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The Crux of Corporate Strategy
Building an Advantaged Portfolio

BY MICHAEL ARMSTRONG, JONATHAN GOODMAN AND GAVIN MCTAVISH

One of the central objectives of corporate strategy is for executive management to think holistically about a company's portfolio of businesses—conceiving and spearheading ways to make the aggregate value of a company's holdings durable over time, and greater than the sum of its parts. This vital mission comprises two central questions: In which businesses should we participate? And, how do we create value within and across[1] our businesses? In other words, where will we play and how will we win,[2] at the portfolio level?

Monitor Deloitte has found[3] that the most successful portfolios exhibit three broad characteristics: They are *strategically sound, value-creating and resilient*. Perhaps this seems obvious. But in our experience—maybe because it requires consideration and testing across a wide range of attributes—companies seldom apply this tripartite "Advantaged Portfolio" approach.

In this white paper, we explore the characteristics of an Advantaged Portfolio and the trio of attributes that constitute each (figure 1). These attributes in aggregate are needed to fully assess, assemble and maintain a top-performing corporate portfolio. A company may need to include additional company-specific criteria to meet its specific goals and aspirations,[4] and the specific weighting of attributes will vary by company. But the nine attributes noted in figure 1 are "default" criteria that will be relevant in a wide range of portfolio contexts.

Executives, academics and consultants have devised numerous frameworks for building and sustaining the optimal corporate portfolio. Our experience suggests that any successful portfolio design framework (as distinct from the portfolio itself) has to have three important features. To begin with, the portfolio framework must be **multi-dimensional** in its criteria, because portfolio evaluation and construction cannot solely be reduced to a simple 2 x 2 matrix; it must focus on the performance of the **portfolio as a system**, i.e., how the parts interact, and not just on the individual components; and it must be **tailorable** to the company in question, since each company has different goals and aspirations. Advantaged Portfolios is a framework designed to meet these criteria.

Figure 1: Characteristics of an Advantaged Portfolio

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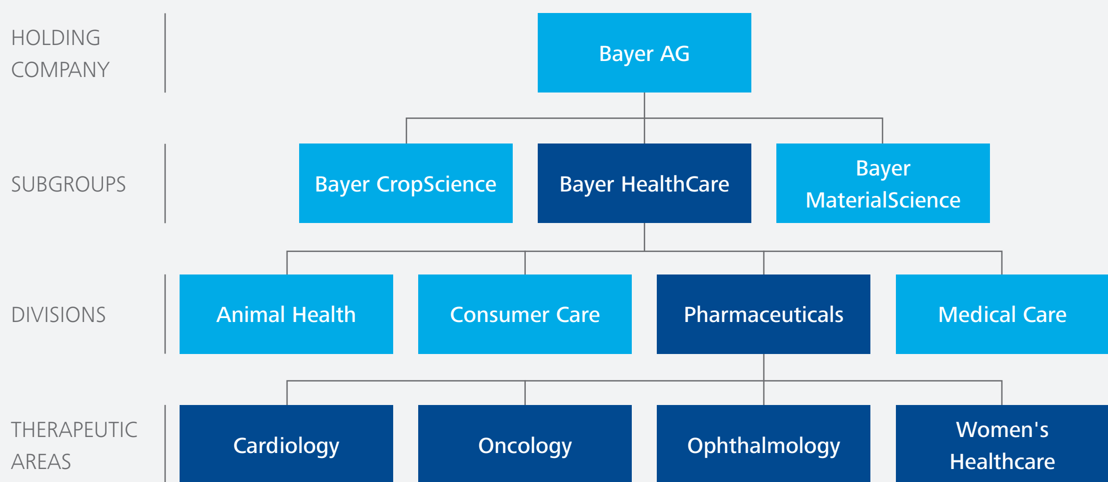
What Is a Portfolio?

In the context of strategy, a portfolio is the collection of businesses that an organization chooses to own or invest in. In a corporate-level portfolio, the unit of analysis is the "strategically distinct business" (SDB). SDBs have distinct competitors, bases of competition or geographies. SDBs may or may not correspond to a company's organizational business units or reporting units. But portfolios can exist at multiple levels within a company—not just at the corporate level. For example, they can exist within a business unit, a division or even a product line. See the example of Bayer AG and its multiple sets of portfolios in figure 2.[5] The right unit of analysis for a portfolio will change based on the level of the portfolio being assessed.

Figure 2: Portfolios Can Exist at Multiple Levels of an Organization



"We are divesting {Shell Petroleum Development Company of Nigeria} because of the wish to focus on areas of competitive advantage that are aligned with our strategy. We're not divesting because we need to. It's not a question of needing the cash . . . we're not in some kind of fire sale or need to act mode. But we are consistently upgrading our portfolio and recycling cash and value back into areas where we believe we're more competitively positioned."[6]

—Simon Henry, Chief Financial Officer, Royal Dutch Shell

An Advantaged Portfolio Is Strategically Sound

Advantaged Portfolios first and foremost must be strategically sound. That means they must foster a strong competitive position, support multiple levels of innovation, and create synergy.

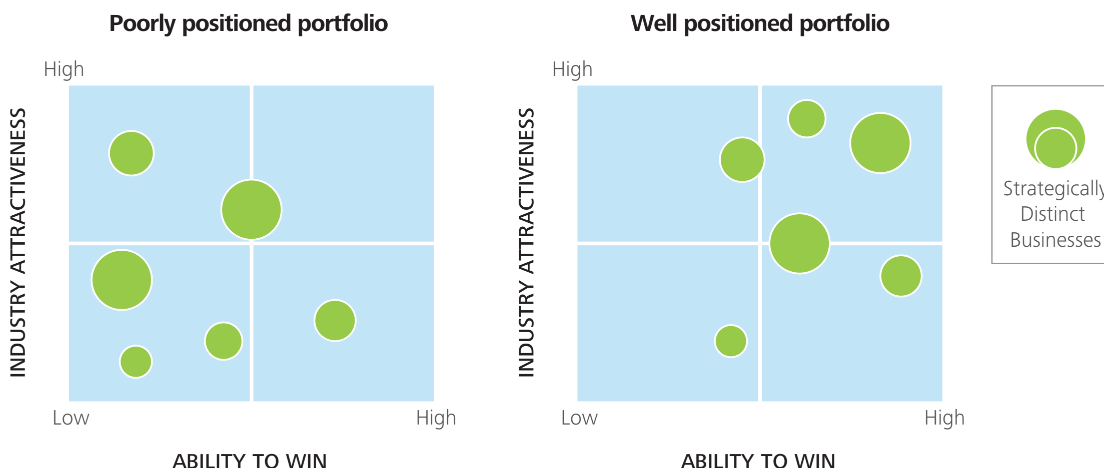
Competitively Positioned

When a portfolio is competitively positioned, its businesses in aggregate participate in more structurally attractive markets and can win in their chosen markets. Even in the context of blurring industry boundaries, the concept and applicability of structural attractiveness endures. As well defined by Michael Porter, industry attractiveness is a function of five forces: competitive rivalry, the bargaining power of buyers and suppliers, the threat of new entrants, and the threat of substitution.[7] The simple fact is that some industries or segments are more likely to support higher returns over time than others.[8] Of course, a company realizes the potential of any industry or segment by winning—i.e., being better than competitors at both creating and capturing value for customers.

Thus, an ideal portfolio is weighted in favor of structurally attractive markets in which the company has a proven ability to win (see figure 3). Portfolios that are more widely distributed—or worse, weighted toward structurally unattractive markets with no (or no enduring) advantage—are far less likely to produce attractive returns over time.

In their recent book *Playing To Win*, A.G. Lafley and Roger Martin set out a clear and pragmatic strategic framework based on the Strategic Choice Cascade, a proven approach to addressing strategy as a set of five inter-related questions, including: Where will an organization play? And, how will they win? The framework was developed over 20 years by strategy consulting firm Monitor Group and used by hundreds of organizations. It provides a powerful approach to thinking about strategic choice and action.

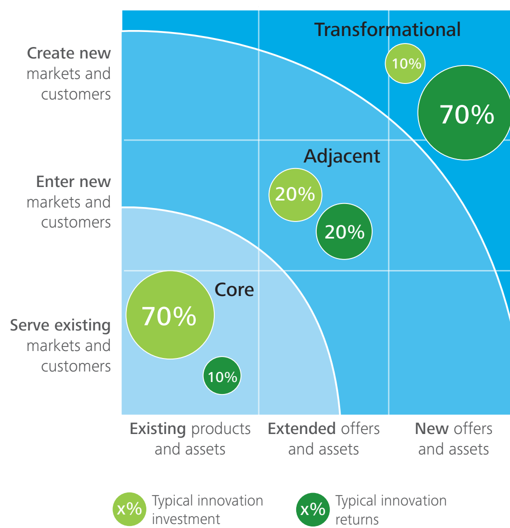
Figure 3: Competitive Position Matrix



Balances Innovation

To be strategically sound, portfolios must also reflect an appropriate blend of innovation opportunities. The idea is to sow the seeds for growth across various time horizons (short, medium, and long-term) and various levels of risk and reward in line with a company's ambition and risk tolerance. As shown in figure 4, innovation opportunities can be classified as core, adjacent or transformational, depending upon how far they diverge from existing offerings and customer base. A "core innovation" is an incremental improvement to an existing product targeted at existing customers. A "transformational innovation" is an initiative focused on offering new products to new customers or to serve needs that have never been expressed.

Figure 4: The Innovation Ambition Matrix and Associated Returns on Innovation Investment



There is a "Golden Ratio" for allocating innovation investments. According to Monitor Deloitte research published in the *Harvard Business Review*,[9] companies that allocated about 70 percent of their innovation activity to core initiatives, 20 percent to adjacent initiatives, and 10 percent to transformational initiatives outperformed their peers—typically realizing a P/E premium of 10 to 20 percent. The ratio is an average across industries and geographies and the right balance will vary by company. A technology company, for example, likely will find a greater investment in adjacent and transformational innovations to be optimal.

Interestingly, the same research data show that the ratio of returns on investment is roughly the inverse of the ideal investment allocation: core innovations typically generate 10 percent of the returns on innovation investment, adjacent efforts generate 20 percent and transformational generate 70 percent.

An Advantaged Portfolio will support a spread of innovation initiatives across core, adjacent and transformational horizons, consistent with the degree of threat and opportunity presented by disruptive technologies, disruptive business models, or competitive activity in the industries represented in the portfolio. In so doing, the portfolio will typically improve the competitiveness of the enterprise in the short, medium and longer terms.

> "Given the time and investment it takes to create a transformative innovation, we are always working on multiple ideas at any point in time. {Procter & Gamble's} Gillette organization is masterful at managing S-curves in blades and razors. As one transformative platform is being launched, the next two platforms are already being designed. In between new platforms their innovations extend the advantages and build on Gillette's outstanding equity."[10]
>
> —**Kathleen Fish, Chief Innovation Officer, Procter & Gamble**

Creates Synergy

Synergy is a well-worn term that is all too often used to justify acquisitions or the presumed soundness of an existing corporate portfolio. But for a corporate entity to create value over time, it must add value above and beyond that which could simply be created (and captured) within its existing stand-alone businesses. In other words, the value of the whole must be greater than the sum of the parts. In this context, Advantaged Portfolios create, support or reinforce synergy across at least one of the following four dimensions (and often across several):

- *Management-oversight synergies* are created by using enhanced management processes and skills in the corporate center to boost the top line or reduce costs across the SDBs. Examples include sophisticated target and incentive setting; exemplary training and recruitment; and superior treasury and capital allocation processes.
- *Horizontal synergies* are produced in two ways: applying valuable assets and capabilities resident in one business to other businesses in the portfolio, or combining assets and capabilities in different businesses to create new value. Examples include joint purchasing, joint R&D, brand extensions, and sharing best practices.
- *Downward synergies* come from leveraging the parent company's assets in the business units. Examples include access to the parent's balance sheet, extending the parent brand to the BUs; and access to parent networks and relationships.
- *Portfolio system synergies* refer to the value created when a portfolio's parts interact with each other as a system. Examples might include combining countercyclical businesses to dampen excessive volatility or vertically integrating key operations to address failed supply or demand markets.

Articulating the synergies in a portfolio is not only necessary when designing a new portfolio. It is increasingly important for day-to-day portfolio management as shareholders, and activist investors in particular, ratchet up the pressure on public companies. In many cases of shareholder activism, the portfolio's composition is at issue.[11] Management must be able to explain clearly and concisely why the company's various businesses create more value together than apart.

> "Synergies are not only about cost reduction. Synergies can be access to markets, exchange of products, avoiding overlaps, and exchange of best practices."[12]
>
> —Carlos Ghosn, Chief Executive Officer and Chairman, Renault Nissan

An Advantaged Portfolio Is Value-Creating

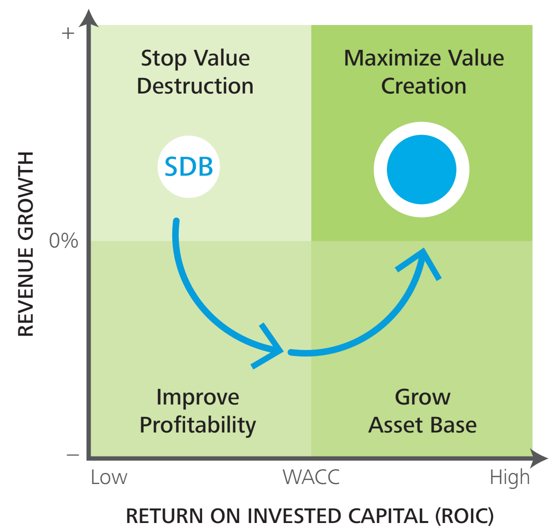
The second core characteristic of an Advantaged Portfolio is that it creates more value than alternative portfolio options. But that value must be viewed through three lenses to provide a clear picture: **intrinsic value, capital markets value**, and the **value of the assets to other owners**. Focusing on any one to the exclusion of the others risks overlooking value-creation opportunities, if not destroying value outright. A company must consider and balance all three.

Maximizes Intrinsic Value

Intrinsic value is best represented by the risk-adjusted cash flows (net of investments) a corporation's existing (and expected future) businesses produce, and is best measured by discounted cash flow (DCF) analysis. An Advantaged Portfolio is simply one whose intrinsic value is greater than that of competing portfolio options, all other things being equal.[13] Moreover, value is created over time by improving intrinsic value—whether by increasing returns on existing capital employed, consistently investing new capital to generate returns that exceed a company's cost of capital, or by releasing unproductive capital. Hence an Advantaged Portfolio is one that lends itself to increasing intrinsic value—which, typically, is more likely if the portfolio in aggregate is competitively positioned (as described earlier).

As with any attribute of an Advantaged Portfolio, maximizing intrinsic value starts with evaluating the current portfolio's performance. This involves assessing where value is being created or destroyed within the portfolio, which requires looking at the two critical drivers of intrinsic value: the **revenue growth** and **return on invested capital** (ROIC) of each component business.

Figure 5: Intrinsic Value Creation



This is a critical step in forming preliminary views on how to treat each business going forward: Should we reduce investment or increase it? Do we need to fix performance first? (see figure 5). The second, and more difficult step of maximizing intrinsic value comes in constructing the new portfolio. Management must conceive different portfolio options, estimate and aggregate the cash flows of each component business, and layer in *both the synergies and dis-synergies inherent in each option*. For instance, what is the value of cross-selling Business 1 products into Business 2? What input cost synergies can we get from combining procurement activities across businesses? What are the tax implications if we exit Business 3? An Advantaged Portfolio maximizes these aggregate cash flows.

> "Intrinsic value [is] an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life."[14]
>
> —**Warren Buffet, Chief Executive Officer, Berkshire Hathaway**

> "As separate publicly traded entities, each company should benefit from enhanced management focus, more efficient capitalization and increased financial transparency. In addition, shareholders will have a more targeted investment opportunity, and incentives for management and employees will be more closely aligned with company performance and shareholder interests. Given these advantages, we are confident that this transaction will enable Brink's Home Security (BHS) and Brink's, Inc. to more quickly realize the valuations they deserve."[15]

—**Michael Dan, Chairman, President and Chief Executive Officer, The Brink's Company in discussing the pending separation of his two businesses**

One of the mistakes we see all too often in public companies is excessive management focus on how investors value the portfolio. While a company must address the current market value of a portfolio in certain circumstances (which we describe below), it will maximize long-term shareholder value through a ruthless focus on enhancing intrinsic value—i.e., the present value of expected future cash flows.

Addresses Capital Markets

As already noted, intrinsic (DCF) value should be the primary metric for assessing the value of a portfolio and different portfolio options. However, market value cannot, and should not, be ignored; it can be as important as intrinsic value in certain circumstances. In theory, market value (driven by market expectations) should align with intrinsic value. In practice, the two measures of value can diverge at a given moment for reasons not related to business performance. For example, a bidding war in a consolidating sector may cause a listed company's equity to trade above its intrinsic value. Conversely, a large-bloc shareholding in the company that constrains trading liquidity may drive down the share price. In such cases where intrinsic and market values diverge, a company may have to (or wish to) make changes to its portfolio that it would not otherwise make.

A significant under-valuation of a business in the capital markets can actually hurt intrinsic value (e.g., by reducing financing options) and in extreme cases can jeopardize a company's independence (e.g., by increasing exposure to a hostile bid). Similarly, if management believes a firm's equity is over-valued in the market, the firm might consider using that valuable equity currency to fund acquisitions that it otherwise might not make. Such over- and under-valuations often occur when the portfolio contains businesses that trade at markedly different multiples. In these cases, portfolio moves may be warranted due to changes in market values, despite no change in underlying cash flows and associated intrinsic value. An Advantaged Portfolio is guided by intrinsic value creation but is not blind to the threats or opportunities created by the capital markets.

Finds the Right Owner

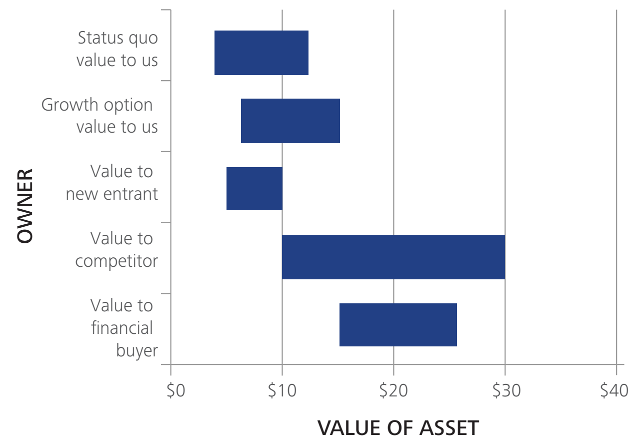
When management identifies the option that both maximizes intrinsic value and addresses capital markets pressures, value will be maximized, right? Not so fast.

Even if a portfolio owner is creating significant intrinsic value for a business, the owner may not be creating as much value as another owner could. A financial buyer might be able to extract more value from the same assets through leverage and financial engineering. A competitor might have an adjacent business through which it could create synergies the current owner cannot. In such cases, the current owner should consider selling the under-exploited business for full value to the value-maximizing party, sometimes called the "natural owner." The proceeds could then be paid out to investors or re-invested into higher-potential businesses—businesses for which the company is truly the value-maximizing owner.

Slow-growth, cash-generative businesses used to be seen as necessary sources of financing for higher-growth businesses in the portfolio. However, with the rise of private equity and other specialized market players, the capital markets have created multiple means of monetizing these "cash cows," often for even greater value than the current owner could generate from the asset. Unless capital markets are particularly tight and financing and M&A are constrained, companies should not feel compelled to keep a business unit just because it generates cash. Generating cash by selling an asset may in fact be the best way to maximize value.

As executives evaluate or redesign their portfolios, they should consider the potential stand-alone value of each business to different potential buyers and compare those values to the intrinsic value of keeping the business within the portfolio, as illustrated in figure 6. On balance, over time, an Advantaged Portfolio will consist of assets for which the current owner is the value-maximizing owner.

Figure 6: Assessing the value of an asset to different owners



"We are trying to be as intellectually honest as we can with ourselves and look at each operation on a present value basis. And just as [CEO Joe Quarin] has said repeatedly, if we are not the best owners, find out who is."[16]

—Ian Kidson, Executive Vice President and Chief Financial Officer, Progressive Waste Solutions

An Advantaged Portfolio Is Resilient

An Advantaged Portfolio is not only strategically sound and value-creating, it is also resilient. In our experience, matters of risk and resilience are among the most overlooked, and least understood, dimensions of portfolio evaluation and design. However, they also are among the most important. Three attributes define resilience.

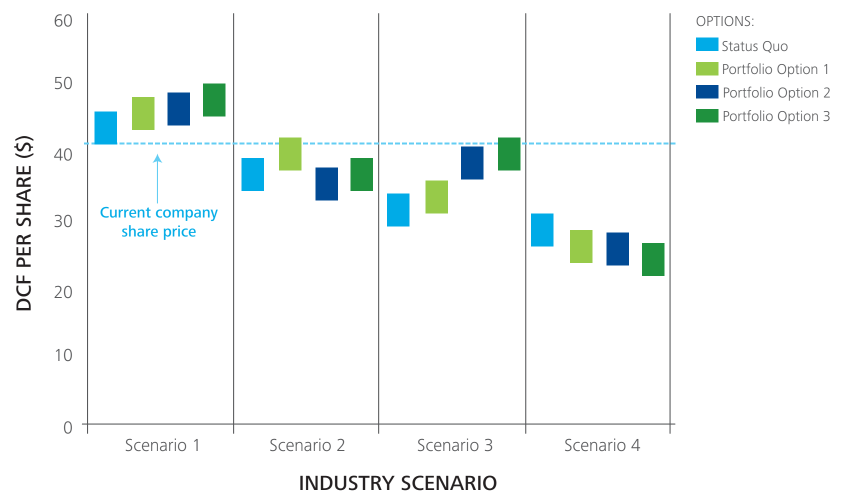
Survives Scenarios

We live and operate today in a period of great change and uncertainty. With shifting economic conditions and the possible consequences of massive disruptive technologies, no one can be certain how customer needs, competitive dynamics, or industry boundaries might change. In some instances, executives deny uncertainty; in others, they become paralyzed by it. The trick is to confront uncertainty, especially when assessing and designing corporate portfolios. In this context, an Advantaged Portfolio is one that—in aggregate—is more likely to perform well in a variety of different, plausible, future environments, not just one that might reflect an executive team's official future.[17]

Best-practice companies use scenarios to stress-test the performance and risk of individual businesses and portfolios overall. Scenarios go beyond simple sensitivity analyses (for example, deviations of 5 to 10 percent from some base-case forecast). They describe coherent stories about how the relevant macro environment might evolve very differently five, 10 or 15 years in the future, and illustrate the potential consequences for industry dynamics and boundaries, customer interactions, or the winning business models.

Ideally, a company will create a number of scenarios and portfolio options, and will evaluate the likely value of the options in each scenario. Consider the example in figure 7. In this instance, the status quo option appears to do well in only one of the scenarios (Scenario 4). It thus is less robust than Option 3, which does well in two. Scenarios not only serve an evaluative purpose. They also play a creative role, helping companies to generate novel strategies and portfolio options.

Figure 7: Discounted Cash Flow Value of Strategic Options by Scenario



> "We're testing our portfolio under different scenarios and . . . we'll see that we have a resilient portfolio with flexibility to adapt if circumstances warrant. Now some things might change, but here's what's not going to change. We're going to allocate capital prudently. We'll continue to migrate our portfolio to a lower cost of supply. We'll maintain capital and financial flexibility and we'll pay our shareholders first."[18]

—Ryan Lance, Chairman and Chief Executive Officer, ConocoPhillips

Builds Optionality

Executives tend to think their strategies' success hinges largely on a particular event (availability of an acquisition target; passage of a law; successful test of a technology, etc.). However, these events may not happen for some time (if at all), and their final form or effects might be less desirable than what the company had hoped. Moreover, as described earlier, significant uncertainty is pervasive – across industries and geographies. An Advantaged Portfolio prudently builds optionality into its portfolio choices, thus enabling multiple potential routes to value in the future. Several tools can help create such optionality:

- *Stage-gating*: mapping strategic choices a company will have to make as various industry events occur or fail to occur ("if/ then");
- *Defining transaction pathways*: mapping alternative deal sequences a company could pursue depending on the success or failure of specific desired acquisitions; and
- *Identifying trend triggers*: identifying the leading indicators of critical trends so a company can dynamically adjust a portfolio over time

It might be asked whether building optionality runs afoul of the idea of commitment – the idea that you should choose one path rather than many, and do the one thing well. In this case, the answer is no, because the optionality we are dealing with here is different. Optionality in the Advantaged Portfolio sense involves hewing to one path that has many forks, and taking one of those forks when a defined event occurs. It keeps a company on one path at a time, preventing it from "letting a thousand flowers bloom" with the attendant costs of watering them all.

Weighs Feasibility and Risk

Ultimately, considering, constructing and refining a corporate portfolio is an exercise in weighing feasibility and risk. Feasibility addresses the challenges of constructing a new portfolio. Can we finance it? Does management have the bandwidth to create it? Are there targets available with the assets we need? Risk addresses the potential for unfavorable developments once the portfolio is created. Will competitors launch a counter-measure? How much does the portfolio depend on the success of a new technology? Will the regulatory environment change? The portfolio of today, indicative of a company's current strategy, constitutes a certain risk profile. Alternative portfolio options present different risk profiles in both the nature and magnitude of risk. An Advantaged Portfolio is one whose feasibility and risk are more attractive than alternative portfolios, given the company's ambition and risk appetite.

In this respect, a company should be comprehensive in considering the types of feasibility and risk (see figure 8 below), recognizing many executive teams tend to underestimate the risk of the status quo and overestimate the risk of doing (or in this case, constructing) something different.[19]

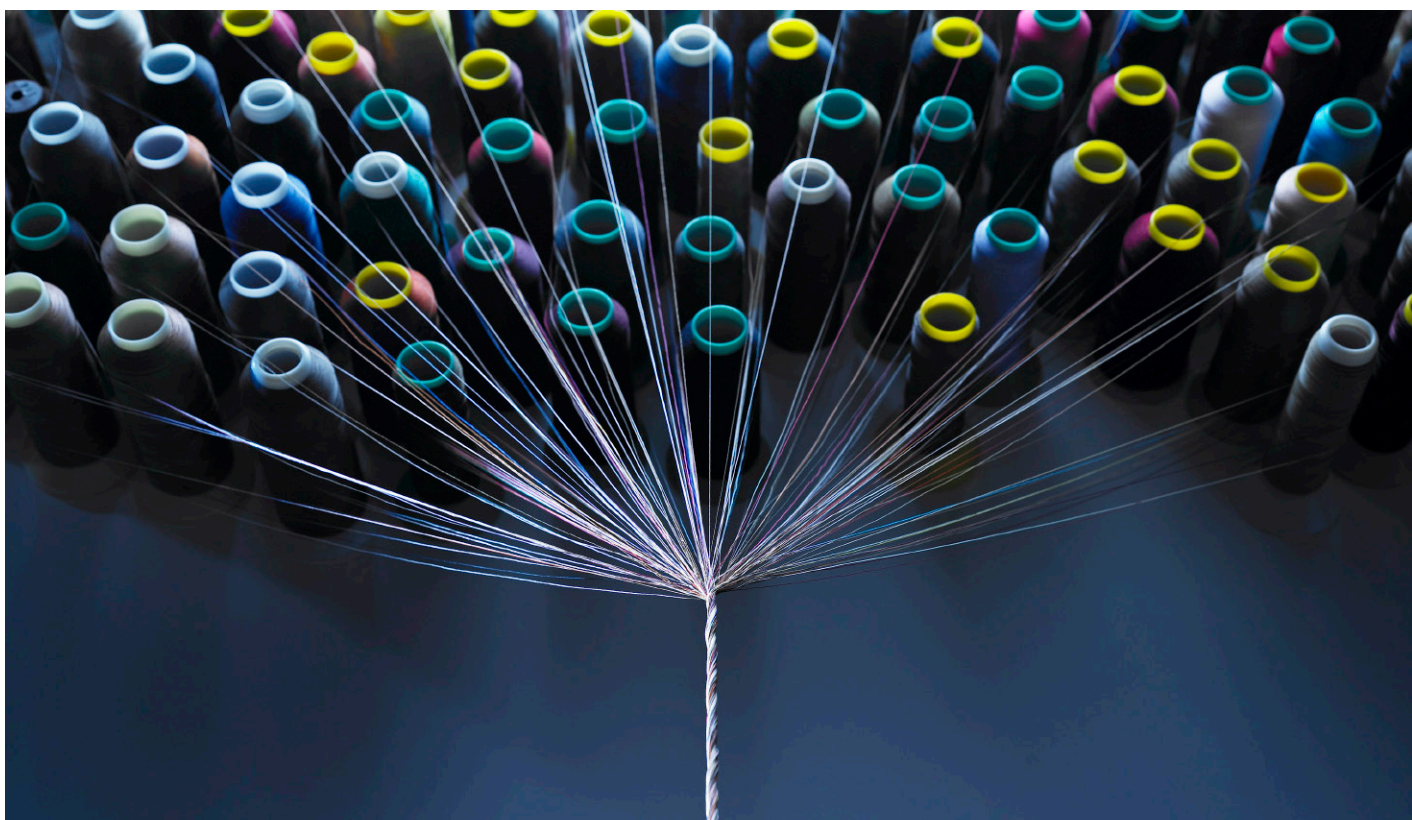
Figure 8: Sample Risk-Assessment Framework

SAMPLE DIMENSIONS	PORTFOLIO OPTION X	PORTFOLIO OPTION Y
FEASIBILITY (PRE-BUILD)		
Ability to Finance	HIGH	LOW
Availability of Targets	MED	MED
Antitrust Feasibility	HIGH	LOW
Management Executability	HIGH	HIGH
RISK (POST-BUILD)		
Competitive Reaction	LOW	LOW
Technology Risk	MED	MED
Regulatory Risk	HIGH	HIGH
Capital Markets Reaction	MED	HIGH
M&A Integration	LOW	LOW
Macroeconomic Risk	MED	LOW

> "I can't take the risk of choosing the 'double down in the core' portfolio or a 'step-out' portfolio today. I need to know whether I can get the necessary deals done for each before I commit one way or the other. I need the option to go either way depending on what we learn."
>
> —Chief Executive Officer, electronic materials company

Importantly, a company must address feasibility and risk both at the component and the portfolio or system levels. For instance, the component parts of the portfolio may be executable individually, but may not be manageable in aggregate. Portfolio-level risks are not always, however, simply an aggregation of individual risks. Aggregate portfolio risk, for example, can be lower than the individual risk levels of the BUs, if the BU profit curves are counter-cyclical or uncorrelated in nature and effectively "smooth" the aggregate portfolio's profit performance.

> "We manage our business as a portfolio and believe we are positioned very well to invest, innovate and balance risk with performance during any economic environment. This balance gives us a competitive advantage especially during times when markets are in transition or seeing slower growth."[20]
>
> **John T. Chambers, Chairman and Chief Executive officer, Cisco Systems**



A Case in Point: Disney

Disney is a notable example of a company in which successive generations of executive management (starting from Roy Disney himself) have carefully considered, constructed and nurtured an Advantaged Portfolio. Leveraging its historic core capabilities in character-development and animation, Disney has built very successful positions in five related businesses: animation, parks and resorts, cable channels, consumer products, and interactive media. Its portfolio is strategically sound—most of its five business units are among the leaders in their industry, and they are knitted together with clear synergies. For example, its animated characters populate its theme parks, media networks and merchandise. And two recent acquisitions—Marvel and LucasFilm[21]—have not only advanced these cross-BU synergies, but have reinvigorated the company's innovation engine by injecting new characters and storylines. Disney's portfolio is also value-creating, which the capital markets have recognized. In the past five years,[22] in fact, its share price has risen more than twice as fast as the S&P 500.[23] Impressively, it has done so in a stable and consistent fashion over that period, demonstrating a great degree of resilience.

Conclusion

An Advantaged Portfolio of businesses—one that is strategically sound, value-generating, and resilient—is at the heart of every successful company. The nine attributes we discussed illustrate what an Advantaged Portfolio looks like, at least at the most basic level for a typical company. They can serve as a valuable guide for executives in their ongoing work to define the businesses in which they should participate and the ways in which they create value within and across their businesses.

Of course, building an "Advantaged" portfolio is not easy. It is not a matter of assessing things on just two or three dimensions. It is not simply a matter of evaluating the strength of individual businesses. Nor is it an arithmetic or algorithmic exercise or a matter of applying a rigid set of criteria to all companies.

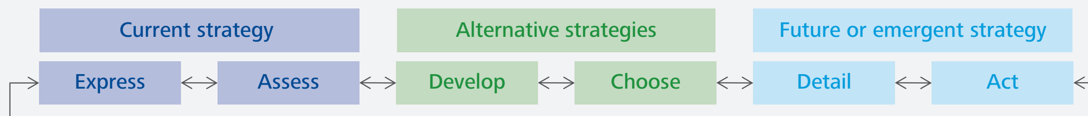
In reality, developing an Advantaged Portfolio is more about creativity and optimization than linear calculation. It requires viewing portfolio options through a wide array of lenses, as well as evaluating both individual and system effects. And it requires using criteria tailored to the company at hand. Most of all, however, designing advantaged portfolios requires hard work: the hard work of wrestling with data, making trade-offs, and making tough choices. In fact, in our view, management must be prepared to hold challenging, data-rich, iterative discussions about what to do (as well as what not to do) when creating an Advantaged Portfolio. Because at the end of the day, good strategy is all about choices. And making the right choices is fundamental to sustaining growth and competitive advantage over the long term.

The Process of Building an Advantaged Portfolio

Thus far we have focused on describing the characteristics of an Advantaged Portfolio to answer the question, *what does it look like once I get there?* The next obvious question, though, is *how do I get there?*

The short answer is that there is a well-defined process for creating an Advantaged Portfolio, and we call it StrategybyDesign™. This portfolio-shaping process encompasses three major stages (see figure 9): expressing or assessing a company's current portfolio strategy; developing and choosing among alternative portfolio options; and finally, detailing and acting on the future strategy and its associated execution and change management requirements.

Figure 9: The StrategybyDesign™ Process



The key to using this process effectively is to tailor it to the needs of the company at that particular point in time. Some companies need help simply articulating or expressing their portfolio strategy so management can align around it. Others need help assessing whether their current portfolio actually works and will continue to work in the future. Some need help generating options or choosing from among an already-agreed set of options. Others may just need help getting traction on a portfolio strategy they have already agreed to. And still others may need to work through the process from end to end. The best counsel on process is for executives to figure out where the company might be getting stuck across this spectrum of steps, and customize the portfolio-design process accordingly.

References

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2. See, for example, A.G. Lafley and Roger Martin, Playing to Win (Massachusetts: Harvard Business School Publishing, 2013). This book outlines Monitor Deloitte's approach to strategy definition and expression.
3. Through our experience over three decades with hundreds of multi-business entities globally whether they be public, private, family-controlled or state owned enterprises.
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11. In a recent survey of activists and corporations, respondents identified ten catalysts of shareholder activism, four of which are linked to portfolio configuration: acquisition announcements, strategic/ operational changes; asset sales, and spin-offs. Schulte Roth & Zabel LLP and Mergermarket, Shareholder Activism Insight, 2014.
12. "In Interview, Ghosn Mulls 'Prize' In Possible Alliance With GM," *Wall Street Journal*. July 13, 2006. http://online.wsj.com/articles/SB115282069310906058, accessed March 18, 2015.
13. Remember that risk needs to be factored into these cash flows. This is done in two ways: 1) through the use of the weighted average cost of capital (WACC), which reflects the "systematic" or inherent risk of the industries in which a company plays; and 2) through the use of probability-weighted forecasts reflecting the company-specific risks of the future cash flows. Risk also needs to be addressed in a more qualitative fashion, as explained in the section on Resilience.
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About the Authors

Mike Armstrong
Director, Monitor Deloitte
Deloitte Consulting LLP
mikearmstrong@deloitte.com

Michael is a director in the Strategy practice of Deloitte Consulting LLP. Prior to joining the firm, he was a partner of Monitor Group and chief executive of the firm's M&A advisory practice. He has worked on a variety of corporate strategy projects and inorganic growth mandates across a range of industries including heavy industry, specialty chemicals, life sciences, and consumer durables.

Michael had previous careers as a lawyer and investment banker. As a banker he worked on a variety of M&A mandates including acquisitions, hostile takeovers, private company divestitures, portfolio analysis, and private placements. Client industries ranged from mining to consumer goods to high-tech. He began his career as a corporate attorney with a large national law firm, focusing on M&A, securities law and financial restructurings.

Michael received his B.A. and law degree (J.D.) from the University of Toronto and an MBA from INSEAD in Fontainebleau, France.

Jonathan Goodman
Partner and Vice Chair, Deloitte Canada
Global Leader of Corporate and Business Unit Strategy, Monitor Deloitte
jwgoodman@deloitte.ca

Jonathan is Monitor Deloitte's global leader for corporate and business unit strategy. He is also vice chair of Deloitte Canada and national practice co-leader of Monitor Deloitte in Canada. Jonathan was formerly a senior partner of Monitor Group where he most recently was head of the firm's global strategy practice and co-chair of Monitor Canada. In his time in consulting, Jonathan has worked closely with executive management at a variety of global corporations to develop business unit and corporate strategies, evaluate and implement M&A opportunities, create alignment of vision through organizational strategy, and to develop and execute value-creation programs.

Jonathan received his Honors B.A from York University and an MBA from the Harvard Graduate School of Business Administration.

Gavin McTavish
Senior Manager, Deloitte Canada
Corporate Strategy Lead, Monitor Deloitte Canada
gmctavish@deloitte.ca

Gavin began his strategic advisory career over a decade ago and has travelled the globe helping clients develop winning strategies. He is corporate strategy lead in Monitor Deloitte Canada and actively involved in client-facing project delivery and thought leadership development for the practice. Gavin advises clients in corporate and growth strategy, managing through uncertainty (scenario planning) and market entry, across multiple industries. Aside from his work as a strategic advisor, Gavin is also an accomplished entrepreneur, having successfully led a distributed solar generation company. Gavin graduated with distinction from the Richard Ivey School of Business.

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