Monitor
Deloitte.

Creating a Sustainably Advantaged Portfolio

Future Confident

Strategic Choices

Strategy can often seem complex, even mysterious. At Monitor Deloitte we believe that it isn't. It is easily defined as a set of choices about winning. Strategy is an integrated set of choices that uniquely positions the company in its industry to create sustainable advantage and superior value relative to the competition. We choose to do certain things, and we choose not to do other things.

This is simply because we cannot anticipate being successful at everything all the time.

There is never enough time or capital.

The hardest part is choosing what not to do. Often failure to make a clear choice is more detrimental than making a poor choice.

Strategy articulation is a process of making choices by answering a set of fundamental questions in an iterative manner, in which all the moving parts influence one another and must be considered together – we call it Strategic Choice Cascade (refer to Figure 1).

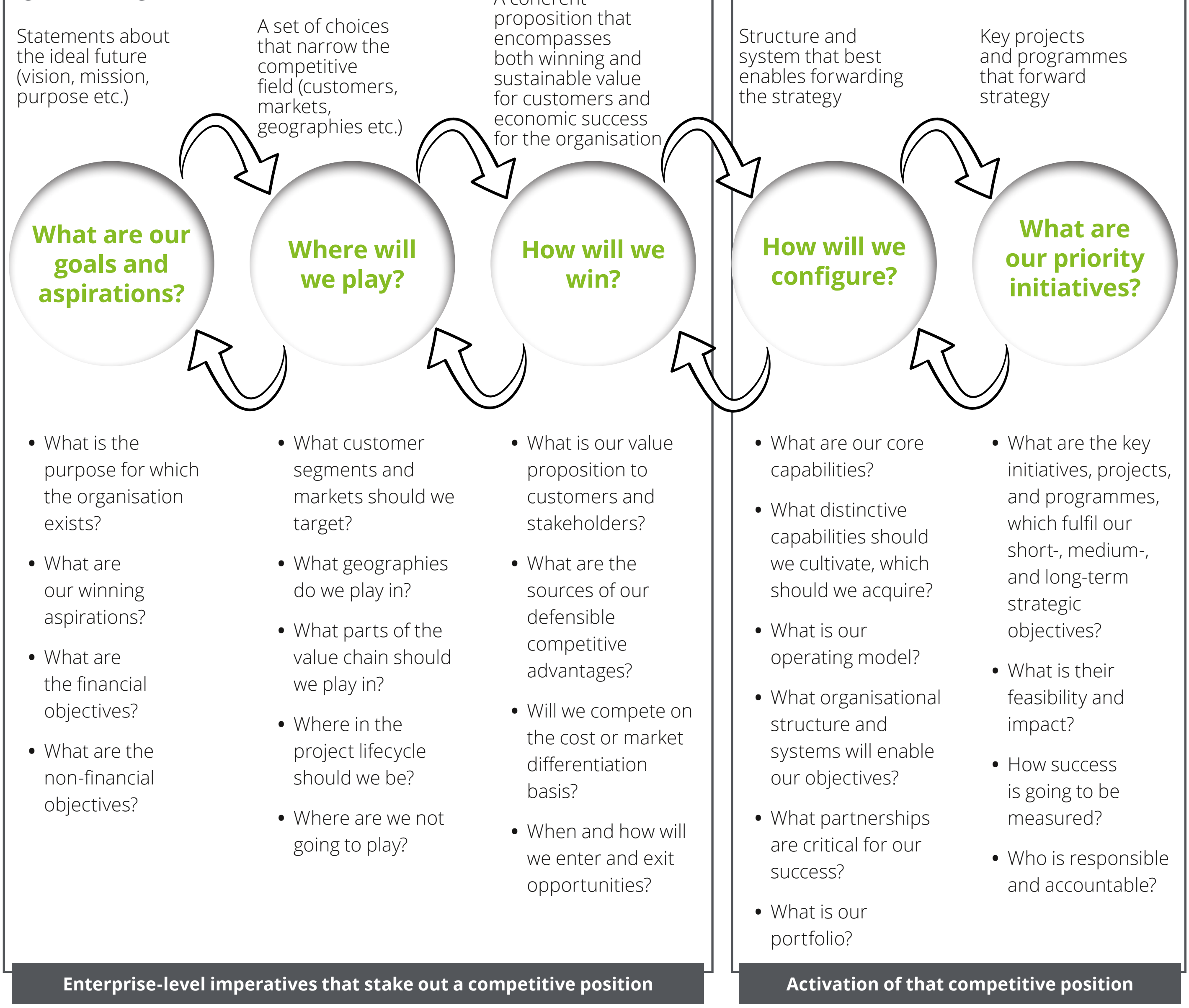


Figure 1. Strategic Choice Cascade

Strategy should connect the dots between how we define winning, the tough choices required to differentiate ourselves from the competition, and how we enable that strategy as an organisation.

Sustainably Advantaged Portfolio Attributes

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 invest? and: How do we create value within and across our businesses?

In other words, where will we play and, how will we win at the portfolio level?

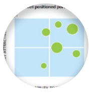
Executives, academics, and consultants have devised numerous frameworks for building and sustaining the optimal corporate portfolio.

Our experience suggests that the most successful portfolios exhibit four broad characteristics.

They are strategically sound, value-creating, resilient and sustainable. Perhaps this seems obvious, but in our experience, maybe because it requires consideration and testing across a wide range of seemingly incomparable attributes, companies seldom apply this Sustainably Advantaged Portfolio approach (refer to Figure 2).

Figure 2. Sustainable Advantaged Portfolio attributes

1. Strategically Sound



1A. Competitively Positioned
Are our businesses competitively positioned in attractive industries?

1B. Balances Innovation
Does the portfolio have the appropriate mix of core, adjacent, and transformational innovations?

1C. Creates Synergies
Do we have synergies that ensure the value of the portfolio is greater than the sum of the parts?

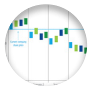
2. Value Creating

2A. Maximises Intrinsic Value
Does the portfolio, as a system, maximise the present value of future cash flows?

2B. Addresses Market Value
Is there a disconnect between intrinsic value and market value that the portfolio must address?

2C. Finds the Right Owner
Are we the value-maximising owner of each of the portfolio?

3. Resilient



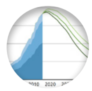
3A. Survives Scenarios
Will the portfolio thrive if the macro environment evolves differently than the expected future?

3B. Builds Optionality
Does the portfolio allow the flexibility to change strategic course in response to uncertain short-term events?

3C. Weighs Feasibility and Risk
Does the portfolio appropriately balance risk and feasibility against the upside potential?

4. Sustainable

4A. Creates Social Value
Will the portfolio make the social impact that society expects of us?



4B. Creates Environmental Value
Will the portfolio adequately improve the environment and address climate change?

4C. Creates Economic Impact
Will the portfolio create economic value to host countries and communities?

Expanding on Figure 2

Strategically Sound

1. A Sustainably Advantaged Portfolio first and foremost must be strategically sound. That means it must foster a strong competitive position, support multiple levels of innovation, and create synergy.

A. When a portfolio is ***competitively positioned***, its businesses in aggregate participate in more structurally attractive markets in which the company has a proven ability to win.

B. An ideal portfolio ***balances innovation*** and supports 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.

C. A Sustainably Advantaged Portfolio ***creates synergies***, adding value above and beyond that 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.

Value Creating

2. The second core characteristic of a Sustainably Advantaged Portfolio is that it creates more value than alternative portfolio options. But that value must be viewed through three lenses to provide a clearer picture: intrinsic value, capital markets value, and the value of the assets to other owners.

A. 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. A Sustainably Advantaged Portfolio is simply one whose intrinsic value is greater than that of competing portfolio options, all other things being equal, it ***maximises intrinsic value***.

B. An ideal portfolio is guided by the intrinsic value creation, but it is not blind to the threats and opportunities created by capital markets. It ***addresses market value*** beyond the intrinsic (DCF) value. 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.

C. A Sustainably Advantaged Portfolio always ***finds the right owner*** and, on balance, over time, will consist of assets for which the current owner is the value-maximising owner. 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. When managers and 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.

Resilient

3. A Sustainably Advantaged Portfolio is not only strategically sound and value-creating, it is also resilient

A. An ideal portfolio 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. In other words, it ***survives scenarios*** and even thrives in the face of uncertainty. Best-practice companies use scenarios to stress-test the performance and risk of individual businesses and portfolios overall.

B. A Sustainably Advantaged Portfolio ***builds optionality*** into its portfolio choices, thus enabling multiple potential routes to value in the future. Optionality 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.

C. Ultimately, considering, constructing and refining a corporate portfolio is an exercise in ***weighing feasibility and risk***. 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. Sustainably Advantaged Portfolio is one whose feasibility and risk are more attractive than alternative portfolios, given the company's ambition and risk appetite.

Sustainable

4. In the last decade, investors are increasingly applying environmental, social and governance (ESG) factors as part of their analysis process to identify material risks and growth opportunities.

The world has realised that business does have a role in society, beyond simply delivering profit to shareholders and taxes to governments. Society now expects that business should play a positive role in meeting their social, economic and environmental imperatives. Investors, customers, and civil society are demanding this – to the extent that shareholder returns are now also compromised by unsustainable business models.

Sustainability is now a core business and portfolio issue.

A. A Sustainably Advantaged Portfolio ***creates social value*** in aggregate. It delivers social impact to the communities that it operates in as well as to society at large. Social impact is best defined by the intended beneficiaries in terms understood by them. This could include improved living conditions, better education, basic healthcare or other pressing social needs.

B. A Sustainably Advantaged Portfolio also ***creates environmental value*** by meeting society's expectations in terms of improving the environment and addressing climate change.

C. Finally, a Sustainably Advantaged Portfolio ***creates economic impact***, by delivering on the aspirations and expectations of the host countries and communities that it operates in, with respect to the business economic impact. This could be in the form of new job creation, preferential local procurement, or taxes and royalties paid.

The twelve attributes of Sustainably Advantaged Portfolios can serve as a valuable guide for executives in defining businesses in which they should participate

A portfolio of businesses, one that is strategically sound, value-generating, resilient and sustainable, is at the heart of every successful company.

This is particularly relevant in turbulent times as we are currently experiencing. The twelve attributes discussed above describe what a Sustainably Advantaged Portfolio should look like, at least at the most basic level for a typical company (refer to the Appendix for a more detailed illustrative example).

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.

The Process of Building a Sustainably Advantaged Portfolio

There is a well-defined process for creating a Sustainably Advantaged Portfolio (refer to Figure 3). This portfolio-shaping process encompasses three major stages: 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.

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 which 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 customise the portfolio-design process accordingly.

Perhaps the greatest difficulty lies in the fact that there is no standard version of a Sustainably Advantaged Portfolio and no two analyses are identical. Each of the twelve tests needs to be specifically tailored to each company, based on the available data, needs, purpose, focus, context, etc.

Metrics for different portfolio attributes are seldom purely quantitative, more often qualitative, or semi-quantitative in nature, and need to be translated into comparable scoring scales in order to ascertain the whole portfolio effect.

But it is important to conduct multiple tests and view the results in context – no single test in isolation of the others, will provide you with a truly strategic answer.

Figure 3. Illustrative process for creating Sustainably Advantaged Portfolio.

- Develop and agree objectives hierarchy (weighting factors for Sustainably Advantaged Portfolio attributes), aligned to overall company strategy
- Develop and agree metrics for each attribute
- Develop and agree scoring scales for each attribute, in order to be able to directly compare different attributes
- Apply twelve tests of the Sustainably Advantaged Portfolio to your current portfolio
- Score each attribute of your current portfolio based on agreed scoring scales
- Total the overall scores for the current portfolio, across all attributes

- Develop portfolio alternatives and options, aligned to strategic goals and aspirations
- Choose the most plausible portfolio options
- Test chosen portfolio options in the Sustainably Advantaged Portfolio evaluation (as described in the preceding step)
- Total the overall scores for all chosen portfolio alternatives

- Compare total scores of the current and alternative portfolio options
- Consider portfolio variations to improve scores and evaluate trade-offs and alternatives
- Choose the best future portfolio based on its overall score and advantages over plausible alternatives

Conclusion

Of course, building a Sustainably 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 a Sustainably Advantaged Portfolio is more about creativity and optimisation 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 in focus and the societal context at hand.

Most of all, however, designing Sustainably 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 a Sustainably 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 in turbulent times.

In the following Appendix we provide an illustrative example of developing a Sustainably Advantaged Portfolio for a hypothetical large chemical company, ChemCo.

While this example practically demonstrates the process execution, portfolio attribute metrics, scoring scales and the process outcomes, its application to your own company's portfolio will be highly customised and most likely result in significant differences and variations.

References

Michael Armstrong, Jonathan Goodman and Gavin McTavish, “The Crux of Corporate Strategy – Building an Advantaged Portfolio”, Monitor Deloitte, 2015

About the Authors:

Andrew Lane
Director | Strategic Transformation Leader
Deloitte Africa

Jacek Guzek
Associate Director | Strategy, Strategic Sensing and Insight Leader
Deloitte Africa