Changing the business portfolio: between the risk of inertia and the risk of strategic mistake

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Large groups stuck in mature Western markets and traditional businesses can hardly grow beyond 4 to 6% per year. Therefore, no matter what regular reorganizations and transitory reductions they make in overhead costs, they do not create value.

The real strategic and financial response for these groups is through a fundamental shift in their business and geography portfolio, to reposition themselves in high growth markets and reallocate resources within these markets to establish leadership positions.

However, for large groups, this is not easy. On the one hand, new markets and geographies may be too small compared to traditional business lines and may only have a small impact on the entire group's financial trajectory. On the other hand, real changes in large-scale businesses are risky.

Many groups give up when faced with the difficulty and the risks of such a strategy. Few initiate profound changes and successfully carry them out. Why?

Major successes

Let us review some iconic successes.

General Electric—1980-2000

Everything has been said about the Jack Welch's success at the helm of the group over the period. In fact, General Electric made two major changes to its business portfolio during those twenty years:

- It internationalized the major businesses in which it had strong competitive positions at an accelerated pace (medical systems, energy production equipment, aircraft engines…); the share of revenue from outside the USA increased from 35% in 1980 to 60% in 2000;
- It grew massively in financial services. These rose from 10% to 50% of the group's revenue from 1980 to 2000 and accounted for 65% of the growth of its market capitalization over the period.

In twenty years, GE became one of the world's leading financial institutions in an industry which had grown from 4.5 to 8 % of the US GDP and had experienced exceptional global growth. Investing massively in a fast-growing industry, developing a differentiated business model compared to traditional players (banks), building leadership or co-leadership in several segments of this industry: all the ingredients for success had been implemented. The size of the group (revenue of $25 billion in 1980) did not hamper its strategic agility and success. Industrial expertise had been supplemented by skills in finance. The choices made regarding the sector in which it diversified, the timing of entry, as well as the strategy and organizational arrangements in this sector were the right ones. *Its TSR[1] was 25% per year.*

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(1) TSR : Total Shareholder Return (including distributions of dividends & free shares and increase in share value).

PPR/Kering—1990-2018

PPR, or Kering today, grew over the period with two major waves of diversification: the withdrawal from the timber businesses and the investment in retail in the 1990s (from 0% of revenue in 1985 to 73% in 2001); the withdrawal from these businesses and the investment in luxury (from 0% of revenue to 71% in 2017), notably with the acquisition of Gucci in the 2000s.

The first wave had a limited impact (TSR of 9% per year over 1985-1995); the investment in retail activities was too late, with many of them already close to maturity. The second wave had a significant impact (TSR of 15% per year over 1995-2018); the group invested while the wave of growth of luxur in Western and emerging countries was (and still is) strong and long.

In terms of portfolio management, the timing (of investments and disinvestments) is a critical element.

Danaher—1988-2018

The management of the business portfolio can be made on an ongoing basis and not be limited to major moves every ten or twenty years.

Danaher, a large American technological conglomerate present in a dozen businesses ($18 billion of revenue in 2017) grew at 12% per year between 1988 and 2018 with a TSR of 20% per year by regularly and strongly changing its business portfolio through divestitures and acquisitions (four hundred acquisitions over thirty years). For example, industrial technologies and testing & measurement activities decreased from 70% of revenue in 2000 to 30% in 2015. However, over the same period life science & diagnostic activities and environment increased from 15% to 50% of revenue.

Regular search for new sources of growth; significant acquisitions and investments to establish leadership positions in these new businesses; ongoing portfolio management and trade-offs in more mature or less attractive businesses; extensive expertise in acquisitions and their integration, and in divestitures. Portfolio management has been as important a value creation factor as the strategies implemented in each business.

Major failures

On the other hand, some examples of failures show the risks incurred during a major change in the business portfolio.

General Electric—2000-2018

Since 2000, General Electric has led a growth and consolidation strategy in several energy-related industrial equipment sectors (wind turbines, oil services equipment, turbines for energy production with the acquisition of Alstom in 2014…) and transportation.

This movement was limited by three factors: the business cycle (impacted by 2001 and 2008 crises), actual growth lower than expectations, increasing competition from Chinese groups (for example Goldwind for the manufacturing of wind turbines).

Between 2015 and 2017 the Group also sold a large portion of its financial services business (Commercial Lending & Leasing divisions, Real Estate, Rail Services…) with unfavorable economic conditions (2014 or 2018 would have been more favorable).

Bad choices, bad timing: General Electric is no longer growing (- 2% p.a. decrease in revenue on average) and since 2000 it has not created any value (average annual TSR of - 7%).

Vivendi—1990 – 2000

It is easy to judge with the benefit of hindsight. On paper, the withdrawal from mature and low-margins water concession businesses at the end of the 1990s and the investment in “businesses of the future” (telecommunications networks, Internet, film studios, video games, music publishing…) with the convergence of content and mediums was brilliant. However, its implementation proved unsuitable given the financial cycle as it was executed at the top of the cycle, before the internet bubble burst, and by paying for acquisitions in cash rather than with shares.

In addition, if the directions were correct, several investments were made in areas where strong growth was a thing of the past rather than of the future (telecommunications), or in acquisitions

which had neither the right positioning nor the business models of the future for the company (Canal +, Universal Music Group, Universal Studios).

Vivendi almost went bankrupt in 2002 and it took 5 years for it to get back on track financially. Between 2000 and 2018, its annual TSR was negative (- 3% p.a.).

Insufficient developments and inertia

For the last fifteen to twenty years, this strategy is the most representative of the situation of large, diversified Western groups. With no strong choice and no risk taken, value creation for shareholders is weak.

Walmart—1960-2018

For thirty years, Walmart had grown at 28% a year and generated an annual TSR of 30% thanks to the wave of development of modern retail and particularly hypermarkets in the USA, then in Europe, then in the world. In 1995, it was the largest global retailer with revenue of $82 billion.

The group reacted perfectly to the slowing down of the penetration of its concepts in mature countries starting in mid-1990s: international development, especially in China as of 1996; development of online retail in 2000. However, growth in these new areas and geographies with additional revenue of $30 billion in twenty years was insufficient to maintain the group's growth at historical level. It slowed down to 8% per year and the annual TSR for 1995-2017 was 12%.

Due to its size, Walmart's movements were insufficient. To maintain growth of at least 10% per year after 1995, it would have been necessary for it to build a market share of more than 50% in China (today it is 5%) and in emerging Asia, or consolidate Europe through several major acquisitions, or build an online business equivalent to that of Amazon today (it is less than 10% of Amazon's).

This clearly shows the nature of the issues for a leader which has already reached a significant size.

Saint-Gobain—2000-2018

Since 2000, Saint-Gobain's revenue growth has been low (on average 2% p.a.). The same is true for its TSR (on average 1% p.a.).

Between 2000 and 2007, growth was moderate (6% p.a.), mainly driven by the first stage of development in emerging countries (from 7 to 16% of revenue between 2000 and 2007).

Since 2007, the group has not grown and has had a negative annual TSR (- 5%). Positions in emerging countries have not changed significantly (from 16% of revenue in 2007 to 21% in 2017). There was no major diversification of the business portfolio or development of breakthrough technologies likely to significantly improve its positions in its traditional markets.

Regular attention to improving profitability did not offset the lack of major movement and growth.

Siemens—2000-2018

Over the last twenty years, Siemens experienced a first stage of development in emerging Asia between 1998 and 2008 (from 10% of revenue in 1998 to 21% in 2008), with an annual TSR of 11%. However, this progress did not continue between 2008 and 2018 (there was only one additional point in revenue in emerging Asia).

In terms of business portfolio, the group—belatedly—withdrew from its telecom business (merger of consumer fixed and mobile network activities with Nokia in 2007; merger of business telecommunications and network activities with Gores Group in 2008) and its lighting business (sale of Osram in 2012). The group also retained its other businesses without any major change or disruption over the period. The natural evolution of these businesses and their new names (for example, automated industrial systems activities renamed "Digital Factory") did not fundamentally change the structure of the portfolio.

Over the last twenty years, growth has remained slow (2% p.a. since 1998), and so did the TSR (7% per year).

For these three examples, in the absence of significant changes, the TSR level was ensured by regular restructuring and reorganizations and profitability improvements, as well as by the decrease of interest rates. *This cannot be repeated indefinitely. It leads to a dead end.*

What to do?

There is no value creation without ambition, risk taking and strong choices. It is the CEO's role to *make these choices* and it is the role of the board to push them and help them make those choices.

No business is attractive forever. Therefore, creating value for large groups inevitably requires regular and profound changes in the business portfolios.

The more successful these groups have been in their traditional business, the more significant the development in a new business must be to have an impact on the entire group. Portfolio strategies "at the margin" have no value. Paradoxically, changes in the business portfolio are therefore all the more difficult for strong leaders.

A large diversified group must create value beyond the unique value created by each of its businesses. This value is based on its ability to capture growth waves and actively manage its asset portfolio based on these waves. Otherwise, it has no value as a group and ends up breaking up and disappearing, voluntarily under the pressure of its shareholders, or "involuntarily" under the pressure of external investors and competitors with a more ambitious vision for their own shareholders.

The current wave of large American conglomerate break-ups (General Electric, United Technologies, DowDuPont, Honeywell…) after twenty years with no value creation will not be limited to the USA. It will also reach Europe.

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Estin & Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists the management of major European, North American and Asian groups in their growth strategies, as well as private equity funds in the analysis and valuation of their investments.