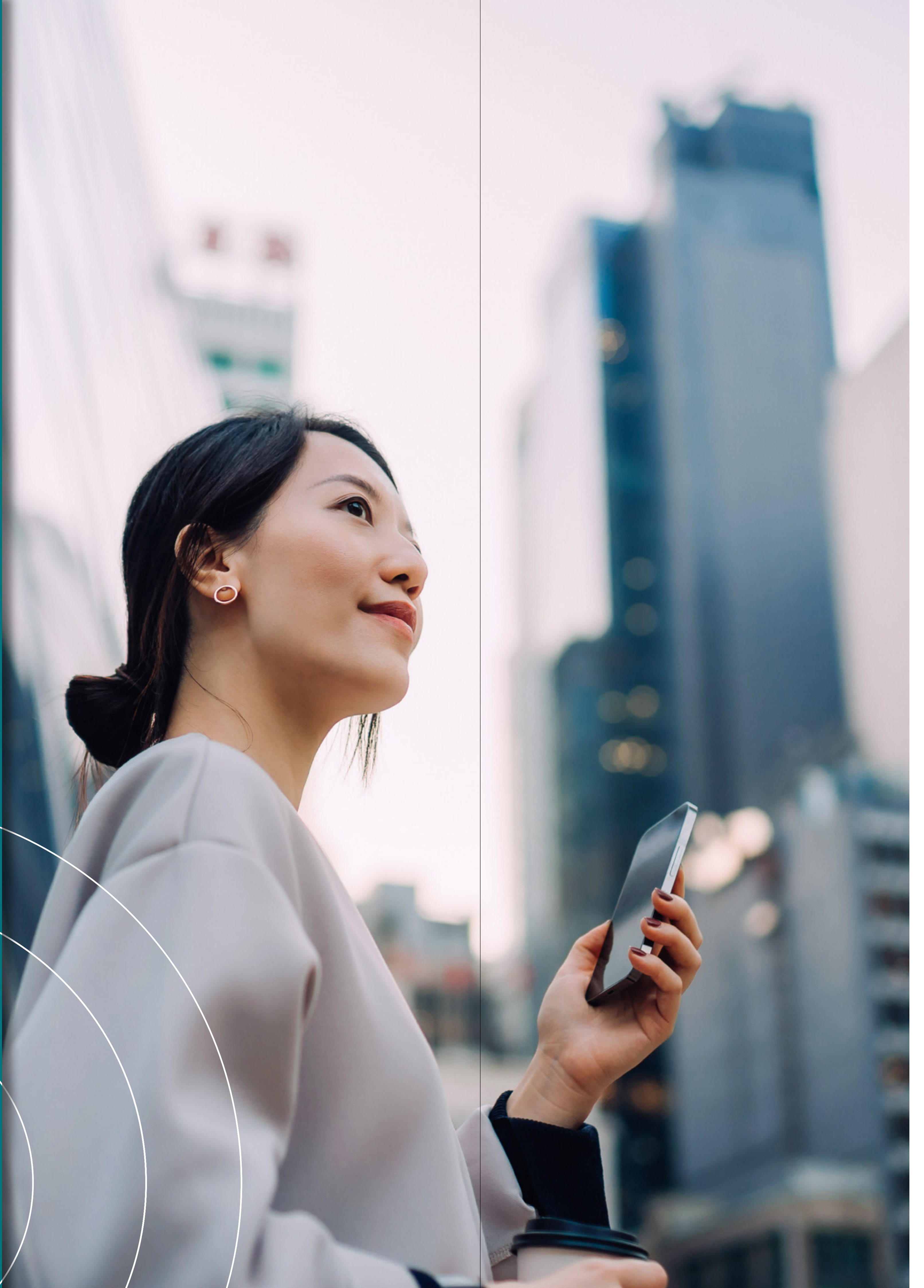
1. Active portfolio management and capital efficiency



Looking around the post-COVID world, it is clear that we are in very different territory than before. Dislocation of marketplaces and trade lanes; rebalancing of energy markets in response to ongoing global conflicts; the rising cost of capital; economic patriotism impacting investment in critical sectors; the recalibration of the Chinese growth story – all these factors and more are profoundly impacting economies and sectors in ways that companies cannot ignore. Globally, and in Asia Pacific in particular, these forces are exerting significant and intensifying pressure on companies to review and adjust their portfolios.

Thriving – and, in many cases, simply surviving – in these new conditions will be defined by companies' ability to develop two key capabilities: resilience, through which they secure their foundations; and transformative growth, where they are able to reinvent their businesses to drive market leadership to ultimately create long term shareholder value. Central to developing these capabilities is the adoption of a more active portfolio-review mindset, where assets are regularly assessed for their fit, cost and contribution to the company's overall strategy. Those that are likely to deliver a competitive advantage are retained, while those that are deemed non-core to future growth or generate marginal returns on capital should be lined up for some form of portfolio rebalancing.

Regardless of approach, it is most important that companies make decisions and act on rebalancing, to prioritise capital to where they can generate greatest returns, as not acting can lead to a spectrum of unfavourable outcomes including missed opportunities that can go unnoticed, through to shareholder activism or takeover where value is transferred away form existing shareholders to the acquirer.

Our portfolio rebalancing survey reveals that 59% of companies in Asia Pacific now review their portfolio holdings at least twice a year, up from 46% globally in 2022. As well as being good corporate practice, active portfolio management is a valuable strategy for addressing the new pressures now facing companies in the region:

Creating or preserving shareholder value

There is always an opportunity cost for companies that have capital tied up in underperforming or non-core businesses they are holding and continue to hold in the hope that they will turn them around. When the 'repair' cost (the investment required to achieve that turnaround) is greater than the price they can achieve by selling it, then it is better to let it go. Persisting with a business as if it is still a good fit, or worse, investing valuable resources to rectify it, leads to value depletion and erosion of shareholder value.

Navigating geo-political realities

While geo-political tensions are always a factor, we are experiencing a period of unusual volatility and this is inevitably impacting board rooms; forcing companies to make portfolio rebalancing decisions at short notice. In the last few years, we have seen upheaval in the energy markets and a mass exodus of Western brands from Russia, following significant political and public pressure over the Russia's invasion of Ukraine, while ongoing tensions between the US and China are leading many brands to consider rebuilding their supply chains in other Asian markets. Companies with an active approach to portfolio review are significantly better prepared to manage the cost and impact of any sudden strategic adjustments driven by geo-political pressures.

Adjusting to regulatory pressures

Corporate governance in Asia Pacific companies lags behind best-in-class practices and, in a bid to drive improvement, many governments are introducing new regulations. For example, authorities in Japan and Korea are targeting listed companies with a price-to-book ratio of less than one (i.e. with a valuation that is less than sum of company's parts). This may lead to a wave of portfolio rationalisation and rebalancing or shutdown of underperforming businesses. This effect may be further amplified by the attention of activist funds piling on additional pressure on such companies to divest assets, and deliver greater shareholder value.

At the same time, competition regulators across the major regions are raising the bar for the approval of mergers and acquisition (M&A) deals, forcing buyers to divest assets in order to secure approval for a deal. For example, Asiana Airlines had to sell its cargo business to win approval from 'the European Union (EU) to acquire Korean Airlines.

Disruption from exponential technologies

The march of technology disruption is relentless. In the previous wave, the digital revolution upended the business models of many traditional companies, particularly in the traditional media and retail sectors, leading to many fire sales of assets. We are facing a new revolution, this time driven by the emergence and rapid proliferation of Gen AI and similar AI-enabled technologies. Companies need to consider the impact of such disruptions on their business models and take measures to realign their portfolios to embrace change. Again, those with an active portfolio review mindset will be best placed to achieve this efficiently and gain any first-mover advantages.

Engaging private equity

Private equity (PE) firms have long been a major force in the M&A market in Europe and the US, and they are now playing an increasingly important role in the Asia Pacific markets. Together with private debt capital, private equity firms are sitting on an estimated US$4 trillion of dry powder – capital that they are under pressure to deploy. Private equity firms are now actively on the hunt for carve-out assets across Asia Pacific. Our survey revealed that 26% of respondents divested to private equity in their most recent divestiture.

In chapter 3 *'Alternate deal structures and private equity'*, we explore in detail the evolving role of private equity firms in the region but suffice to say that their cash on hand, relative agility and non-competitor status makes a compelling proposition for companies in a hurry to divest non-core assets. For Asian companies reluctant to close the book on once-cherished businesses or unwilling to accept the reputational hit associated with divestment, private equity firms also offer the tantalising prospect of alternative exits.

While private equity firms are typically buyout engines, in Asia Pacific, they are adopting innovative strategies including JVs and partnerships in which they are willing to take a minority stake alongside the parent company and use their distinctive skills to create value from non-core business divisions and share the benefits. Blackstone recently took a majority stake in Sony Payments from Sony Bank and will partner with Sony Bank to co-invest and drive growth in the payments business. Companies should take note of this trend and consider such opportunities, preferably as early as possible.

The rise of activism in Asia

As we've already mentioned, companies also need to factor in the rise of activism in Asia – a feature that now looks set to stay. Activist funds often target cash-rich low-profit businesses, those with weak governance structures and those with conglomerate discount and then agitate for the break-up or divestment of certain portfolios. HSBC was part of a long-running campaign by Ping An to break up and even though the HSBC board won, it came at the compromise of divesting its Canadian retail business.

ESG and the road to net zero

Many companies are already re-examining their existing businesses through an ESG lens and identifying problematic assets to divest or wind down. Those that are not will have to step in line soon; the investor, workforce and media pressure to decarbonise, to tread lightly and employ well, is intensifying around the world, including in Asia Pacific. This is particularly the case in the energy sector, where many are divesting fossil fuel dependent assets to release capital for investment in renewables and clean energy. BP sold its global petrochemicals business to INEOS. In chapter 4, *'ESG is a critical driver of deal value'* we explore the growing importance of ESG considerations in detail, but it's already clear that the days of ESG as a 'nice-to-have' story are over. ESG is now central to the way stakeholders of all kinds view businesses.

The emergence and intensification of all these pressures is undoubtedly going to drive companies in Asia Pacific to increase their scrutiny of portfolio holdings, as they seek to rebalance and ensure they are both resilient and equipped to deliver transformative growth. In some Asia Pacific markets, portfolio management is still a relatively new concept – companies have typically held on to assets even when they have underperformed. That is clearly changing and active portfolio review, already widely used by western multinationals, seems likely to become much more widely accepted as a strategy for optimising portfolio holdings in this altered landscape.

Moving towards active portfolio management

As we noted earlier, the fact that companies in Asia Pacific are already reviewing their portfolios at least twice a year is encouraging. However, in order to be truly agile and able to course correct, companies should be moving to an 'always on' mindset when it comes to portfolio review, dedicating resources and board-level bandwidth to ensuring that assets are aligned with the overall strategic direction and, where they are not, being willing and able to move quickly to divest or engage with partners who can create value.

And when we say 'mindset' we mean it: developing both resilience and the potential for transformative growth means embracing the constantly shifting nature of markets and geopolitics and developing a state of readiness. If a metaphor is useful, it is akin to steering a sailing yacht – setting a course while simultaneously and continuously responding and adapting to the wind, waves and tide.

In advising companies on how best to achieve the required state of resilience and growth readiness, Deloitte Monitor's Advantaged Portfolio framework[2,3] outlines four broad characteristics that a successful portfolio needs to display:

1. Strategic strength

- Does the portfolio align to and advance the company's enterprise strategy? Without this alignment, while it may deliver reasonable financial return, and in the short term it is unlikely to create sustainable competitive advantages that are shared across portfolio businesses.
- Are the businesses competitively positioned in industries and markets that effectively capture evolving customer demands? Active assessment and action to carve-out businesses that are not attractive and have a limited ability to win will enable the reallocation of resources to attractive sectors with greater ability to win.

2. Value creation

- Are there synergies between businesses that ensure the value of the portfolio is greater than the sum of the parts? Identifying and exploiting intra-company synergies is one of the most powerful ways to capture a portfolio premium.
- Has capital been deployed in the most attractive areas or is there an opportunity to recycle capital to optimise returns?

3. Resilience

- Does the portfolio have the flexibility to survive multiple strategic scenarios in uncertain times? Effective portfolio management should articulate multiple growth paths to achieve future state portfolio and their related trade-offs, including anticipating potential changes within the enterprise portfolio.

4. Sustainability

- Does the portfolio create social, environmental and economic value and deliver positive social impact to the communities that it operates in? Society now expects that business think beyond profits and should play a positive role in these addressing these requirements.

Rebalancing your portfolio to fuel growth

The main goals

Ultimately, the main goals of an active portfolio management approach are: to put the company in a better position to achieve its strategic objectives and withstand the impact of market developments and factors beyond its control. Moving towards active portfolio management is, however, a significant change; requiring structured thinking and senior-level buy-in and commitment. This initial roadmap towards active portfolio management provides a useful framework to begin that process:

1. Strategic alignment and competitive positioning

- Analyse key forces that could influence the portfolio, including technological advances, market shifts, regulatory changes, and economic conditions
- Connect that analysis with enterprise strategy and chart the current and future competitive positioning, identifying the capabilities that will be required to succeed

2. Financial and operational controls

- Identify the financial and operational levers that will maximise return and achieve wider goals, particularly relating to ESG considerations

3. Scenario planning

- Develop multiple plausible future scenarios based on the intersection of critical uncertainties identified in the industry analysis

4. Optionality and risk adjustment

- Develop strategic options ranging from 'no-regret' moves that are beneficial in all scenarios to more speculative 'big bets' that could pay off in specific scenarios
- Establish a dynamic strategy that can evolve as new information becomes available or as specific scenarios or risks begin to materialise
- Leverage advances in AI to develop an active monitoring system that maps against the scenarios.

Case Study

BHP's divestiture of its Blackwater and Daunia mines

Deal summary

BHP Mitsubishi Alliance (BMA), a metallurgical coal joint venture in Queensland, Australia between BHP Group Limited (BHP) and Mitsubishi Development Pty Ltd (MDP), divested two of its operating mines, Blackwater and Daunia, in April 2024 for AU$6.4 billion.

Background

The decision to divest the Blackwater and Daunia mines stemmed from BMA's strategic imperative to optimise its portfolio composition as part of its proactive strategy to upgrade its portfolio of higher-quality metallurgical coal. BHP stated that, as a result of the divestment, more than 85% of BMA's production is now premium hard coking coal, which is sought after by global steelmakers to help increase production efficiency and lower emissions. Additionally, the divestiture created a strategic opportunity for BHP to realign its resources from an ESG perspective. This strategic shift enabled BHP to focus on future-facing commodities, such as copper, and environmental responsibility.

The transaction is one of the most operationally complex transactions that BHP has completed with the asset sale structure, change in rail and port arrangements and the preference to complete the transaction without a Transitional Services Agreement (TSA); all presenting significant challenges during the completion process.

Because the two operating mines were part of a highly integrated portfolio of assets, the separation at divestment also required the disentangling of co-mingled data and personnel. In addition, the transaction meant running two sales processes concurrently, allowing for the possibility of the mines being sold to different parties.

Supporting success with Deloitte

Deloitte's role as lead separation adviser encompassed strategic planning, execution, and readiness activities, with a focus on achieving separation objectives while maintaining safety, operational continuity and deal value.

This transaction marked BHP's second significant separation in the region and BHP incorporated valuable insights from the first, embedding practices such as involving separation advisers in the transaction structure sooner and assigning dedicated roles to key capabilities within the critical workstreams. This proactive approach ultimately led to a more favourable outcome. Integrating separation processes and establishing centralised governance early in the separation lifecycle, enabled and de-risked the 'no TSA' option, provided clear direction of the separation process in the transaction documents, and facilitated the concurrent running of two sales processes.

Positive outcomes

BHP successfully navigated complex challenges and executed the divestment with minimal disruptions to operations and ensured a safe and stable operational environment throughout the transaction period.

The divestiture of the Blackwater and Daunia mines marked a significant achievement for BHP. By safely separating the operational coal mines within the envisaged transaction timeline, BHP was able to realise its strategic objectives while optimising portfolio value.

The transaction enabled BHP to reallocate resources towards core growth areas that reflect ESG concerns.

Ultimately, the successful divestment reinforced BHP's commitment to proactive portfolio management and value creation in a dynamic market environment.

Rebalancing your portfolio to fuel growth

> "Working collaboratively with Deloitte was pivotal in structuring our separation approach and execution. Establishing centralised governance early in the separation lifecycle, enabled and de-risked the 'no TSA' option and provided clear direction for the separation requirements in the transaction documents. This approach enabled the concurrent running of two sales processes, ensuring a smooth and efficient transition.
>
> **Andrew Larder**
> BHP Separation Lead