how best to try to grow the value of each business, and then with this information in hand they must identify opportunities where portfolio changes can create value.

And then, of course, they must execute the plan effectively. The best portfolio realignment plans in the world are worthless without effective execution. Management must sell and buy the right businesses at the right price and at the right time. Just as now may be a great time to sell business units, it may be best to wait and build investment capacity for the next downturn so acquisitions can be made at lower prices.

Those that execute portfolio changes well can add a significant dimension to their ability to drive higher total shareholder returns for their owners.

Gregory V. Milano, a regular CFO columnist, is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.