

Portfolio

Franz-Friedrich Neubauer

Management

*The Concept of Profit Potentials
and its Application*

Kluwer

Franz-Friedrich Neubauer

Portfolio Management

**The Concept of Profit Potentials and
its Application**

**Kluwer Law and Taxation Publishers
Deventer • Boston**

Kluwer Law and Taxation Publishers

P.O. Box 23 Tel. : 31-5700-47261
7400 GA Deventer Telex: 49295
The Netherlands Fax : 31-5700-22244

Translated from the German by John Dally and Brenda J. Sutton in close collaboration with the author.

Cover design: Boudewijn Betzema

ISBN 90 6544 500 5

Exhibit 5 has been reprinted with the permission of Prentice Hall, Inc., Englewood Cliffs N.J. from Derek Abell, *Defining the Business: The Starting Point of Strategic Planning*, © 1980, p. 50.

Exhibits 20, 23, and 26 have been reprinted with the permission of The Free Press, a Division of Macmillan, Inc. from *The PIMS Principles: Linking Strategy to Performance* by Robert D. Buzzell and Bradley T. Gale, © 1987 by The Free Press.

© 1990, Kluwer Law and Taxation Publishers, Deventer, The Netherlands

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without the prior written permission of the publishers.

PORTFOLIO MANAGEMENT

For Eva, Julia and Anna:
May the portfolio of their lives always be balanced.

Preface

'La vie crée l'ordre, mais l'ordre ne crée pas la vie – Life creates order, but order does not (yet) create any life'. This maxim by the French author Antoine de Saint-Exupéry serves as a motto for this study of the younger forms of Portfolio Management. It has been chosen with good reason: after a rather rapid acceptance, the early generations of Portfolio Management approaches were quickly accused of resulting in stale planning rituals, rather than producing entrepreneurial thinking. It is the aim of this study to demonstrate that the shallowness observed in some of the early applications of Portfolio Management are by no means an inherent weakness of the system, but rather the results of inadequate use. The guiding idea in this context is that rituals, as important as they may be for the structuring, communication and testing of plans, by the sheer nature of the exercise can only be a secondary consideration. In the first phase, the emphasis has to be on the creative aspect of planning, on the entrepreneurial idea: the creation and maintenance of profit potentials within a company which represent 'life' in the sense of the quote by de Saint-Exupéry. If a sufficient number of profit potentials have been created (or existing ones carefully groomed) the 'order' of the planning ritual follows almost automatically; the latter helps to transform these potentials into actual profits.

The concept of the profit potential will, therefore, be stressed throughout this study. The emphasis will be mainly on the identification and maintenance of profit potentials; the creation of new profit potentials, e.g. with the help of 'start-up businesses' or diversification efforts – as meaningful and timely they may be under certain circum-

stances – will not play a major role. Throughout the book the practical aspects of portfolio management will be emphasised.

The book is a translation from the German of the now totally revised third edition. This revision would not have been possible without discussions with my colleagues at the International Management Institute (IMI) in Geneva (and at its succeeding organisation, IMD in Lausanne) as well as in other academic institutions on the one hand and the practical collaboration and the exchange of ideas with practitioners on the other; due to the international orientation of IMI and IMD, these practitioners are active all over the globe. Although I owe them a heart-felt word of thanks, it is impossible to list the names of everyone.

Some among them who particularly influenced my thinking should be mentioned explicitly, though. Among them is ALOYS GAELWEILER, the late planning executive of BBC; Gaelweiler was a 'fire brand' in the best sense of the word: full of ideas, stimulating to the limits of provocation and unsurpassed in his ability to formulate his thoughts. He is one of the pioneers of portfolio management in the German speaking world and contributed in particular to the development of the concept of the profit potential. His thinking is to a large extent mirrored in this book.

Also to be mentioned in this context is the name of PETER E. OCHSNER, who – in particular during his tenure as the planning executive of a large Swiss group of firms – was a much appreciated discussion partner. Together with a group of his colleagues, he and the author developed and installed a planning system in which we attempted to develop the early forms of Portfolio Management even further. The results of this exercise are included in this book.

It is, furthermore, appropriate to thank BRADLEY T. GALE and ROBERT H. LUCHS, both from the Strategic Planning Institute in Cambridge (Mass.) and London (which serves as the organisational home of the PIMS Program). I have maintained a close and fruitful collaboration with these men for many years, as evidenced in this text.

JOHN DALLY and BRENDA SUTTON relieved me of a large portion of the burden of translating the text; their always optimistic and cheerful help made this task much easier. Any author necessarily stands on the shoulders of others; for any possible shortcomings of his work he is nevertheless exclusively responsible himself. The same holds, of course, for this author.

SANDRA SCHOCH took on the task of transforming the different ver-

sions of the translation into a useful manuscript. Her dedication and patience in the process were exemplary.

A heart-felt word of thanks is also due to DR. JUAN F. RADA, Director General of IMD for his gracious support of the project.

Carl von Clausewitz, the Prussian General who influenced deeply the strategic thinking of the military leaders throughout Europe particularly in the 19th century, once identified talent, the consistency of purpose, and boldness as the pillars of strategic thinking and acting. I hope this book will help to strengthen these pillars. After all, the need to think and act strategically (as the book defines this term) has hardly been greater in the history of our enterprises than today.

Lausanne, Spring 1990

F. FRIEDRICH NEUBAUER

Table of Contents

A. Introduction	
Portfolio management: an instrument of strategy	1
B. The identification and maintenance of profit potentials as a central task of portfolio management	5
I. A set of steering mechanisms	5
II. The key attributes of profit potential	7
III. Additional insights	10
IV. Factors which contribute to profit potential	15
C. The SBU: the key to portfolio management	19
I. Why SBUs?	19
II. What do we understand by an SBU?	20
III. How are SBUs determined?	21
1. Segmentation procedures based primarily on practical experience	23
a. The segmentation criteria of General Electric	23
b. An example from the building materials industry	24
i. Two key elements: a product line and a served market	25
ii. The product line as a starting point	25
iii. Determining the served market	26
c. The PIMS approach to segmentation	28
Step 1: Listing of provisional SBUs	28
Step 2: From 'provisional' to 'final' SBU	30
Step 3: Determining the limits of the served market ...	31

d. A multi-dimensional approach to segmentation	32
i. Dimensions for defining SBUs	32
The product	33
Customers	33
Geographic reach	34
Stage of the value-added chain	34
ii. Using these dimensions to define SBUs	34
2. The SBUs versus the existing corporate organisational structure	37
3. Implications of segmentation	38
a. There is no single 'correct' segmentation	38
b. The dangers of suboptimisation	38
c. Resegmenting SBUs	38
 D. Portfolio management using a multi-factor analysis (nine-block matrix)	41
I. Introduction	41
II. Developing a business grid	42
1. Evaluating market attractiveness	44
2. Evaluating the competitive position	47
III. The generation of the current portfolio	50
IV. The identification of natural ('normal') strategies	54
1. The concept of natural strategies	54
2. Steps for developing a natural strategy	54
a. The basic message of a current matrix	55
b. The starting positions in the current matrix	58
c. Basic strategies available	60
d. Natural strategies	64
e. Final selection of strategy	65
i. Formulation of the preferred SBU strategy	66
ii. Reconciling the preferred strategy with corporate considerations	68
iii. Developing the target portfolio	69
f. Checking the existing management systems	69
i. Control systems in portfolio management	73
ii. Personnel management in portfolio planning	73
V. Technology grids	75
1. The increasing importance of technology	75
2. The influence of technology on strategic management	76
3. The development of the technology portfolio	76

4. Relationship between the market and technology portfolios	78
VI. Are the 'grids' progress?	81
E. Portfolio in the context of the PIMS Program	85
I. PIMS: a logical next step in the development of portfolio theory	85
II. An overview: The PIMS concept	85
1. The database	87
2. The systematic search for the determinants of success	88
3. Some research results	93
III. A closer look at the most important determinants of profitability	93
1. The PIMS 'Competitive Strategy Paradigm'	93
2. Determinants of the competitive position	96
a. Market share	96
i. Three measures	96
ii. Difficulties in expressing market shares	97
iii. Effects of market share on profitability	97
b. Quality as a determinant of profitability	103
i. Two views of quality	103
ii. The effects of quality on ROI	106
iii. Why are quality and ROI positively correlated?	108
3. Market structure as a determinant of profitability	115
a. The effects of capital intensity on profitability	115
b. Possible explanations for the negative influence of capital intensity on ROI	115
4. The explanatory power of the determinants	120
IV. Important PIMS models	120
1. The Par model	120
2. The strategy model	122
V. Portfolio analysis using PIMS	123
1. Simple portfolio analysis using PIMS	123
2. The complex form of portfolio management using PIMS	125
VI. Managing clusters of SBUs	129
VII. Some objections to PIMS	130
F. Portfolio management: a fad or an enduring management tool?	135
I. Portfolio management – A subject of controversy	135

CONTENTS

II. Strengths of portfolio management	135
III. The most commonly mentioned weaknesses	137
IV. Conclusion	140
Notes and References	141

A. Introduction

Portfolio management: an instrument of strategy

Portfolio management has played a significant role in the strategic management of companies since the early 1970s. Although it is relatively simple to place its development in an historical context,^{6*} it is rather difficult to trace its conceptual evolution. Such an effort can be facilitated if one is able to show how portfolio management contributes to the advancement of the main purpose of strategic management, namely the creation of a strong strategic position in those markets in which the corporation has decided to compete. In doing this, one can demonstrate that portfolio management represents one link in a series of efforts to explain the determinants of a strategic position. While a strong strategic position gains increasing recognition as an essential element of a company's commercial success, the term 'profit potential' is more and more used to describe it – particularly in the Germanic literature on business administration. Although the concept of a strategic position requires some further exploration, it is quite obvious that the stronger the strategic position, the higher the profit potential, and vice versa. While it is the strategic management's responsibility to create and maintain such a long-term profit potential, it is the responsibility of the operational management to exploit this potential; that is, to turn it into profits. Since securing a profit potential lies at the heart of strategic management, the first section of this text will focus on this subject in detail (*see* Exhibit 1).

A cursory examination will show that in a typical, broadly-based (i.e. diversified) modern corporation a strategic position does not only

* Numbers refer to the chapter 'Notes and References', pp. 141–147.

exist at a corporate-wide level, but also at lower echelons within the organisation. For example, if one were to segment a company into its component product and service lines, one would find that each of these discrete activities has its own strategic position in the market, and thus contributes independently to the overall strategic position of the company. These individual activities (or business units, as they are frequently called), require individual strategies, planning, and control. The need to coordinate the planning between business units, and to aggregate such diverse activities into a coherent strategy, has provided the stimulus for developing portfolio management. The term 'portfolio management' was borrowed from the securities industry where securities, such as shares, are combined into optimum portfolios according to some criteria. Similarly, strategic management strives to combine business units in an optimum fashion – balancing high-growth, cash-hungry activity units with mature, cash-providing business units – while simultaneously assuring that a sufficient number of promising 'Crown Princes' are groomed to replace business units which are nearing the end of their life cycles.

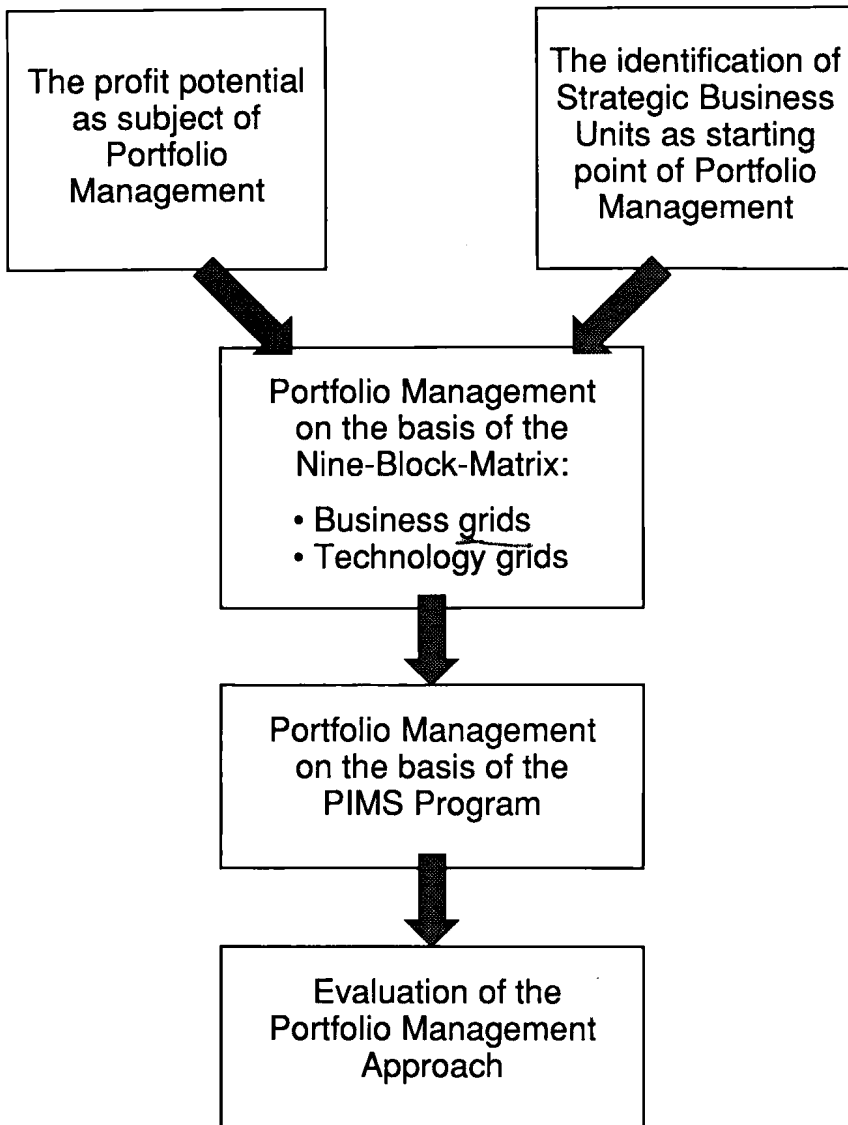
Business units constitute a pivotal element of portfolio management, and their identification represents one of the most difficult assignments of modern management. Therefore, the second section discusses some methodologies for segmenting companies into units meaningful for planning purposes (Exhibit 1). The determination of these business units, or 'strategic business units' (SBUs), as they have become known in the management literature, is the starting point of portfolio management.

The next two sections describe, step-by-step, different portfolio management approaches for evaluating the profit potential of a business unit (Exhibit 1). The profit potential of the company as a whole may then be judged by evaluating the portfolio of business units using a nine-block matrix, or 'business grid'.

Portfolio management can, however, no longer be based on a business/market strategy alone, but must consider the availability of the relevant technology; therefore, following the recent developments in portfolio thinking, the supporting technology strategy is discussed within the framework of a 'technology grid'.

Section E demonstrates how the research results of PIMS can be used in portfolio management. PIMS, an acronym for 'Profit Impact of Market Strategy', is an ongoing international empirical study that aims to identify determinants of profit; this section also describes the attempts of PIMS to actually quantify (or at least approximate) the profit potentials of units.

EXHIBIT 1: THE BASIC BUILDING BLOCKS OF THIS STUDY



The strengths and weaknesses of each approach to portfolio management are reviewed as these developments are presented, and the final section is reserved for a general review of the effectiveness of portfolio management as an overall concept.

This text emphasises the practical aspects of the themes under discussion; yet even the most thorough presentation of these approaches can but offer a manager stimulus to insight, and food for thought. Ultimately, it is the manager's own vision and judgement which determine the future success or failure of a company. This judgement can, however, be supported by systematic management approaches. One of these is portfolio management.

B. The identification and maintenance of profit potentials as a central task of portfolio management

I. A SET OF STEERING MECHANISMS

One school of management theory²⁸ which has gained wide acceptance during the last few decades – particularly in the European stream of Business Administration – recognises the concept of profit potential as being a critical steering mechanism when it comes to ensuring the long-term survival of a company. Historically, the attention of management practice (and theory) was focused on the maintenance of liquidity as the key instrument with which to direct management action. This approach was quite sound, as liquidity is the life's blood, the oxygen supply (or whatever metaphor one wants to use) of a company: as long as an enterprise is able to secure a positive cash flow, it is viable. For this reason, management learned to monitor – and later on even to plan – the factors which determine liquidity, namely cash inflows and outflows.

Managing liquidity alone, however, eventually became insufficient as a steering mechanism when it came to assuring the long-term viability of a company. Some of the reasons for this observation include:²⁶

Our economies developed such a state of complexity that a company can no longer be directed with the help of cash flow calculations alone. Factors such as multi-period manufacturing, the availability of credits, and – later on – the necessity of funding research and development prior to product introduction, have created the need for additional planning and steering instruments. This need resulted in the development of accrual