Strategic Resource Management

The Hidden Secret to Outperformance

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About This Report

Our goal was to identify how much of exemplars' performance can be explained by decisions made about resource allocation (i.e. portfolio shape) relative to sector peers.

We looked at the relative performance of the S&P Global 1200 companies over 10 years (since the financial crisis), with total shareholder returns used to judge outperformance.

The report is organised in three sections.

Overview of Key Messages

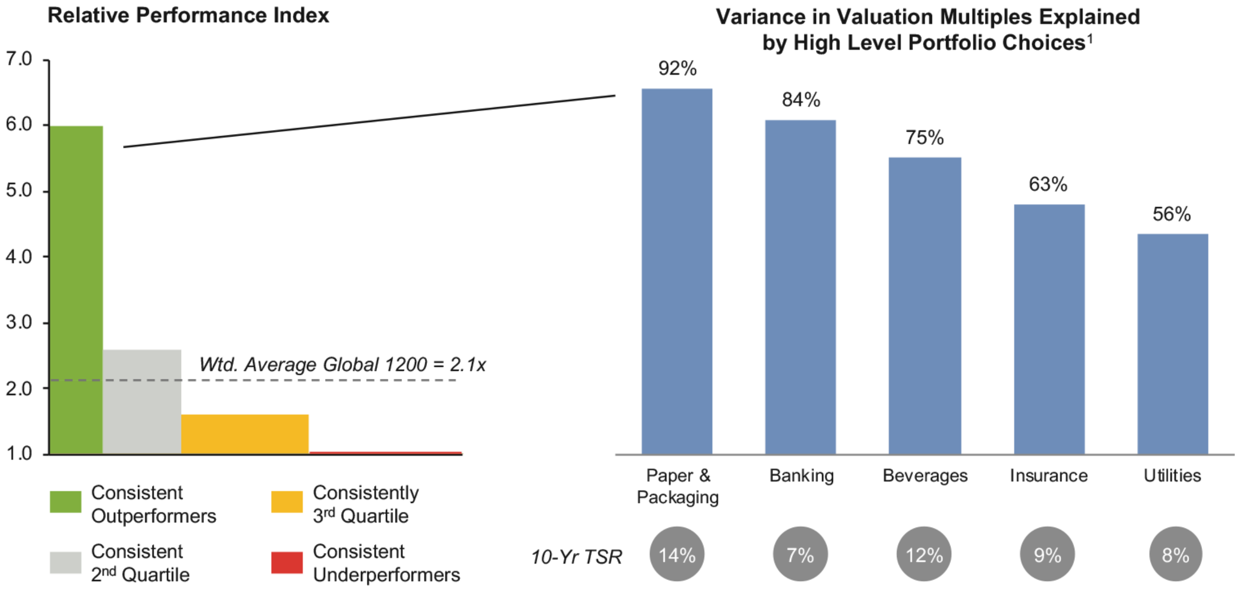
- Solid operational performance matters; if your team can't reliably execute you're finished.
- However, the path to superior performance is determined by management's decisions about where to focus the firm's strategic resources (time, people and capital).
- Our research found that at least 60–75% of the difference in performance can be attributed to high-level portfolio choices.
- This was the finding from a comprehensive study of 1,200 companies and their relative performance over the last 10 years (post the financial crisis).
- Focusing a company's strategic resources on the right geographies, subsectors, and customer segments, what we call Strategic Resource Management (SRM), makes a big difference.
- The importance of Strategic Resource Management may seem obvious, but the evidence shows that it's hard to do well. We provide five very human reasons that explain why most companies aren't as successful as they could be:
    1. It's outside the comfort zone of many senior managers
    2. The status quo feels less risky
    3. Hard choices mean CEOs have to say "no" to some business owners
    4. Annual budgeting and planning games get in the way
    5. Strategic decisions are often deferred due to the pressure to meet budgets
- The implication for senior management is stark. In this report we outline six actions CEOs and their teams can take to help ensure outperformance is within their grasp.

Key Research Findings

In the last 10 years, only 10% of companies have consistently outperformed i.e., delivered top quartile TSR returns in both the first and last five-year periods. These companies generated 2.5x more growth, delivered 6x better returns on capital and attracted a 3x higher valuation multiple than the average S&P Global 1200 company. What distinguished these outperformers were the choices they made about how to allocate strategic resources. Indeed 60–75% of the performance variation between companies in the same sector can be explained by high-level choices about where resources should be focused (Figure 1).

In a poorly performing sector like banking, high-level portfolio shape is important, and explains at least 84% of the difference in performance. Even in attractive sectors, such as beverages, it pays to focus, with high-level portfolio shape explaining at least 75% of the difference in performance across this sector.

Figure 1: How Much Portfolio Shape Explains Outperformance Within Sectors



Why Strategic Resource Management Is Hard To Do Well

- Strategic resource management is **outside of the comfort zone of senior managers** whose typical path to top roles is via a track record of delivering sustained operational improvement, rather than through making better portfolio choices;
- Continuing with the **status quo feels less risky** than taking bold decisions on future strategic focus and portfolio shape;
- Successful SRM requires hard choices about whose business to starve or exit to invest behind others, but **CEOs don't like saying no** to the executives running those businesses and often this results in a 'peanut butter' approach to resource allocation;
- The **annual budgeting and planning games get in the way**, as the battle to win extra resources crowds out decisions on future shape and investment priorities; and
- **Nobody likes missing their budget**, so the pressure to deliver quarterly earnings means that when push comes to shove harder strategic choices are deferred.

What Management Can Do

1. **Understand your starting point.** Build a granular view on the value created for the company and customers in the existing portfolio (e.g., by geography, subsector, product segment, customer). In the beverages sector, Brown Forman's consistently strong performance can be explained by a superior starting point with a portfolio weighted towards American Whiskey.

2. **Develop a view of the trend line.** Look at how customer needs and behaviours are changing and the implications for where value will be created in the future. Constellation Brands' outperformance in beverages has been driven by reshaping their portfolio from wine to US beer. Time will tell if their view of the trend line, and their latest strategic bet on Canopy, will pay off.

3. **Put in place a disciplined financial framework.** Set high standards for reinvestment in the business, optimise balance sheet leverage, and be willing to raise external finance to pursue value-creating opportunities. At JP Morgan Chase, CEO Jamie Dimon's financial discipline and low tolerance for value destruction helps explain how that company has outperformed the rest of the banking sector.

4. **Optimise the use of all resources.** Adopt a zero-based approach to resource allocation. Use the annual processes to look at 100% of the capital and talent base. Concentrate resources on businesses that can sustain or build valuable differences. Continuously ask whether there is a higher value use for any resources they control.

5. **Actively reshape the portfolio.** Use acquisitions and divestitures to accelerate the reallocation of capital and other resources to the highest-value opportunities, with a strong internal finance and M&A capability to support a continuous programmatic approach. Rentokil's outperformance in recent years owes a lot to a 2013 decision to focus on pest control and hygiene, and selling off other assets.

6. **Invest behind intangibles.** Ensure they are customer focused, innovate to remain on trend and build reputational and brand value to sustain profitable growth over the long-term e.g. Nvidia's investments in R&D have enabled them to outperform by maintaining their leadership in PC graphics and developing new use cases across healthcare, consumer electronics, deep-learning cloud computing and autonomous vehicles.

Overview of Key Findings and Select Sectors

Overview of the Research

The goal of the study was to identify how much of exemplars' performance can be explained by decisions made about resource allocation (portfolio shape) relative to sector peers. We looked at the relative performance of the S&P Global 1200 companies, as of July 2019, which captures ~70% of global market capitalisation. Data was pulled for a 10-year period from 2009–2018, post the financial crisis, with total shareholder returns used to judge outperformance.

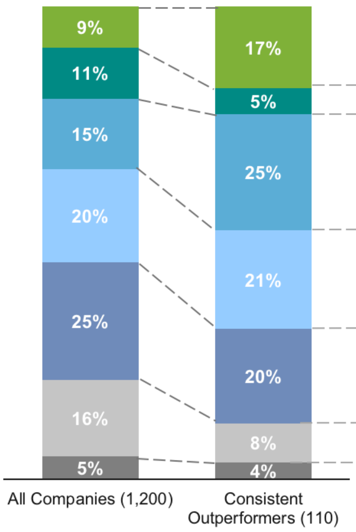
Consistent outperformers were defined as companies that delivered top quartile TSR in both the 2010–2014 and the 2014–2018 time periods to remove the volatility seen in 2009 TSR performance, which was heavily impacted by the financial crisis. A range of industries were examined in more detail by breaking down each company into a set of meaningful portfolio pieces e.g., geography x line of business. We then used regression analysis to understand how much portfolio shape explained a company's performance (as measured by market-to-book).

Further insights were collected on the performance and financial framework of consistent outperformers to understand differences in resource management.

Characteristics of Outperformers

Since the financial crisis, only 10% of companies have been consistent outperformers. They were seen across all sectors, however IT and Communications and Health Care were overweight and Financials and Oil and Gas underweight.

Figure 2: Sector Mix and Relative Performance of Consistent Outperformers

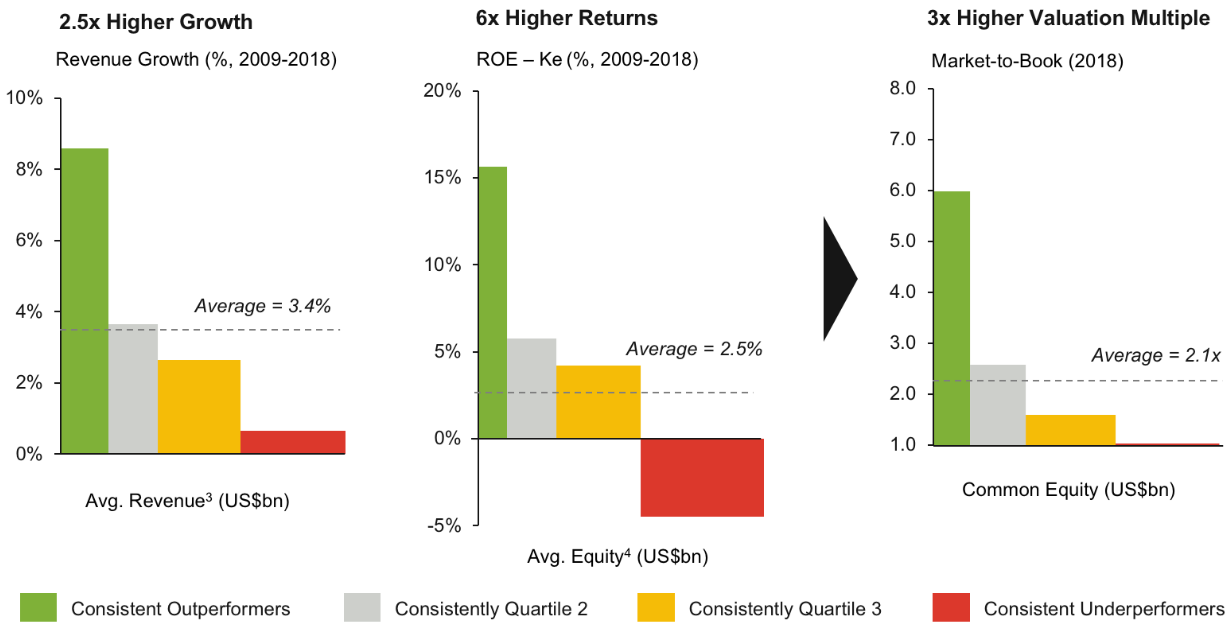


Consistent Outperformer Average – Global Average[2]

	10-Year Revenue Growth	10-Year Average ROE – Ke	2018 M/B	10-Year TSR
Health Care	+3%	+0%	+2.0	+8%
Oil & Gas and Utilities	-1%	+4%	+0.6	+12%
IT and Communications	+6%	+7%	+3.5	+10%
Consumer	+2%	+5%	+2.2	+9%
Industrials and Materials	+3%	+6%	+1.4	+9%
Financials	+6%	+9%	+4.1	+10%
Real Estate	+7%	+6%	+0.8	+12%

Outperforming companies generated 2.5x more growth, delivered 6x better returns on capital and attracted a valuation multiple 3x higher than the average S&P Global 1200 company.

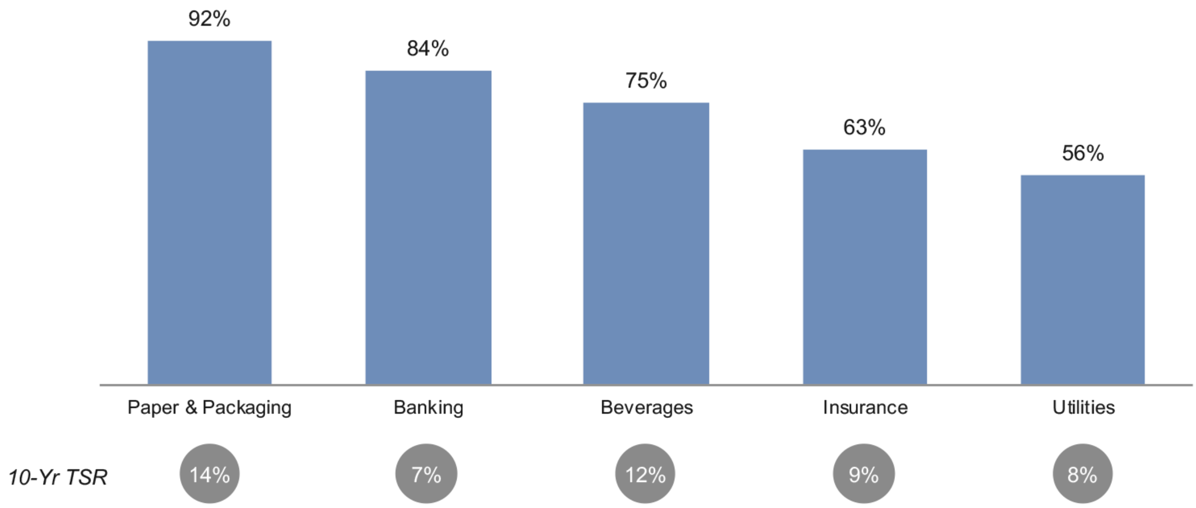
Figure 3: Relative Performance of Consistent Outperformers



Importance of Portfolio Choices

At least 60–75% of the performance variation between companies in the same sector can be explained by high-level choices about where resources should be focused.

Figure 4: Variance in Market-to-Book Values Explained by High-Level Portfolio Choices[1]



While high, this range probably understates the contribution of participation choices to performance variation between competing companies.

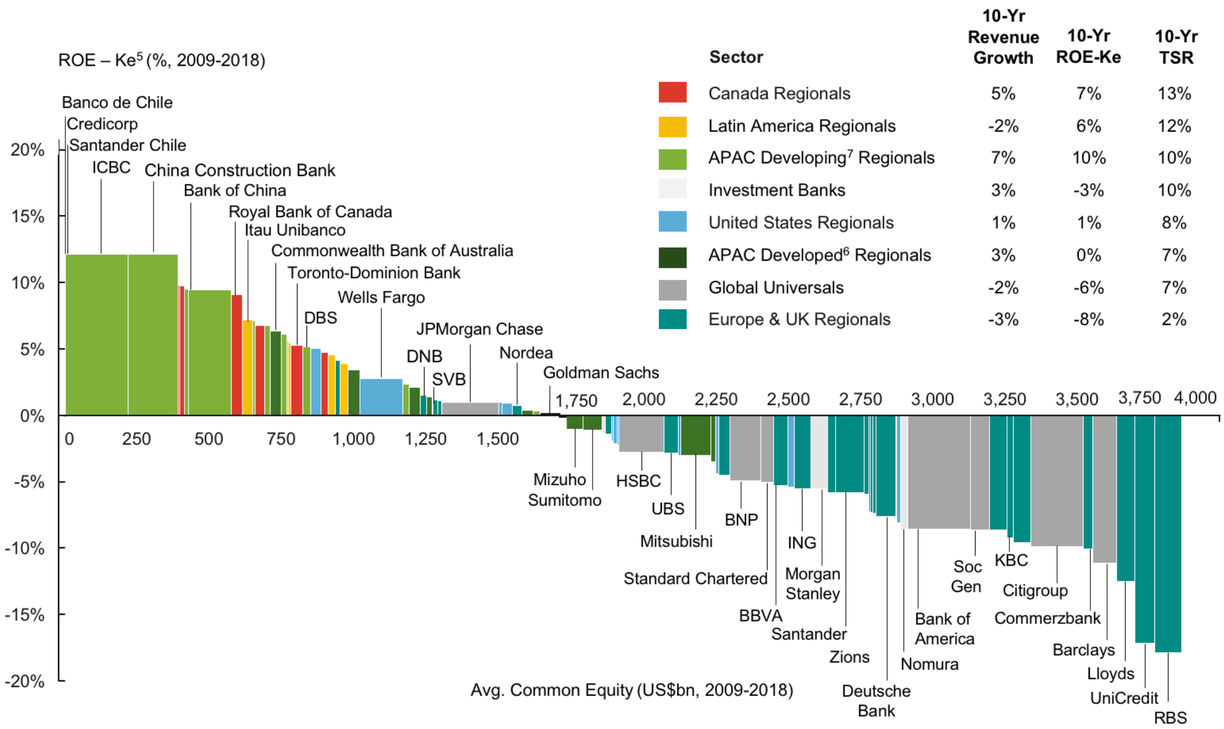
Given limitations in the granularity of publicly reported data, the research necessarily focused on the highest level of choice (i.e., broad customer groups, product categories and geographies). However, our analysis of individual standout performers and work with clients on a more granular breakdown of participation choices reveals an even bigger role for such decisions in determining outperformance.

The secret to successful SRM is defining the "where" in a granular way, so that each piece of the portfolio represents material and distinct market spaces to invest behind. The more you understand the "where", the better you can align the organisation's strategic resources (capital, people, time) with the greatest opportunities to grow customer and company value.

Banking Sector Example

The banking sector has underperformed other sectors in the last 10 years, in part as a consequence of more onerous regulatory capital standards since the crisis. More than half of the banks in the S&P Global 1200 delivered returns below their cost of equity in that time.

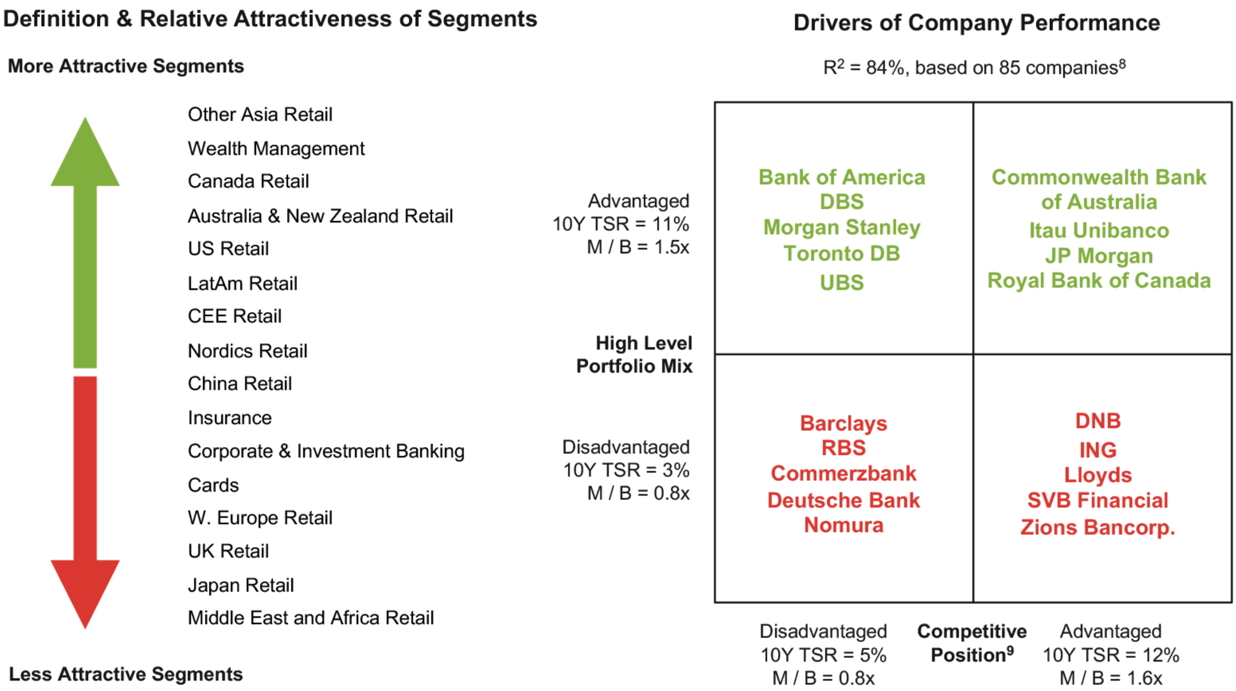
Figure 5: Long-term Economic Performance Across Banks



Even in a poorly performing sector, there are some standout banks that have outperformed their peers and many companies in other industries. Some of that standout performance is a result of being in the right geographies (e.g., China, Australia, Canada). But within those geographies, choices about which business lines to favour and which to exit have helped deliver strong financial performance and shareholder returns for some players. Indeed, at a high level (i.e. which geographies, what broad types of customer, what major business lines) portfolio choice appears to be even more important in banking than almost all other industries. This explains 84% of the variation in performance across the sector (Figure 6).

JP Morgan Chase has outperformed other banks in a relatively profitable geography (US) by adopting a disciplined financial framework to enable the CEO and management team to make the right strategic choices about which geographies and business lines to invest behind. For instance, the US retail banking team recognised some time ago that they were too large to make significant acquisitions. In 2014 the team calculated they could grow by targeting specific cities, where they didn't have a presence, with a broad offer that local players would struggle to match. By doing so, and by investing to reduce costs to serve new and existing customers, the JPM Consumer and Community Banking business delivered a 28% return on equity in 2018, with a four-year compound growth rate for deposits double that of the industry average.

Figure 6: Relative Attractiveness of Different Subsectors and Drivers of Bank Performance

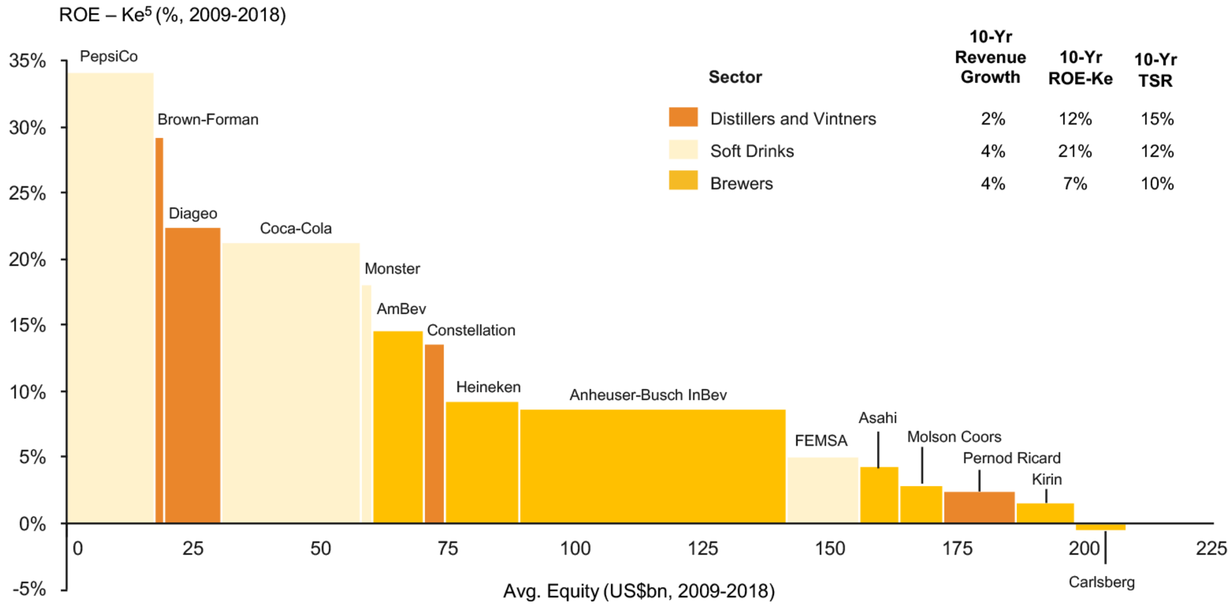


Beverages Sector Deep Dive

The average market economics for beverage companies are attractive, ranked 4 out of 26 across all subsectors. Almost all beverage companies delivered returns above their cost of equity, yet there is a wide distribution in the level of these returns (Figure 7).

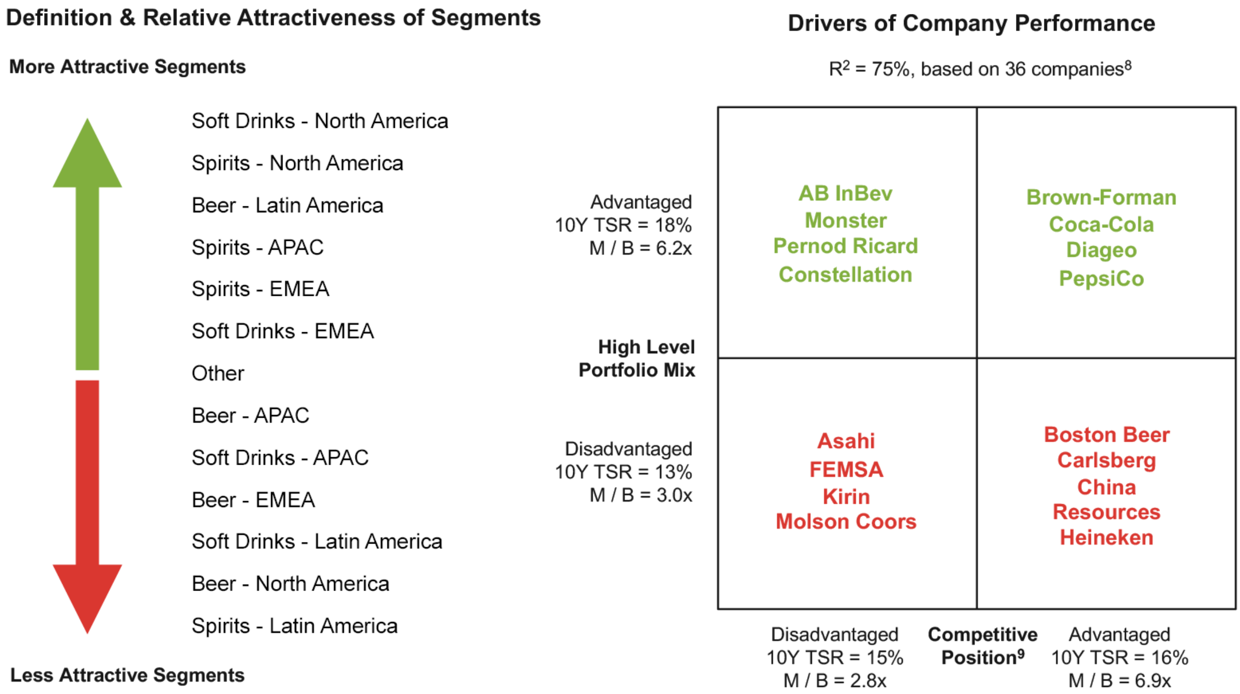
On average, distillers and vintners outperformed soft drink makers who outperformed brewers. Brown Forman and Constellation's high growth and increased returns underpinned Distillers higher TSRs. The higher growth in brewers was not sufficient to offset their lower returns on capital.

Figure 7: Long-term Economic Performance Across Beverage Companies



Regression analysis on the subsegments of these companies and other pure plays suggests that 75% of the variation performance (as measured by difference in market-to-books) is explained by high-level portfolio mix (Figure 8).

Figure 8: Relative Attractiveness of Different Subsectors and Drivers of Company Performance



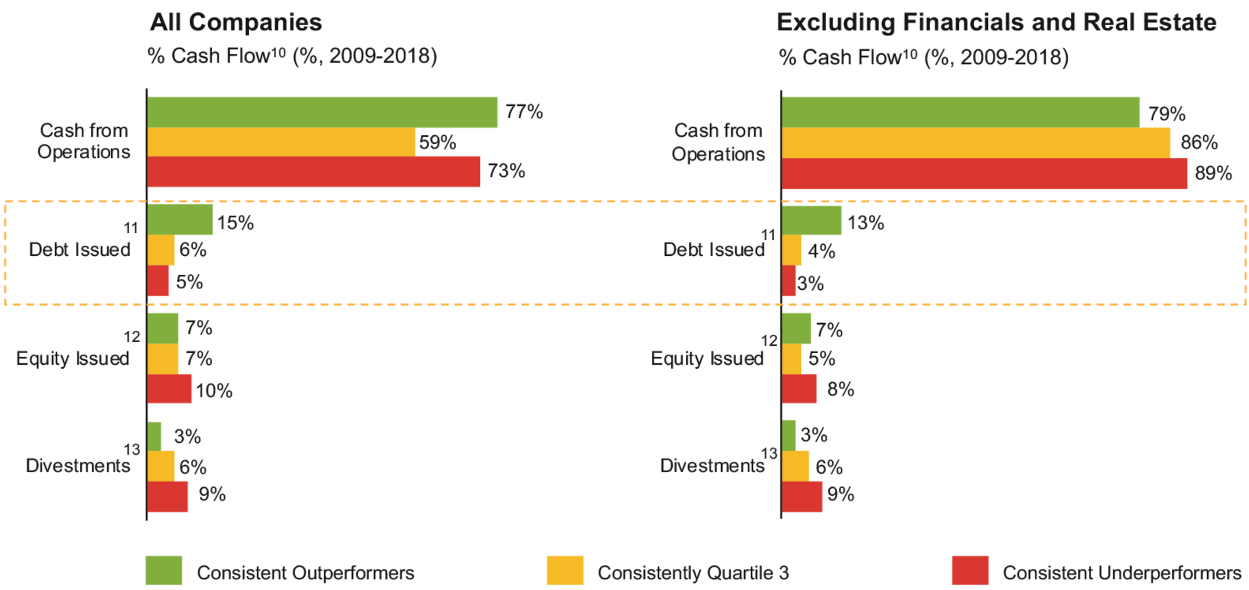
Brown Forman’s consistently strong performance can be explained by a superior starting point with a portfolio weighted towards spirits in North America. In fact this likely understates the true impact of mix as their superior position in North American spirits can be explained by their continued focus on growing the premium tier of the American Whiskey category.

Constellation Brands outperformance has been driven by reshaping their portfolio from wine to US beer through the acquisition of Grupo Modelo’s business and only time will tell if their early strategic bet on Canopy, and the cannabis market, will pay off, which is currently a negative weight on their stock.

Investment Behaviours of Outperformers

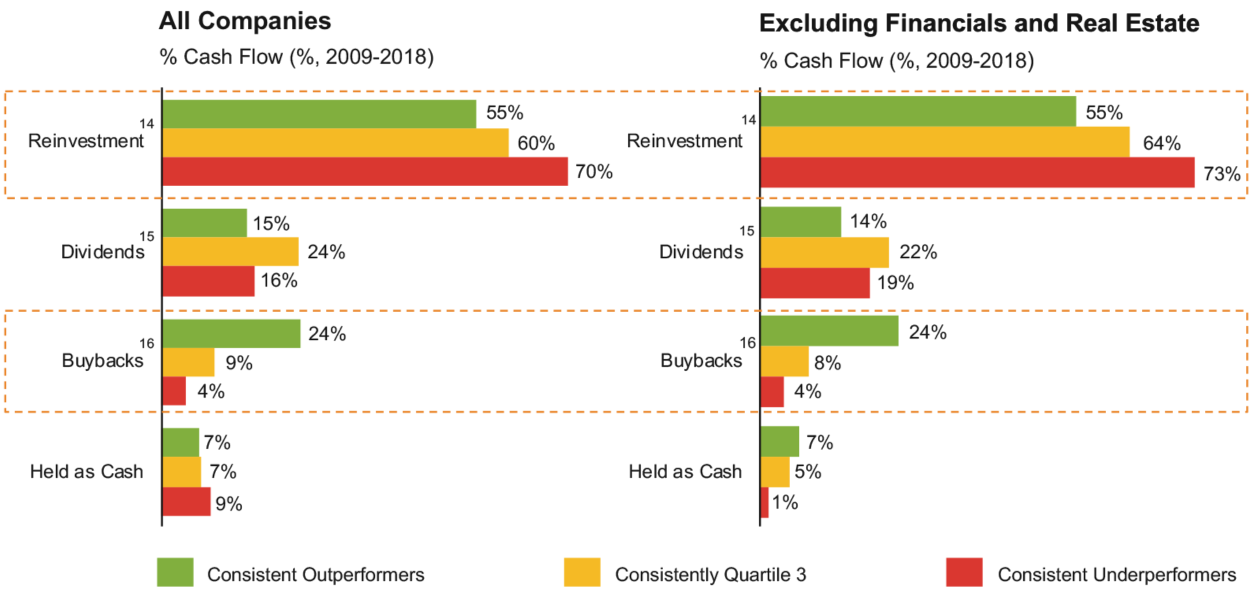
Outperformers are willing, and able, to raise debt and equity to pursue value-creating opportunities.

Figure 9: Sources of Cash



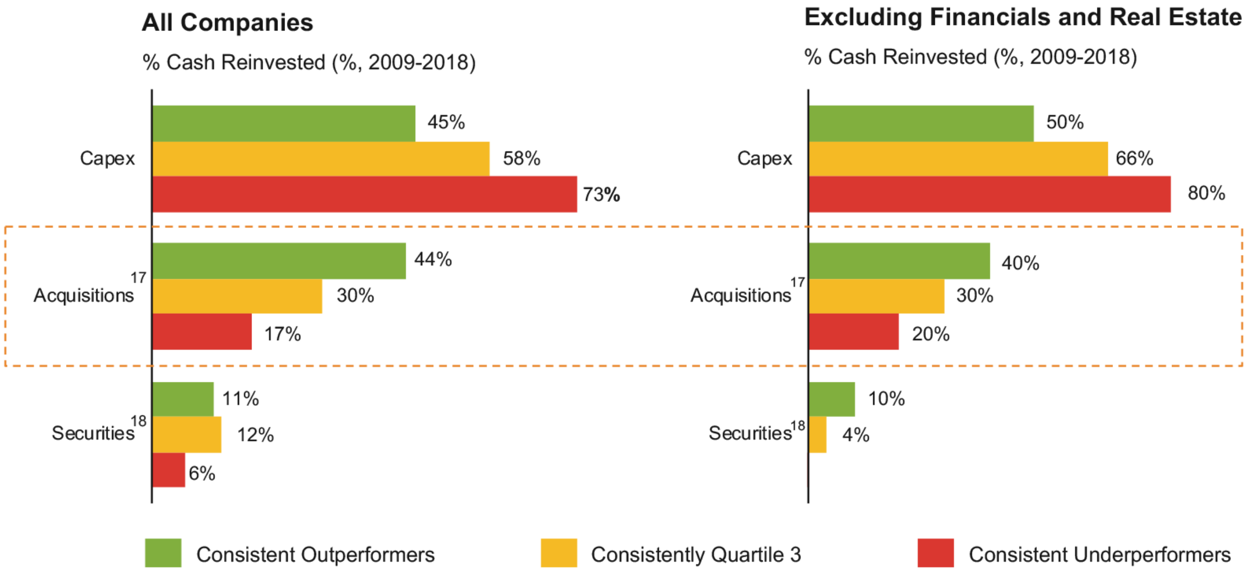
Outperformers reinvest c.55% of cash back into the business and return a higher percentage of cash to shareholders with a bias for buybacks.

Figure 10: Uses of cash



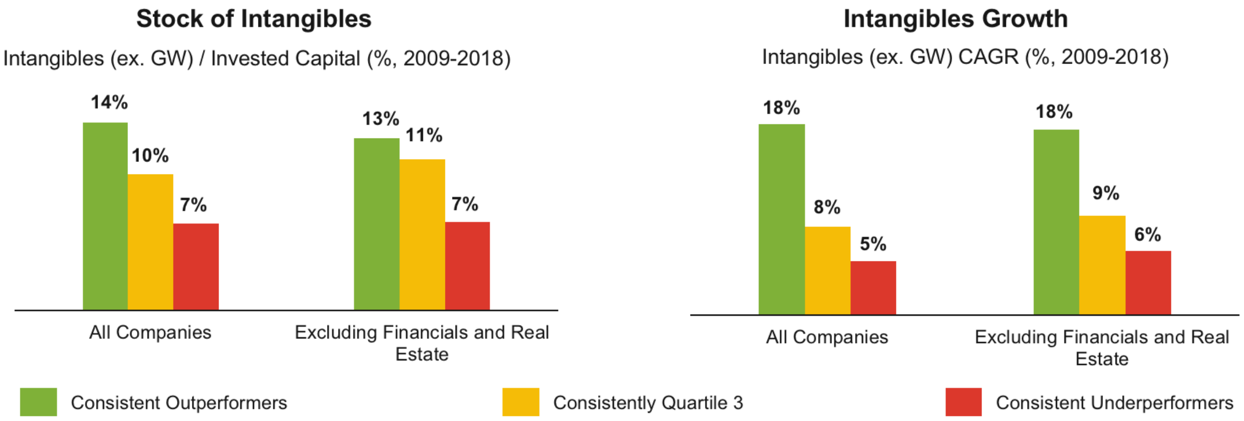
Outperformers generate significant returns above their cost of capital (Figure 3) and are less dependent on cash from operations to fund activity (Figure 9). Both of these factors contribute to the fact that in outperformers a lower percentage of the cash reinvested in the business goes towards funding the Capex requirements of the existing business. Instead, through a combination of choice and capacity, they invest more behind acquisitions. While our prior research, and many other studies, have shown that M&A is not a route to outperformance, it is undoubtedly a lever that consistent outperformers effectively deploy.

Figure 11: Reinvestment in the Business



Through a combination of organic and inorganic activity, outperformers invest behind and grow the intangible assets in the business. This activity ensures they stay customer focused, innovate to remain on trend and build reputational and brand value to sustain profitable growth in the long-term.

Figure 12: Growth of Intangibles

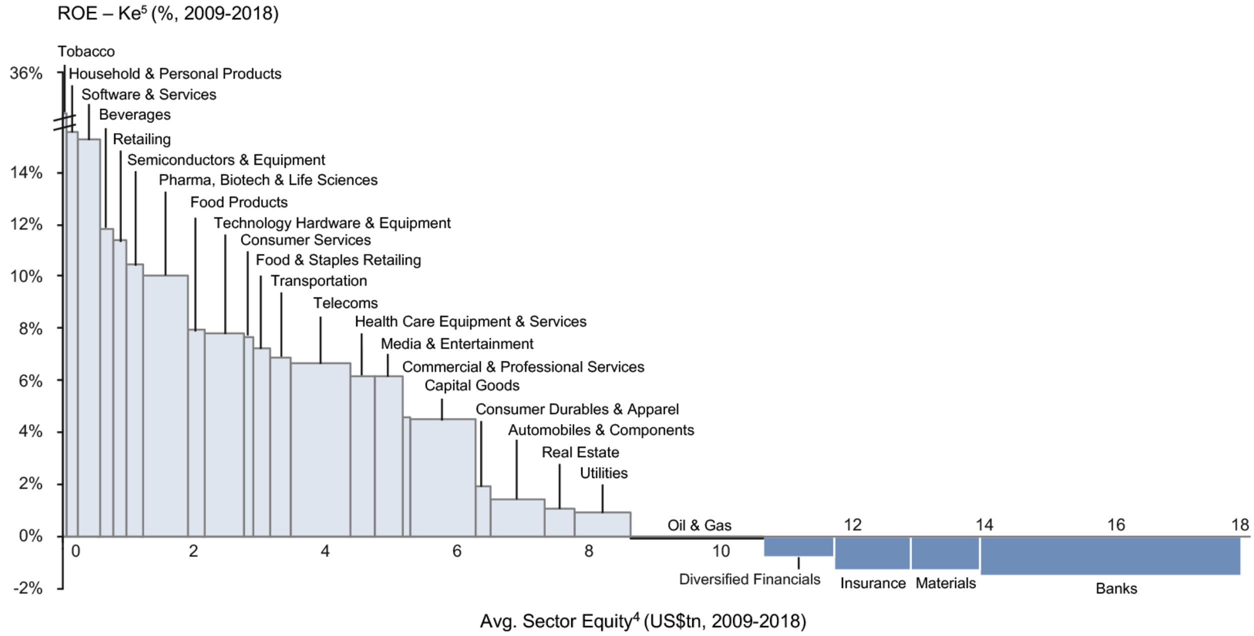


Appendices and Notes

Appendix 1: Relative Performance of Different Subsectors

SUBSECTOR	10-YEAR TSR	10-YEAR ROE- KE	10-YEAR REVENUE GROWTH
RETAILING	28%	11%	7%
TECHNOLOGY HARDWARE AND EQUIPMENT	21%	8%	5%
SEMICONDUCTORS & EQUIPMENT	20%	10%	12%
SOFTWARE & SERVICES	20%	15%	5%
MEDIA AND ENTERTAINMENT	19%	6%	9%
HEALTH CARE EQUIPMENT AND SERVICES	18%	6%	7%
CONSUMER SERVICES	17%	8%	4%
CONSUMER DURABLES & APPAREL	16%	2%	4%
CAPITAL GOODS	14%	4%	2%
TRANSPORTATION	13%	7%	4%
DIVERSIFIED FINANCIALS	13%	(1%)	7%
REAL ESTATE	12%	1%	8%
PHARMACEUTICALS, BIOTECH & LIFE SCIENCES	12%	10%	3%
BEVERAGES	12%	12%	4%
HOUSEHOLD & PERSONAL PRODUCTS	11%	16%	1%
AUTOMOBILES & COMPONENTS	11%	1%	5%
COMMERCIAL & PROFESSIONAL SERVICES	11%	5%	2%
TOBACCO	11%	34%	0%
FOOD PRODUCTS	10%	8%	1%
FOOD & STAPLES RETAILING	10%	7%	3%
MATERIALS	10%	(1%)	4%
INSURANCE	9%	(1%)	1%
BANKS	8%	(2%)	2%
UTILITIES	8%	1%	(1%)
TELECOMMUNICATION SERVICES	7%	7%	1%
OIL & GAS	5%	0%	3%

Appendix 2: Relative Economic Returns of Different Subsectors



Notes

1. For each industry, a set of meaningful “portfolio pieces” were established based on how the companies in each industry typically report their participation. For each company, data was then collated to determine the weight of each portfolio piece in the overall corporate portfolio. The weights were then regressed against overall company performance (as measured by variance in relevant valuation multiples, i.e. Market-to-Book for Banking, Beverages, Utilities; TEV/EBITDA for Paper & Packaging; Price-to-Earnings for Insurance)
2. Based on S&P Global 1200 constituents as of July 2019, which captures ~70% of global market capitalisation; simple averages exclude outliers (3+ standard deviations from the mean)
3. Sum of average company revenues over time period
4. Sum of average company equity over time period
5. Ke based on CAPM using 5-year weekly historical betas relative to each company’s regional index
6. Includes Japan and Australia
7. Includes China, Hong Kong, Singapore, South Korea, Taiwan
8. Including also select companies outside S&P Global 1,200 to improve subsegment coverage
9. A proportion of competitive position will be explained by more granular choices on where to compete within the high-level segments described
10. Totals do not add to 100% due to other financing activities, other investing activities, and forex / other adjustments; other financing activities captures net increase in deposits, which represents a significant source of cash flow for banks
11. Debt issued net of debt repayments
12. Equity issued includes issues of common and preferred shares
13. Divestments include sales of PPE
14. Reinvestment includes capex, acquisitions, purchases of intangibles, purchases of real estate and investments in securities
15. Dividends include common, preferred and special dividends
16. Buybacks include common and preferred share buybacks
17. Acquisitions include purchases of intangibles and real estate
18. Investments in marketable and equity securities

Sources

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About Marakon

We have over 40 years of experience **partnering with senior management** to drive outperformance through better decision making about where, how and when to invest **strategic resources** (capital, people, time, assets), in the pursuit of a more **valued and valuable company.**