



# Holding structure – from Conglomerate Discount to Management Value Added

by Stefan Heppelmann and Marco Hoffleith

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## Executive Summary

The whole is less than the sum of its parts. This is how the situation of many holding companies can be outlined. The reason: The capital market values holding companies with a conglomerate discount of 5 to 10% on average, and even up to 20% according to pan-European surveys. In view of the main function of the holdings i.e. to increase the synergistic effects by means of co-ordination, capital procurement, and allocation, this deduction seems surprising at first glance. However, efficient capital markets do not make mistakes. Therefore, what is the cause of all this?

If we inspect the current group structures more precisely it can be clearly seen that those holdings operating on a global basis are frequently characterised by decentralised decision-making processes and strong operative business fields. A large portion of them are structured as weak management holdings. In contrast to financial holdings, they do not only have an investment in subsidiaries, but should ensure that they manage them strategically. It is precisely this management demand, however, that they frequently fail to execute. The active management of the portfolio of activities is either carried out too hesitantly or is restricted to the disposal of unprofitable business units. The target setting and allocation of capital resources are both based on budgets or bottom-up plans and are frequently politically motivated. The stars in portfolios are not or are insufficiently promoted by means of demanding goals. Many holding company head offices, therefore, have to face up to the question of whether they actually create added value or merely represent an additional consolidation level.

In order to compete with financial holdings' head offices of holding companies must fulfil three management functions, i.e.

1. Setting top-down value added targets
2. Focusing investment funding and
3. Securing the operationalisation of the portfolio strategy in the respective business divisions.

Conversely, all support functions from the holding should be relocated to in-house shared service centres. Fulfilling these management tasks consequently is honoured by the capital market so that the whole creates more value than the sum of its parts.

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## The Conglomerate Discount – expression of dissatisfied capital markets and a door opener for financial investors

On average, the Conglomerate Discount, i.e. the reduction in valuation by the capital market due to the organisational merger of business fields in order to form holding amounts of 5 to 10% in general and up to 20% in those case studies based on European samples. To put it in another way: The net effect, i.e. the difference between the added value of the holding tasks (drafting of the reports, optimisation of taxes, procurement of investment funding in the capital market, and cash management) and the linked costs (overhead costs, slowing down of the decision making process due to hierarchies – a variety of functions) is deemed negative. As a logical consequence of this, the group sections are valued higher based on a stand-alone consideration compared to the group as a whole.

Holdings are typically valued with marked reductions on the capital market

This fact should be the cause of much worry for the board members of these holdings. The reduction in valuation is based solely on the chosen organisational structures and has nothing to do with the validity and sustainability of the group sector's individual business models. Therefore, it must be permissible to question as to whether such holding structures are justifiable, which evidently do not help in adding value. The consideration of the possible ways that such holdings can be broken up is the consequence – particularly in view of the fact that spin-offs, buy outs, and demergers of group sectors represent tangible alternatives. Financial investors are also attracted by conglomerate discounts and in turn can act as catalysts of a potential break up. If the holding board wants to pre-empt these kinds of scenarios, then it must convince investors and capital markets of the meaningfulness of the holding as an organisational form.

The board must prove the meaningfulness of the holding structure

## The structure of the group head office is fundamentally dependent on the holding's management demand

The role of the holding structure has always had a mirror image of the management theories that, respectively, prevailed. In the 1970s and 1990s, for instance, it was an expression of the conviction that was widely held at these times that a diversification effect due to different business fields in the portfolio would be advantageous. Nowadays, the holding structure is more of an expression of a dynamic business fields' portfolio, the changing composition of which is characterised by a continuous search for new growth fields in changing markets. The tasks of the group holding vary in this case depending on their self-conception and claim to leadership, ranging from pure financing to the specification of strategic guidelines and in turn extending to interference in operative business activities.

The self-conception and claim of holding leadership have changed over the years.

A holding from which no economic advantages can be derived is unsuitable as an organisational form

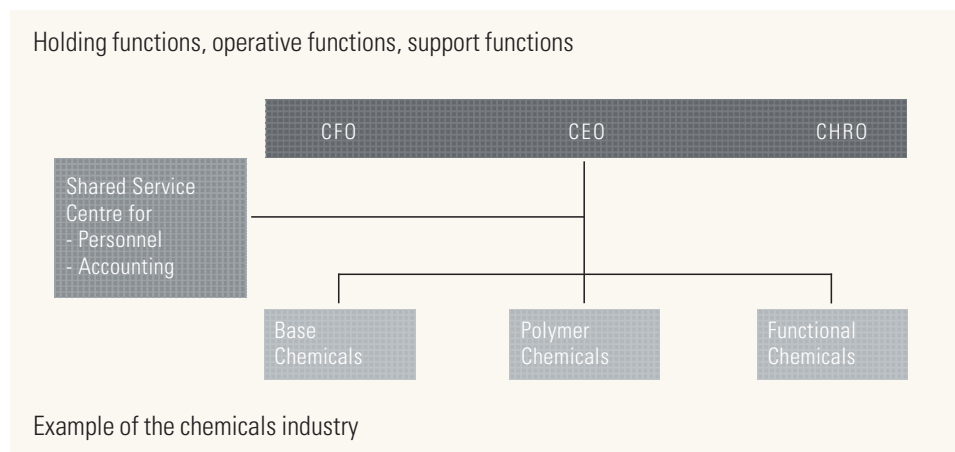
A distinction must be made between the holding's functions that it performs in order to categorise the holding's management strength. In terms of its minimum function, the holding must perform tasks that guarantee its legal existence. These include, for instance, the consolidation of P&L accounts and balance sheets, the preparation of annual financial statements, securing liquidity, the payment of taxes and dividends, as well as the observation of all the statutory and regulatory provisions. However, the extension of these functions beyond this scope should be integrated into the respective actions in order to derive economic benefits. Otherwise, this would not be a meaningful structural variant.

Between a dream and reality: The dilemma between local autonomy and central control

In October 2006, the Economist Intelligence Unit, a Research Tank of The Economist, published a survey with the title "Global dreams, local realities – The challenge of managing multinationals". This survey confirmed the dilemma between local autonomy and central control that globally active groups are currently facing. Many group boards find it difficult to achieve this balancing act between the surrendering of authority to the local management and the desire for control by means of centralisation. The survey, which was conducted with nearly 300 executive participants, demonstrates a trend towards the de-centralisation of functions such as sales, marketing, PR, and HR as well as towards centralisation in the strategy, finance, and IT sectors.

The holding must make a sustained contribution towards value creation in order to convince the market

The results of the survey confirm Stern Stewart & Co. belief that the inward and outward positioning of the holding is ultimately determined by the scope of the central functions that have been assumed. The goal of every holding must be to provide a clearly recognisable added value. The pure standardisation of processes and grouping of tasks for the purpose of increasing efficiency and economy of scale benefits is insufficient to create sustained added value. On the other hand, the clear separation into the control functions of the holding, operative corporate tasks for segments, as well as support functions ensures a clearer self-conception of the individual units by means of their contribution towards value added for the shareholders.



Stern Stewart & Co. experiences demonstrate that a holding structure is only justified in economic terms if these management functions are performed:

- I) **Specification of value added goals for the business areas**
- II) **Focusing of the investment funds**
- III) **“Operationalisation” of the portfolio strategy.**

A holding is typically only worthwhile in economic terms if it performs central management functions

The starting point of active portfolio management is to stipulate ambitious goal specifications for the individual business fields that are based on the capital market expectations and competitors' performance. Depending on the value added targets that have been derived, the holding's head office must ensure that investment funds are directed into the business areas with the greatest levels of potential. Once the value added targets and direction of the strategic thrust have been clearly established, the holding must initiate the operationalisation of these specifications within the individual business areas: Within the framework of a value added agenda, the framework parameters are stipulated and constantly monitored for the progress made. The measures are derived and initiated at the level of the individual business areas.

## I) Specification of value added goals for the business areas

Three clear structural questions are faced by the holding at the start of the process of value-based goal derivation:

1. **What level of performance does the capital market anticipate from the business fields in the future?**
2. **What level of performance does the capital market anticipate from competitors in the future?**
3. **How good is the present level of competition compared to the competition?**

It should be possible to measure the specification of value oriented targets based on capital market expectations

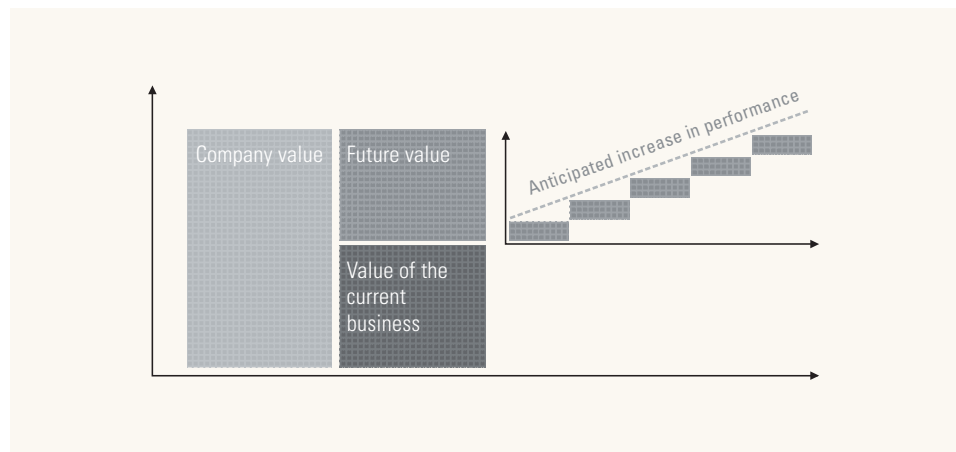
Through this process, the answering of these questions outlines the sequence of goal derivation. However, in practice, the holding management rarely has an answer. The answers in response to the simple question of where the goals within the company actually stem from are often sobering. The targets for the individual business fields are frequently based on the budget or the planning, and thereby are driven bottom-up. Thus, the management's own forecasts become the measuring gauge in terms of the attainment of targets: The more conservative the budget planning is the greater the likelihood that this yardstick will be successfully achieved. The “hockey stick” effect, which is seen in many budgets impressively substantiates this logic. The consequence is that they quickly forget to

However, in everyday business life, you will rarely find such capital market oriented systems

look beyond their own company when they start target setting. However, only an outside-in-perspective makes it possible to assess the ambitions of the in-house (medium-term) planning compared to the competition and investor's anticipations.

The future expectations of investors can be gauged via the "future value" concept.

To this end, the most important thing is to analyse the expectations of the capital market in terms of future performance. By means of the Stern Stewart & Co. "Future Value" concept, the future expectations of investors that are implicitly contained within the share price can be quantified by dividing the company value into two: (a) the value of the current business (this corresponds to the capitalised current performance as a perpetuity) and (b) the future value (corresponds to the value of the future increases in performance).



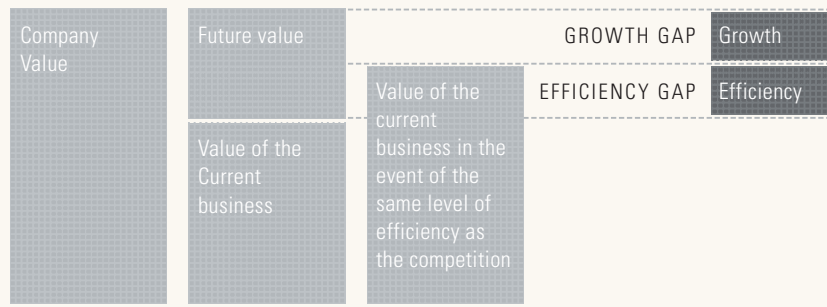
The definition of the future value in turn forms the basis for the planning of value added activities

The future value describes an improvement in performance, which is necessary to fulfil investors' expectations. If we transfer this division to the company values of the competitors, then we will obtain more information about which future expectations the capital market has in these companies. A goal gap is defined by means of the capital market's expectations in your own company and in the competitors by reflecting the anticipated performance improvements against your own (medium-term) plans.

Once the goal gap is defined it is important to identify the ways in which it can be closed. In principle, two directions are plausible to this end:

1. **Improvement of efficiency (both capital and process efficiency):**  
This comprises all the measures that improve the operating results if the capital is employed, and thereby increase the return.
2. **Profitable growth:**  
Growth creates added value as long as the costs of the capital that is additionally invested are lower than the results that are generated with the investment.

## Two ways of closing the goal gap



The question of which of the two options is appropriate in turn results from the respective answer to the third question that was initially posed (“How good is the present level of performance compared to the competition?”). Benchmarking provides more information about this. The “formula” to close the goal gap, therefore, appears quite simple: The value gap is reduced for such time by means of an improvement in efficiency until the efficiency level of the competitors is reached, i.e. the efficiency gap is closed. The remaining part of the value gap – the growth gap – must be closed by means of profitable growth, i.e. by means of an extension of the existing activities or by entry into new business fields.

### Conclusion:

The derivation of goals from an outside-in perspective in turn examines the demand levels of your own planning compared to the capital market expectations and competition. The holding can specify goals in a transparent process and thus depoliticise the planning and budget. By means of this goal setting process, it secures the acceptance of the goal specifications by referring to the capital market and competitor’s performance. However, the process offers an additional advantage: It links the target setting with capital allocation. The level of future expectations in the individual business fields, or in their competitors, makes it possible to draw conclusions about their respective market attractiveness.

A difference in the level of efficiency compared to the competition is the first lever to close the value gap...  
...while profitable growth holds the greatest prospects of success in the long-term

By integrating an external perspective, the holding can depoliticise the planning and budget

## II) Focusing of investment funds

The allocation of resources should be driven by future expectations ...

If the goal specifications have been laid down, the holding must ensure that all the business fields are provided with the necessary capital funds. The allocation logic appears very clearly in this process: The limited capital resources are distributed to the largest potential growth fields in the portfolio.

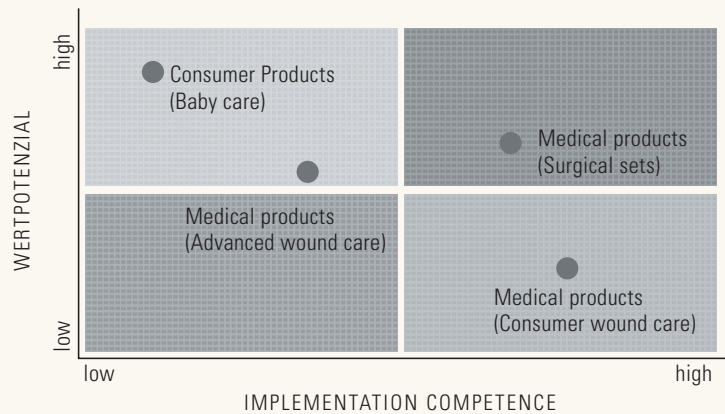
... while factors such as department size or negotiation skills are currently still determining factors

However, the current practice is different in many groups. Capital resources are often not allocated without taking the areas of potential into account and are frequently at odds with the strategy and goal specifications. Deterministic distribution keys ensure that large business fields tend to be favoured. Thus, the volumes awarded for investments for the replacement and maintenance of assets often form a large part of the annual investment budgets. The political influence, which the largest sectors in groups enjoy, further exacerbates this effect. There are, therefore, only insufficient capital resources for the smaller fields that offer greater growth potential in the future – with the consequence that the areas of growth potential cannot be completely exploited. In addition, the allocation process is many times driven by the demand of the individual branches (bottom-up) in practice. The consequence is that the budget orientation during the allocation, or granting, of funding is carried out based on the watering can principle.

Just like a financial investor, the holding must direct capital resources into growth fields that are based on clear criteria

The task of the holding now consists in ensuring, in a first step, that the cashflows that are generated by the individual business divisions are collected as part of a cash pooling process. With the aid of clear group guidelines it must counteract the excessive consumption of the excess capital resources by the business divisions themselves and instead allocate them to the business fields with the greatest future potential, based on clear criteria in a manner similar to that of a financial investor. To this end, it is imperative to develop a clear understanding of which business fields in the portfolio will drive the appreciation of value in the future. Two variables serve as decision making criteria in this process: The attractiveness of the business field in terms of its value, and the company's own competence in relation to its competition regarding the creation of value in these markets.

### Capital allocation matrix



Example of health care in line with consumers' needs

The variable of value attractiveness answers the question of to what extent value creation is possible within a business field due to the customer benefits that are offered as well as the market and competitive situation. The growth gaps for the individual sectors were already identified during the goal derivation process. They provide information in terms of which business fields the capital market expects to see growth.

The potential of the results from the interaction of attractiveness in terms of value and realisation competence

The variable of realisation competence answers the question of how capable a company actually is in increasing the value potential in the anticipated growth sectors, based on its strengths and weakness compared to its competitors.

Growth investments offer a value added path, if high value contributions are forecasted in a core business field, and if the realisation competence is high compared to the competitors. If, on the other hand, the forecasted areas of value potential are low, this does not have to lead to the business field in question being sold off – in the event that the company simultaneously has high levels of realisation competence, these low areas of value potential could be exploited by means of increases in efficiency. Likewise, in the reverse case of a high level of value potential set against a low level of realisation competence, the answer does not have to be that the levels of competence should be increased; because other market competitors could be prepared to pay substantial premiums for the high levels of market attractiveness. Only if both variables are at low levels would there be hardly any alternatives to a reduction in commitment or the respective sale.



Once the direction of the strategic thrust has been stipulated for the entire portfolio, it is important to provide the respective business fields with those investment funds that they need to realise regarding their value added goals. Capital allocation is, therefore, the instrument in terms of the strategic orientation by means of which the distribution of resources is determined.

**Conclusion:**

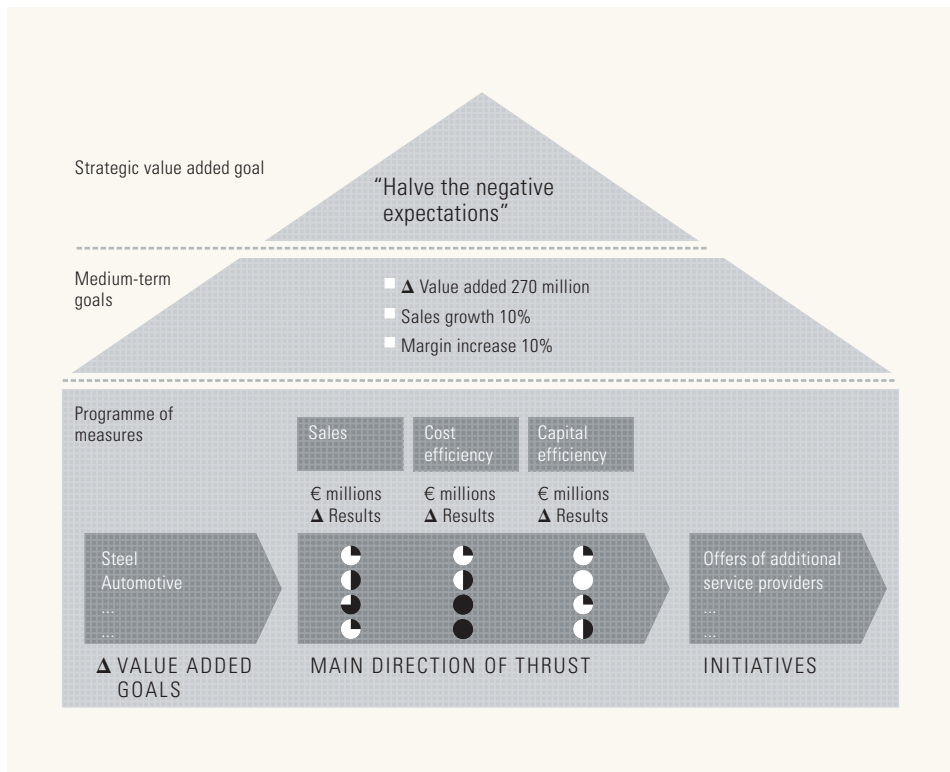
The amount of resources granted and the proportion of the goal specifications

The potential orientation allocation process makes it possible for the holding to act like a strategic investor vis-à-vis the business fields, based on transparent criteria and to consistently direct capital resources into growth fields with a large amount of potential. The investment volume and goal specification should be in harmony: The more capital resources a business field obtains, the higher its goal specifications should be.

**III) “Operationalisation” of the portfolio strategy**

A cogent value added agenda forms the basis for the implementation of the goals

In addition to the specification of value added goals and the allocation of capital resources that are adequate for the goal, there is a third compulsory function holding, i.e. securing the operationalisation of the strategic specifications and goals. To this end, the holding must set up an appropriate infrastructure. For this purpose, Stern Stewart & Co. recommends that its clients draft a value added agenda and communicate this inwardly and outwardly. In addition to the definition of a group goal, it is essential in terms of communication in the capital market to present a cogent concept with respect to how and when the goals will be attained. Furthermore, this is precisely where the holding can make a contribution towards value creation: By means of the credible communication of the value creation outwardly and by securing the operationalisation of the goals inwardly. A value agenda offers the necessary infrastructure for the operationalisation and prioritisation of the relevant measures for attaining the respective goals.

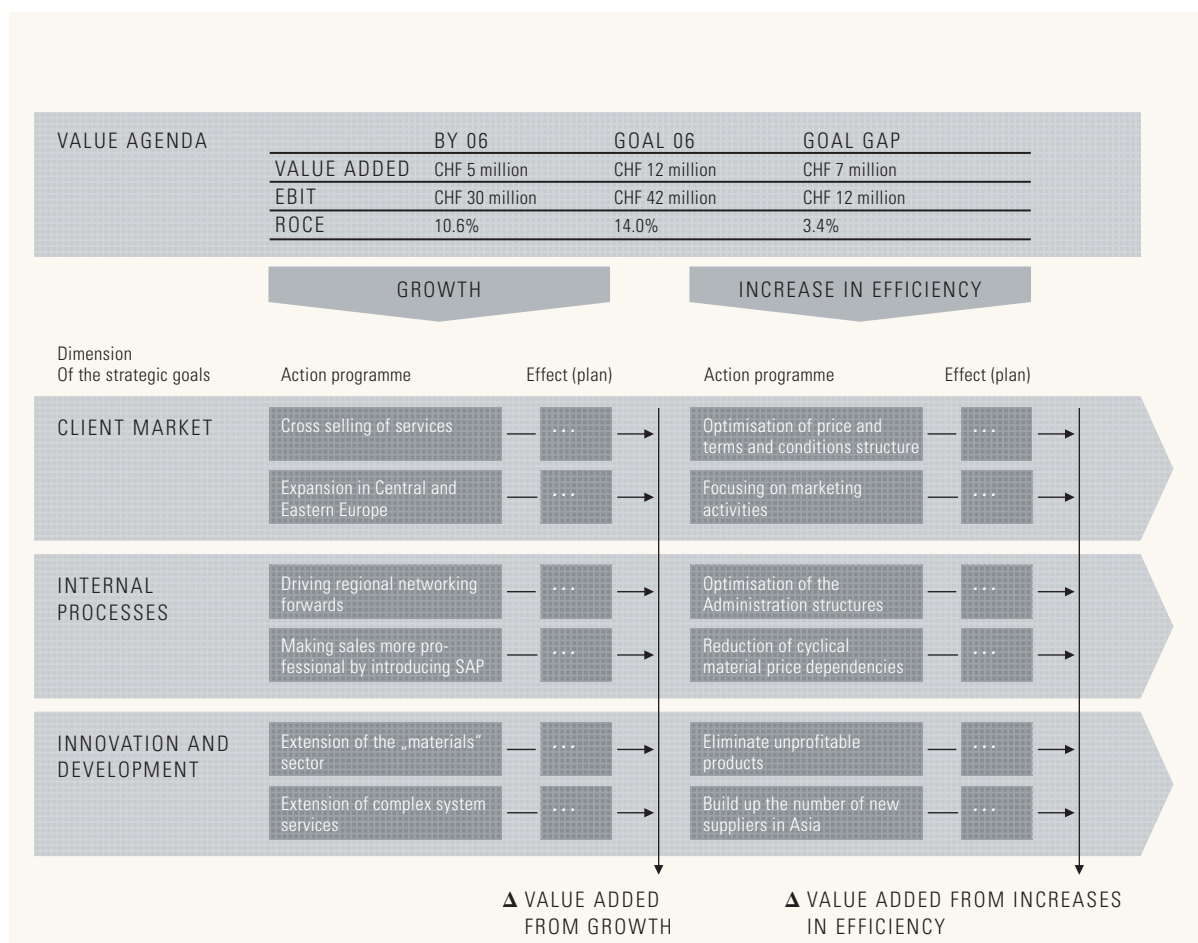


The goal of the value added agenda is to define the specific goals at an operative level and identify the relevant value drivers. It is to be concluded by the formulation of specific action programmes in order to positively influence the value drivers.

The benchmarking during the derivation of goals forms the starting point. The aggregated benchmarking variables such as EBIT or ROCE are further broken down into their component parts to make the causes of the differing performance levels vis-à-vis the competition more transparent. On the basis of the results of this analysis, a main thrust direction can be identified in a second step, which should be pursued in order to attain the goals. In this case, a distinction should be made between a focus upon

The detailed competition benchmarking of performance variables reveals the starting levels

- Sales/Operating results growth
- Cost efficiency
- Capital efficiency



## Example of the operationalisation of efficiency and growth goals

Specific action programmes help to positively influence the value drivers

Irrespective of the strategic thrust direction that has been identified, the relevant value drivers that are relevant for the implementation of this thrust direction in a third step, i.e. those factors, which have a key influence on the goal to be attained. In a third step, it is a matter of linking the value drivers with the specific programmes of actions. In the case of this step, the business fields themselves tend to bear the responsibility. The holding's task is rather to monitor the implementation and progress in the form of monitoring and to communicate partial successes to the capital market that have been achieved.

The holding acts as a central monitoring and communication body and, therefore, drives the appreciation in value forwards

The holding's value added thus consists in triggering this process and orchestrating and monitoring the implementation. By communicating a group wide value added goal, it raises investors' expectations and thus raises the pressure on the business fields to achieve the anticipated levels of performance.

## Final overview

If the holding consistently implements the three central management functions, then it makes an active contribution towards adding value to the group and thus justifies its own existence from an economic point of view. It creates a company philosophy that is directed towards a value added agenda by means of top-down specifications based on capital market expectations and the competitors' performance. An allocation policy that is based on the goal specifications secure the group's future viability in the form of a dynamic portfolio that includes business fields with significant future potential. The operationalisation within the framework of a value added agenda guarantees a systematic cause analysis of the benchmarking results at an operative level, the identification of the relevant value drivers, as well as their linking with specific action programmes. If the value added goal is ultimately communicated at the group level, and the way in which the goal should be achieved is made transparent, the investors' sense of insecurity in terms of the added value of a holding structure should be considerably reduced and thus the conglomerate discount should melt away.

## The authors



Stefan Heppelmann, CFA  
Partner  
sheppelmann@sternstewart.de



Marco Hoffleith  
mhoffleith@sternstewart.de

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Stern Stewart & Co. GmbH

Salvatorplatz 4

D-80333 München

T +49.89.242071.0

F +49.89.242071.11

E [info@sternstewart.de](mailto:info@sternstewart.de)

I [www.sternstewart.de](http://www.sternstewart.de)

Schottenring 16

A-1010 Wien

T +43.1.53712.4111

F +43.1.53712.4000

E [info@sternstewart.at](mailto:info@sternstewart.at)

I [www.sternstewart.at](http://www.sternstewart.at)

Seefeldstrasse 69

CH-8008 Zürich

T +41.43.488.36.39

F +41.43.488.35.00

E [info@sternstewart.ch](mailto:info@sternstewart.ch)

I [www.sternstewart.ch](http://www.sternstewart.ch)

