KPMG

Putting the 'active' in active portfolio management

By Todd Dubner and Ramahi Sarma-Rupavtarm

CFOs have the opportunity to dispel corporate value-creation mythology and embrace fresh valuation insights that allow them to drive above-market returns from multi-business portfolios. If they do, they'll be applying the same unflinching value lens private equity and activist investors already use, in pursuit of their own goals.

The concept of the "diversification discount" described an era of conglomerate splits, and explained why multi-business portfolios were being undervalued as a whole, relative to the value of the sum of their parts. In practice, CFOs may find their efforts to address the discount stubbornly resistant to accepted corporate myths; acquisitions don't create more value than divestitures. Defaulting to the conventional wisdom that inorganic growth is the best way to unlock value, corporate leaders often face dissonance between what they think their companies' overall valuation ought to be, and what the market actually states.

Now, armed with new insight and some of same powerful valuation frameworks deployed by activists, CFOs can take advantage of the very tactics that in the past provoked corporate fear and reaction, to control their own narratives. Legacy thinking and imprecise guidance can give way to top-down strategic hypotheses combined with fact-based perspectives and analyses, allowing CFOs to decide where to invest, when to divest and where to drive organic growth. Timing is now: In the first quarter of 2021 alone, activists demanded change at more than 160 U.S.-based companies, according to a recent report[1] from Reuters.

Pulling the right value levers

The potential shift in CFO mindsets will be more about understanding value correlations than a wholly new set of financial metrics. Many financial observers, for example, had long assumed the discount could be tied to management failure to create synergies across disparate businesses. In other words, to lack of action or insufficient action. In fact, a pathbreaking KPMG study[2] correlates discounts to disparities in financial characteristics across multiple business, such as differing growth rates, profitability rates or capital/asset intensity.

Our research shows that, yes, the markets do reward action, provided it is the right action—more precisely, the right combination of "run," "buy" or "sell" initiatives, based upon a correct understanding of valuation drivers. Whatever their chosen path, two North Star questions for CFOs will remain constant: 1) What businesses is the company in? and 2) Which businesses should the company retain to maximize value, acquire or divest to a better owner? In our experience, getting to the answers is a more difficult science than it would appear, especially for CFOs whose engagement with active portfolio management is either infrequent or event driven.

1 Reuters, "Activist investors post strong returns with board campaigns in first quarter," April 29, 2021.

2 Source: KPMG, "Can your valuation be improved?"; Dubner, Sarma-Rupavtarm, Feldman, Shapiro, Pernsteiner.

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Top value strategies of active portfolio management:

CFOs interested in improving the market value of their portfolios should consider strategies that incorporate these steps:

1. Identify what businesses your company actually is in, without the artificial constraints of segment reporting. This assessment breaks the business down into its actual component pieces.
2. Assess how each business would be valued as a stand-alone entity in best-case circumstances, if all constraints on capital and management bandwidth were removed, and business units performed at their maximum financial potential.
3. Use clear-eyed "who-is-the-best-owner-of-this-business?" logic to determine continued ownership or sale of each business. Allocate resources to the highest-margin-potential units. Move to rapidly divest the others.

Replacing common misconceptions with actionable fact

Corporate value-building strategies are often based on common misconceptions, and the myth of acquisitions as the fast road to value creation is no exception. It is easy to see why CFOs tend to prefer acquisitions to divestitures: It's more conventionally "bold" to expand a portfolio than to "optimize" it. But activist investors take a more dispassionate approach, which CFOs can do well to emulate. In fact, divestures create higher excess returns (3.4 percent) than acquisitions (2.2 percent), when measured in compounded monthly returns after the first year. Another busted myth: the market penalizes divesting non-core assets. Fact: Divestitures result in high valuation multiples, when measured from a year before divestiture to one year after—.5X in EV/EBIDTA, and 1.4X in P/E.[3]

Think like an activist

As financial stewards of their companies, CFOs can play a key role in partnering with chief executives and boards, to help them think like activists. Research-based insight can help CFOs steer clear, for example, of becoming activist targets themselves: Our own drill-down of 400 deals shows which financial signals (such as low credit quality or impaired goodwill) were more likely to make a company a target for activists. Companies can now start pre-emptively monitoring those "early warning" signals themselves.

Data now also highlights more clearly how activists successfully invest in their "keepers" to improve growth and performance. When we analyzed more than 100 activist campaigns that focused on operational improvements under the direction of activists, the target companies grew revenue by more than nine percent and generated improvements in both operating margins and use of working capital. The improvements were not simply from cost-cutting, but shifts in strategic planning, a new approach to growth, and a fresh look at executive compensation.

3 Source: KPMG, "Global Financial Reporting and Valuation" webcast, 12/14/21.

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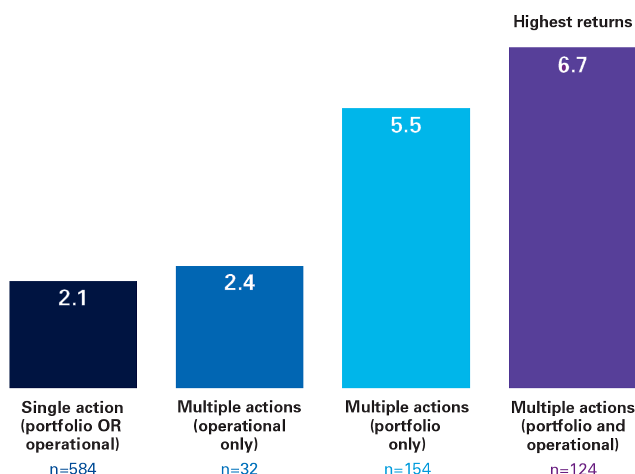
Reverse engineering what activists do to create value by number and type of actions

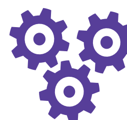
Average excess returns



Type of actions

Portfolio

- Sell company/segments
- Spin off non-core assets
- Return cash to shareholders
- Revise capital structure



Operational

- Cost reduction
- Shift in strategic plan
- New approach to growth
- Executive comp

a) n = 817 campaigns characterized into action categories

(b) Excess return is defined as the difference between the target's stock return and an index that attempts to represent "broad US equity returns" for one year starting with the 13D date. The index's constituents (price-weighted) are the NYSE, Amex and Nasdaq composite indices, replicating the methodology of academic papers on this topic. When a campaign has more than one goal, the excess return of that campaign is included in the analysis of all goals.

Sources: KPMG analysis, Factset database

For CFOs, new looks at "What business are you in?"

Delivering above market shareholder value is a long game, composed of business management strategies to better align performance of business units across the portfolio; a refined investor-relations approach with strategies to help investors and analysts understand how to fully value disparate units; and defined acquisition or divestiture plans to craft a better aligned and higher value portfolio.

In the meantime, the stakes are high. CFOs who are not evaluating their multi-business portfolio through an activist lens can wager the activists are. In our experience, activist campaigns are expensive for would-be hostile acquirers, and shareholder-value-destroying for defenders. CFOs who want to fend off activist advances—and do right by their own shareholders—will want to closely examine the activist approaches—at the very least, as pre-emptive due-diligence.

Find more related CFO insights at visit.kpmg.us/CFOperspectives or visit our Active Portfolio Management landing page at https://advisory.kpmg.us/services/portfolio-strategy.html.

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