THE MISSING LINKS IN INVESTMENT ANALYSIS

A PORTFOLIO MANAGEMENT STRATEGY TO MAKE INVESTMENTS WORK

MICHAEL HEPINSTALL
DANIEL LYONS
MARK PELLERIN

Confronted with tighter profit margins and greater risks, executives are under more pressure than ever to deliver higher returns from their business portfolios. In response, most companies are now weighing investments aimed at improving their performance. In the first half of this year alone, companies announced 19,932 mergers and acquisitions worth $1.8 trillion – the highest value since the first half of 2007, according to Dealogic. (See Exhibit 1.)

But there is a real risk that the acquiring companies could end up worse off, unless they take a fundamentally different tack to evaluating investments. Standard investment opportunity assessment tools that are based on hurdle rates determined by weight-adjusted costs of capital are proving to be flawed for several reasons: First, non-financial risks, such as regulatory and strategic risks, are typically not captured in such cost of capital allocations, even though they can dramatically affect business performance. Second, there is a tendency for companies to make capital allocation decisions on a stand-alone basis, as opposed to examining their impact on their entire portfolio of businesses. Third, many firms lack the capability to evaluate their future corporate portfolio's performance under a range of market and strategic scenarios.

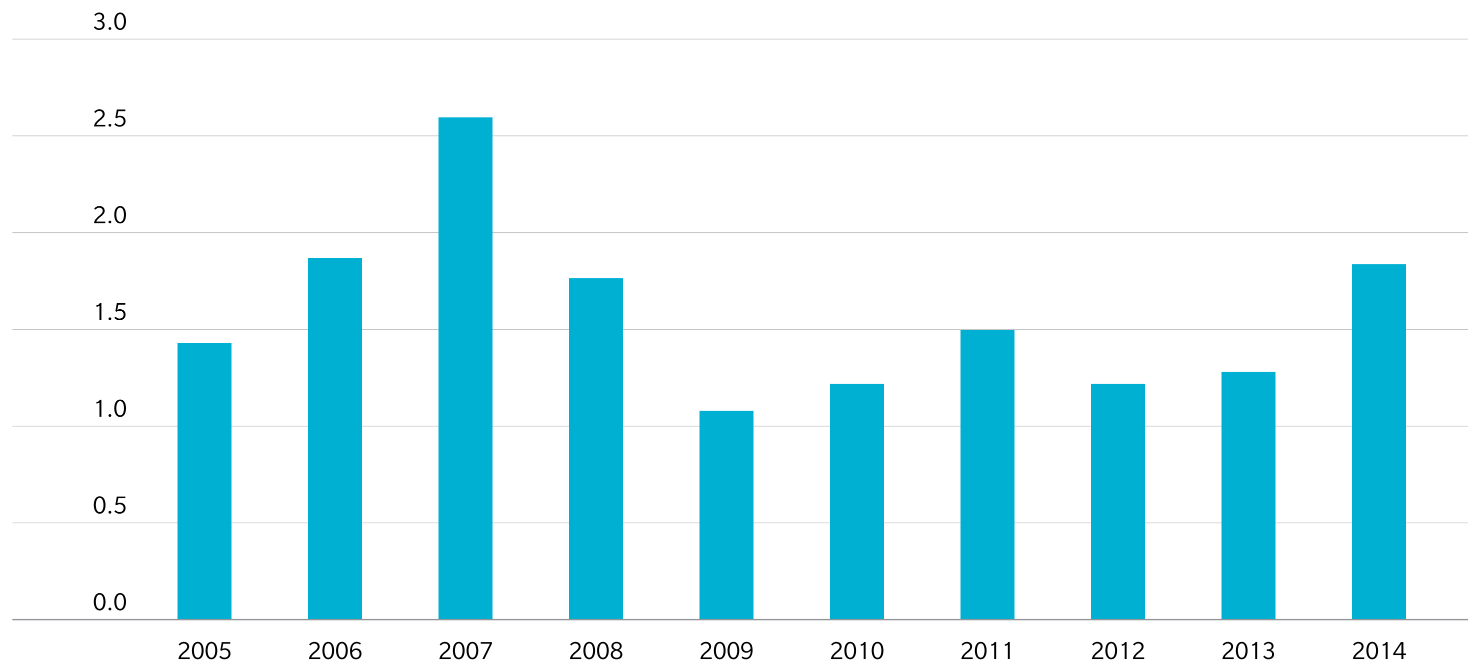
We contend that companies will only discover the surest path to profitability for their entire business portfolio if they address these three shortcomings in their investment analysis. Many appear to have grown their portfolios too quickly, inhibiting their ability to integrate new businesses and reducing their returns on invested capital.

Indeed, when we examined the risk-return profiles of energy companies that make up the Standard & Poor's 500 index over a five-year time horizon, we discovered that the companies that more actively managed their portfolios by making greater capital expenditures or divestitures did not acheive superior returns. We estimate that 95 percent of these energy companies have the potential to improve their portfolio returns by at least 3 percent without assuming additional levels of risk if they follow the four steps outlined in this article. (See Exhibit 2.)

The energy sector is not alone: The same conundrum exists across multiple industries. To solve this problem, companies must do much more than simply identify attractive assets. They must also be prepared to operate them and manage the risks that accompany the acquisition.

EXHIBIT 1: TOTAL ANNOUNCED MERGERS AND ACQUISITIONS
FOR THE FIRST TWO QUARTERS OF EACH YEAR

DEAL VALUE AT ANNOUNCEMENT ($ TRILLION)



Source: Dealogic

Before examining potential solutions to these challenges more closely, let's look at why the three different types of blind spots mentioned above matter for the future of health care, energy, and banking industries.

BLIND SPOT 1
NON-FINANCIAL RISKS

Health plans will be unable to allocate capital effectively unless they take a proactive approach to understanding the non-financial risks they face. Non-financial risks have dramatically altered the health care industry's economics, especially over the past five years. Regulatory risk introduced by health care reform in the United States has made it challenging for health plans to formulate strategies. At the same time, new forms of health care delivery and disruptive consumer business models such as HealthKit, Apple's new app that enables users to keep track of their personal health and fitness data, will likely transform the ways in which people think about their health and well-being in the future.

The impact of health care reform is already starting to take its toll on the profitability of health plans. Due to regulatory oversight over pricing, product commoditization, and the introduction of consumer choice through health care exchanges, revenues are depressed at the same time that margins are being squeezed by rising medical costs.

<HOME>

As a result, health plans are faced with two choices. They must either diversify their business models and seek new sources of profitability or prepare for consolidation and roll-ups in the sector. Examples of new diversified "big plays" include developing new consumer health engagement technologies, reimagining consumer health and well-being experience models, and starting care delivery enablement businesses.

But it will be years before any of these new strategies pan out, and health plans will need to adapt in step with a highly regulated, rapidly evolving market architecture. Since the government has increased its industry oversight through health care reform, small decisions (such as the delay of the government's SHOP exchange offering health insurance to businesses, or changes to individual coverage mandates) have had huge ripple effects.

86%
The percentage of senior financial professionals who expect as much, or more, difficulty forecasting critical risks in the future

BLIND SPOT 2
GOING IT ALONE

It is well known that acquisitions can often be worth more as part of the organization's portfolio than on a stand-alone basis. However, what is less understood is that the "synergy" created by an acquisition often comes from a different part of the organization than the primary operator of the asset.

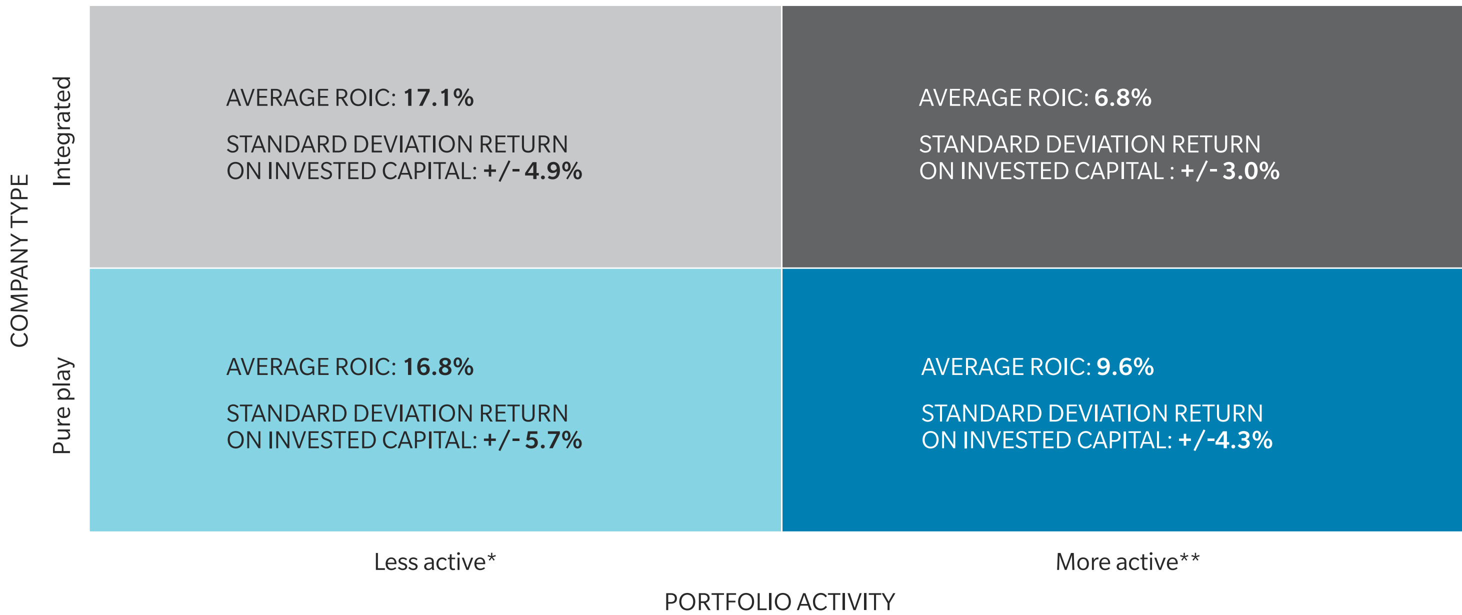
International oil companies are large and complex organizations where decisions are often made in "silos" operating independent of one another. The supply and trading arms of these companies typically have the best perspective on the company's potential opportunities to earn greater margins in the market based on the quality, location, and timing of sales. However, the supply and trading businesses usually do not weigh in on decisions to invest in assets for operations, such as refinery upgrades.

By breaking down these silos, companies can discover investments that add greater value. For example, if refinery operations work closely with supply and trading divisions to make investment decisions, integrated oil companies are more likely to identify additional marketing and trading opportunities that potential investments can create.

<HOME>

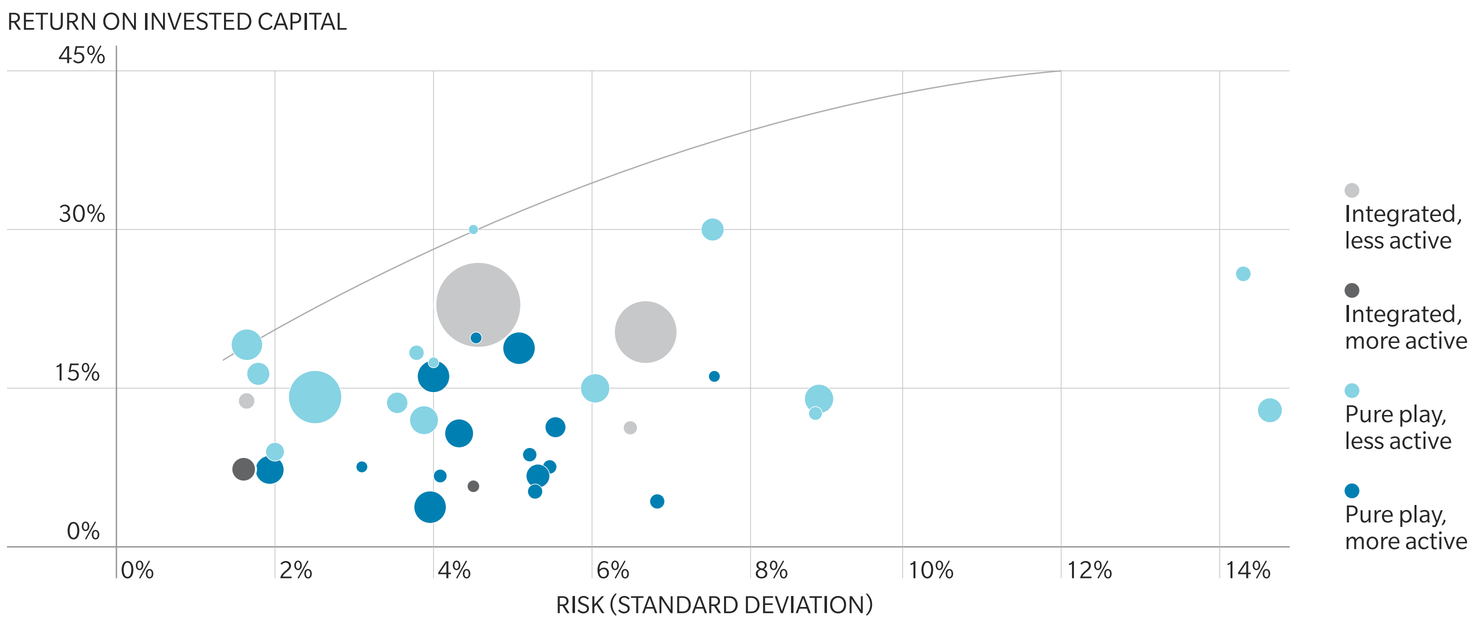
EXHIBIT 2: MORE ACTIVE PORTFOLIO MANAGEMENT IS NOT A SUBSTITUTE FOR QUALITY INVESTMENT DECISIONS

THE 40 ENERGY COMPANIES IN THE S&P 500 THAT HAVE DEVOTED A LARGER PERCENTAGE OF REVENUES TO CAPITAL EXPENDITURES AND DIVESTITURES ARE UNDERPERFORMING THEIR PEERS...



Source: Oliver Wyman market analysis of industrial company
* Invest (or divest) less than 30% of annual revenue
** Investment (divestment) activity = Balancing activity = [Absolute value (capital expenditures) + absolute value (divestitures)]/Revenue
return on invested capital = Earnings before interest and taxes/(Total assets – cash – accounts payable – accounts receivable)

...BUT THEY CAN IMPROVE THEIR PERFORMANCE IF THEY OPTIMIZE THEIR PORTFOLIO ALONG A “RISK-RETURN EFFICIENT CORPORATE INVESTMENT FRONTIER”



Source: Dealogic
Note: The “risk-return efficient corporate investment frontier” presents a series of potential options for a business portfolio to achieve its most attractive return for the level of acceptable risk

<HOME>

BLIND SPOT 3
TUNNEL VISION

No one can predict the future. Companies must build robust investment portfolios that can deliver returns in a wide range of alternative market and price scenarios. But many companies fail to consider unconventional scenarios while constructing their portfolios and make investment decisions based on a static view of the future, or else consider only a small subset of possible outcomes.

As the recent credit crisis demonstrated, effective scenario planning is essential not only to the profitability of the banking industry, but to the viability of banks as going concerns, in large part because of their highly leveraged balance sheets. In response to the systemic risk that the crisis exposed, regulators have since instituted stringent "stress tests," such as the Comprehensive Capital Analysis and Review program (or CCAR). In such tests, banks must evaluate the impact of scenarios that would be stressful to the industry as a whole (such as a generalized downturn) on their business, as well as at least one scenario designed to probe their own unique vulnerabilities.

In order to provide rigorous support for their estimates, banks have made significant investments in tools and processes designed to translate the stress test scenarios into the detailed line-item impact that each scenario would have on their various business segments.

As such capabilities become more established, banks may also employ them extensively in the service of portfolio management objectives, such as setting the risk appetite and optimizing the risk-return metrics of the organization. Stress tests are an increasingly salient driver of capital requirements, which should be factored into projected returns on capital when comparing investment opportunities. Similarly, reference to stress scenarios can help a bank to define and communicate its risk appetite internally, allowing decision makers to apply it more consistently.

NEXT STEPS

The reasons why companies often fall short of evaluating the potential impact of investments on their entire business portfolio may seem straightforward. But in our experience, companies rarely address these challenges when they are actually making an investment decision. Instead, some executives rely on subjective judgment that reflects their strategic views. One Fortune 500 chief financial officer candidly summed

up this approach by stating, "If I like the investment, the required return is 11 percent. If not, it's 14 percent." Or, in other cases, companies resist divestments for fear of signaling balance sheet weakness.

Below are four steps that, in our experience, have enabled companies to move forward.

1. **Define a target strategic portfolio.** Developing a multidimensional investment policy statement to guide portfolio investment and rebalancing decisions helps to align stakeholders about the future direction of the company. Target portfolios should consider both expected returns and the organization's risk appetite. Portfolio constraints – such as the type of asset and liquidity, concentration of assets, geographic footprint, ownership structure, as well as such issues as legal, regulatory, and social considerations – should also be taken into account.

2. **Establish an analytical risk-return framework**. The investment challenge that businesses face is complicated by the large number of disparate investment opportunities competing for capital across business units. For instance, an integrated energy company has to balance investments to build out upstream (domestic, international, deepwater, unconventional), midstream (terminals, pipelines, rail transportation), and downstream (refining, supply and trading, retail) businesses. Indeed, a company might have more than 10 asset classes within their portfolio, each with a unique risk-return profile, and each in turn requiring a unique risk-adjusted hurdle rate.

   As a result, a framework to profile individual assets and, ultimately, make trade-offs in a data-driven manner, is essential to determine the optimal mix for a company's portfolio. A corporate risk register should be used to identify and assess the key risks, drivers, and root causes of variation in financial performance. Risk-adjusted hurdle rates should be developed at the asset class level.

3. **Measure individual asset performance.** Companies need a quantitative and systematic way to quickly screen new portfolio investment opportunities, as well as to monitor the performance of existing assets. While defining the target strategic portfolio may establish the company's direction, it does not make individual asset investment or divestiture decisions any easier, nor does it prescribe the timing, which is based largely on available market opportunities.

$1.8 trillion

The value of mergers and acquisitions announced globally in the first half of 2014

<HOME>

To make better portfolio management decisions, it's important to build a results-based culture and accountability for asset performance. At the same time, performance measurements need to be carefully calibrated to capture the total return contributions of an asset across organizational silos, and adjust for risk in a manner that considers plausible extreme scenarios, not just historical volatility.

4. **Optimize the efficient corporate portfolio frontier**. Unlocking incremental value within any portfolio typically requires rebalancing assets to realize higher returns for the same or less risk. Unfortunately, financial executives increasingly are finding it challenging to make financial forecasts. According to a recent survey of senior finance executives conducted by the Association for Financial Professionals and the Marsh & McLennan Companies Global Risk Center, 86 percent anticipate they will have as much, if not more, difficulty forecasting critical risks to their businesses over the next three years.

   One solution is for companies to develop a dynamic set of tools and modeling capabilities that simulate the performance of various portfolio options under a range of commonly accepted and stress scenarios. The outputs from this type of application become invaluable in giving the company's executive team and board of directors added confidence in their portfolio decision making. This same type of optimization can be used at a more granular level within most organizations to evaluate customers, suppliers, and products and optimize priorities and resource allocations accordingly.

CONCLUSION

Transforming a business portfolio requires the will and the ability to account for a wide range of critical risks and evaluate their impact on an organization's financial performance as a whole going forward. But we believe those businesses that take the time to select the assets that best suit all of these needs will find their efforts rewarded. For they will likely be the organizations that improve their returns by the widest margin as industries reshape themselves and businesses make more investments and acquisitions.

Michael Hepinstall is a New York-based principal in Oliver Wyman's Financial Services practice.
Daniel Lyons is a Toronto-based principal in Oliver Wyman's Healthcare and Life Sciences practice.
Mark Pellerin is a New York-based principal in Oliver Wyman's Energy practice.

<HOME>