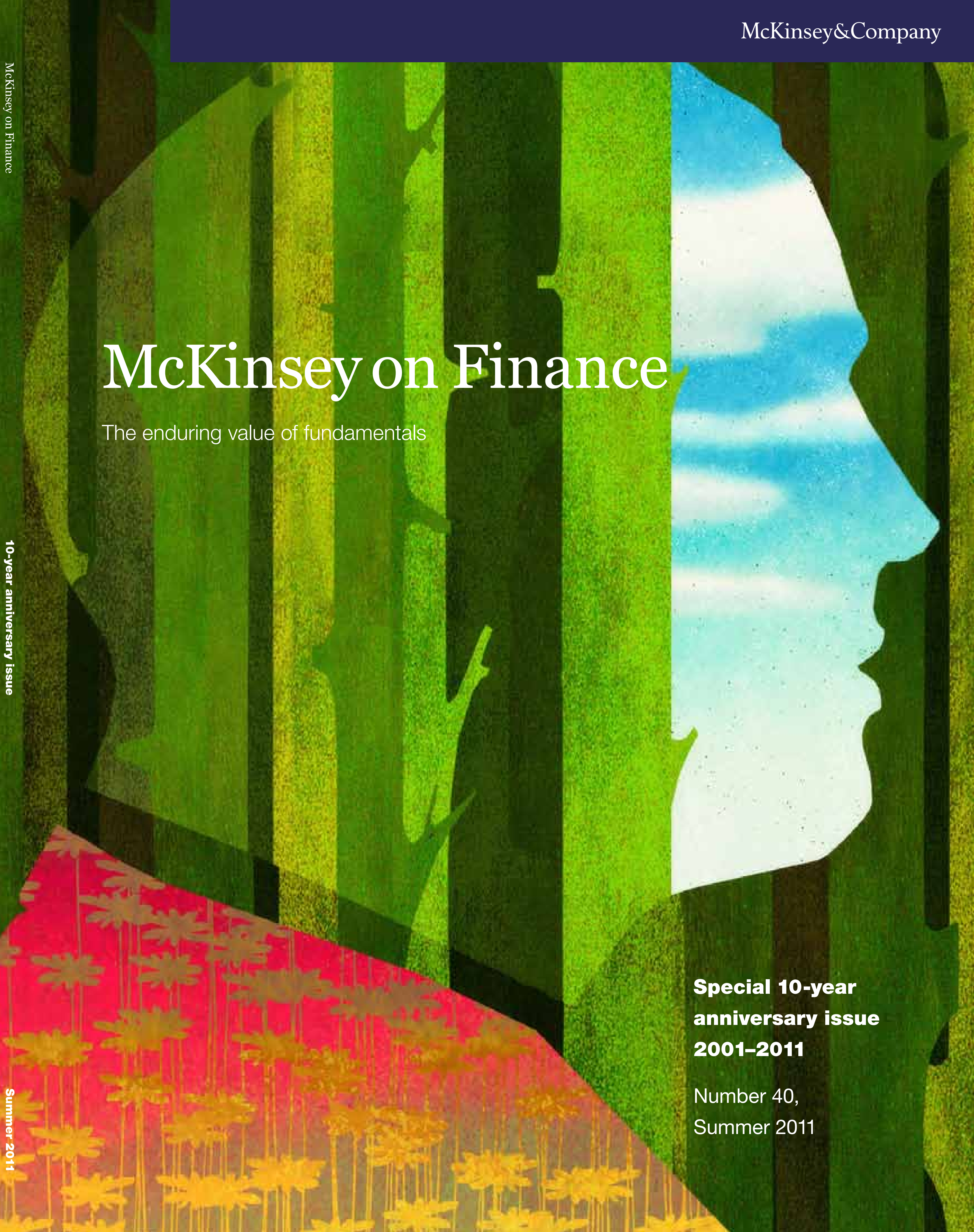
McKinsey&Company
McKinsey on Finance
The enduring value of fundamentals
Special 10-year anniversary issue 2001–2011
Number 40, Summer 2011
McKinsey on Finance
10-year anniversary issue
Summer 2011

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# McKinsey on Finance

The enduring value of fundamentals

**Special 10-year anniversary issue 2001–2011**

Number 40,
Summer 2011

# Editors’ note

When we published the inaugural issue of *McKinsey on Finance*, in the summer of 2001, CFOs were facing the challenges of navigating a global economy recovering from a downturn and bruised by corporate misbehavior during the dot-com market crash. The outlook for growth, valuation, and financial regulation was uncertain at best.

The philosophy of the new publication’s editorial board was that companies could best improve their performance in the face of these uncertainties by drawing on the established principles of finance. After a decade marked by both crisis and profound changes in global financial markets, that remains our approach.

If a single theme has run through the pages of *McKinsey on Finance* over the past ten years, it has been the importance of challenging the many and recurring incomplete, misleading, and faddish interpretations of finance. We have advanced interpretations of value creation that respect the long-term effectiveness of capital markets—and are cautious about mistaking short-term “noise” for indications of long-term value creation. Our authors have also sought to provide specific tools to help finance leaders run their varied functions more effectively and efficiently, and thus to influence the direction of their companies.

For this special anniversary anthology, we’ve compiled a selection of articles and excerpts from the past decade that we believe remain useful for driving performance even today.

In this issue, you'll find "The CEO's guide to corporate finance," which applies the four cornerstones of corporate finance to decisions in mergers and acquisitions, divestitures, project analysis and downside risk, and executive compensation. The section on growth examines the difficulty that large successful companies have in sustaining it, as well as some of the practical trade-offs afforded by different types of growth.

Further in, you'll find a section on governance and risk, articles that draw from our experience with active managers in private equity and from fundamental analysis of hedging and risk management. There's also a section on dealing with investors: describing a better way to communicate with different segments of investors, considering the value of transparency in accounting and investor communications, and examining the clearest indication of investor thinking—the movement of stock markets. Finally, the anthology ends with a practical look at the role of the CFO and how to improve the efficiency of the finance function.

We hope that the articles and excerpts that follow will help you to explore the value and creative application of tested finance fundamentals in a rapidly changing world. Additional related reading, as well as this collection and the full versions of excerpted articles, can be found on mckinseyquarterly.com.

**Bill Huyett and Tim Koller**

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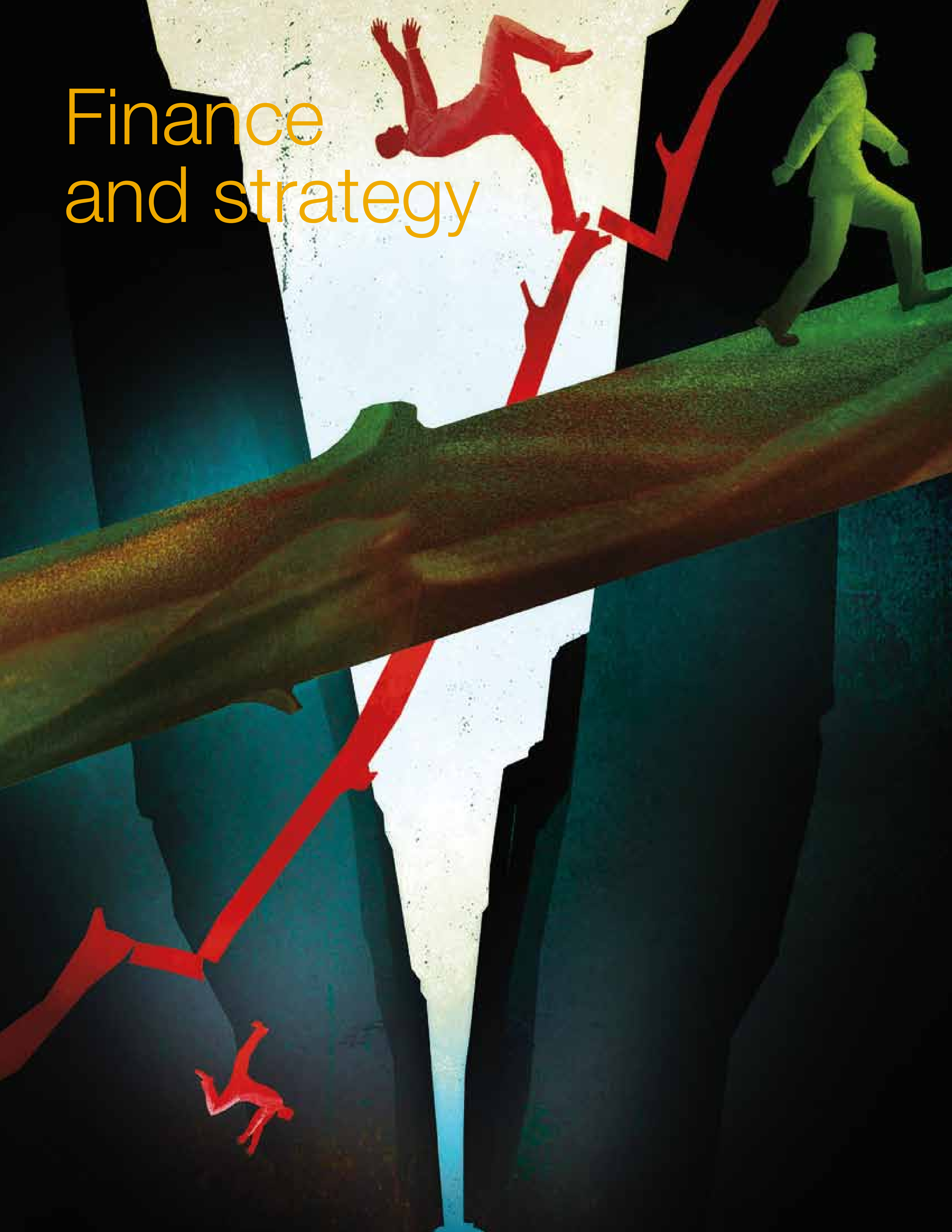
# Finance and strategy



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# The CEO's guide to corporate finance

**Richard Dobbs, Bill Huyett, and Tim Koller**

**Number 37, Autumn 2010**

Four principles can help you make great financial decisions—even when the CFO's not in the room.

It's one thing for a CFO to understand the technical methods of valuation—and for members of the finance organization to apply them to help line managers monitor and improve company performance. But it's still more powerful when CEOs, board members, and other nonfinancial executives internalize the principles of value creation. Doing so allows them to make independent, courageous, and even unpopular business decisions in the face of myths and misconceptions about what creates value.

When an organization's senior leaders have a strong financial compass, it's easier for them to resist the siren songs of financial engineering, excessive leverage, and the idea (common during boom times) that somehow the established rules of economics no longer apply. Misconceptions like these—which can lead companies to make value-destroying

Excerpt from
# Are you still the best owner of your assets?

**Richard Dobbs, Bill Huyett, and Tim Koller**

**Number 34, Winter 2010**

The best-owner life cycle means that executives must continually seek out new acquisitions for which their companies could be the best owner. Applying the best-owner principle often leads acquirers toward targets very different from those that traditional target-screening approaches might uncover. Traditional ones often focus on targets that perform well financially and are somehow related to the acquirer's business lines. But through the best-owner lens, such characteristics might have little or no importance. It might be better, for instance, to seek out a financially weak company that has great potential for improvement, especially if the acquirer has proven performance-improvement expertise. Or it might be better to focus attention on tangible opportunities to cut costs or on the existence of common customers than on vague notions such as how related the target may be to the acquirer.

Keeping the best-owner principle front and center can also help with negotiations for an acquisition by keeping managers focused on what the target is worth specifically to their own company—as well as to other bidders. Many managers err in M&A by estimating only an acquisition's value to their own company. Because they are unaware of the target's value to other potential better owners—or how high those other owners might be willing to bid—they get lulled into conducting negotiations right up to their breakeven point, creating less value for their own shareholders. Instead of asking how much they *can* pay, they should be asking what's the least they need to pay to win the deal and create the most value.

decisions and slow down entire economies—take hold with surprising and disturbing ease.

What we hope to do in this article is show how four principles, or cornerstones, can help senior executives and board members make some of their most important decisions. The four cornerstones are disarmingly simple:

1. The core-of-value principle establishes that value creation is a function of returns on capital and growth, while highlighting some important subtleties associated with applying these concepts.

2. The conservation-of-value principle says that it doesn't matter how you slice the financial pie with financial engineering, share repurchases, or acquisitions; only improving cash flows will create value.

3. The expectations treadmill principle explains how movements in a company's share price reflect changes in the stock market's expectations about performance, not just the company's actual performance (in terms of growth and returns on invested capital). The higher those expectations, the better that company must perform just to keep up.

4. The best-owner principle states that no business has an inherent value in and of itself; it has a different value to different owners

or potential owners—a value based on how they manage it and what strategy they pursue.

Ignoring these cornerstones can lead to poor decisions that erode the value of companies. Consider what happened during the run-up to the financial crisis that began in 2007. Participants in the securitized-mortgage market all assumed that securitizing risky home loans made them more valuable because it reduced the risk of the assets. But this notion violates the conservation-of-value rule. Securitization did not increase the aggregated cash flows of the home loans, so no value was created, and the initial risks remained. Securitizing the assets simply enabled the risks to be passed on to other owners: some investors, somewhere, had to be holding them.

Obvious as this seems in hindsight, a great many smart people missed it at the time. And the same thing happens every day in executive suites and boardrooms as managers and company directors evaluate acquisitions, divestitures, projects, and executive compensation. As we'll see, the four cornerstones of finance provide a perennially stable frame of reference for managerial decisions like these.

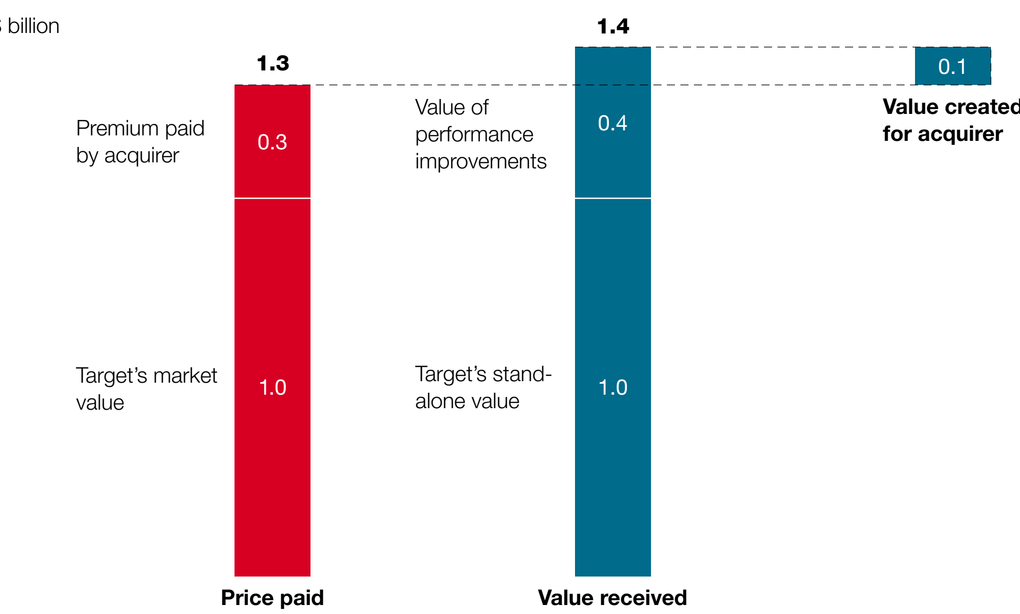
## Mergers and acquisitions

Acquisitions are both an important source of growth for companies and an important element of a dynamic economy. Acquisitions that put companies in the hands of better owners or managers or that reduce excess capacity typically create substantial value both for the economy as a whole and for investors.

You can see this effect in the increased combined cash flows of the many companies involved in acquisitions. But although they create value overall,

Exhibit 1

**To create value, an acquirer must achieve performance improvements that are greater than the premium paid.**



the distribution of that value tends to be lopsided, accruing primarily to the selling companies' shareholders. In fact, most empirical research shows that just half of the acquiring companies create value for their own shareholders.

The conservation-of-value principle is an excellent reality check for executives who want to make sure their acquisitions create value for their shareholders. The principle reminds us that acquisitions create value when the cash flows of the combined companies are greater than they would otherwise have been. Some of that value will accrue to the acquirer's shareholders if it doesn't pay too much for the acquisition.

Exhibit 1 shows how this process works. Company A buys Company B for $1.3 billion—a transaction that includes a 30 percent premium over its market value. Company A expects to increase the value of Company B by 40 percent through various operating improvements, so the value of Company B to Company A is $1.4 billion. Subtracting the purchase price of $1.3 billion from $1.4 billion leaves $100 million of value creation for Company A's shareholders.

In other words, when the stand-alone value of the target equals the market value, the acquirer creates value for its shareholders only when the value of improvements is greater than the premium paid. With this in mind, it's easy to see why most of the value creation from acquisitions goes to the sellers' shareholders: if a company pays a 30 percent premium, it must increase the target's value by at least 30 percent to create any value.

While a 30 or 40 percent performance improvement sounds steep, that's what acquirers often achieve. For example, Exhibit 2 highlights four large deals in the consumer products sector. Performance improvements typically exceeded 50 percent of the target's value.

Our example also shows why it's difficult for an acquirer to create a substantial amount of value from acquisitions. Let's assume that Company A was worth about three times Company B at the time of the acquisition. Significant as such a deal would be, it's likely to increase Company A's value by only 3 percent—the $100 million of value creation depicted in Exhibit 1, divided by Company A's value, $3 billion.

Exhibit 2

**Dramatic performance improvements created significant value in these four acquisitions.**

| | Present value of announced performance improvements as % of target's stand-alone value | Premium paid as % of target's stand-alone value | Net value created from acquisition as % of purchase price |
|---|---|---|---|
| Kellogg acquires Keebler (2000) | 45–70 | 15 | 30–50 |
| PepsiCo acquires Quaker Oats (2000) | 35–55 | 10 | 25–40 |
| Clorox acquires First Brands (1998) | 70–105 | 60 | 5–25 |
| Henkel acquires National Starch (2007) | 60–90 | 55 | 5–25 |

Finally, it's worth noting that we have not mentioned an acquisition's effect on earnings per share (EPS). Although this metric is often considered, no empirical link shows that expected EPS accretion or dilution is an important indicator of whether an acquisition will create or destroy value. Deals that strengthen near-term EPS and deals that dilute near-term EPS are equally likely to create or destroy value. Bankers and other finance professionals know all this, but as one told us recently, many nonetheless "use it as a simple way to communicate with boards of directors." To avoid confusion during such communications, executives should remind themselves and their colleagues that EPS has nothing to say about which company is the best owner of specific corporate assets or about how merging two entities will change the cash flows they generate.

## Divestitures

Executives are often concerned that divestitures will look like an admission of failure, make their company smaller, and reduce its stock market value. Yet the research shows that, on the contrary, the stock market consistently reacts positively to divestiture announcements.[1] The divested business units also benefit. Research has shown that the profit margins of spun-off businesses tend to increase by one-third during the three years after the transactions are complete.[2]

These findings illustrate the benefit of continually applying the best-owner principle: the attractiveness of a business and its best owner will probably change over time. At different stages of an industry's or company's lifespan, resource decisions that once made economic sense can become problematic. For instance, the company that invented a groundbreaking innovation may not be best suited to exploit it. Similarly, as demand falls off in a mature industry, companies that have been in it a long time are likely to have excess capacity and therefore may no longer be the best owners.

A value-creating approach to divestitures can lead to the pruning of good and bad businesses at any stage of their life cycles. Clearly, divesting a good business is often not an intuitive choice and may be difficult for managers—even if that business would be better owned by another company. It therefore makes sense to enforce some discipline in active portfolio management. One way to do so is to hold regular review meetings specifically devoted to business exits, ensuring that the topic remains on the executive agenda and that each unit receives a date stamp, or estimated time of exit. This practice has the advantage of obliging executives to evaluate all businesses as the "sell-by date" approaches.

Executives and boards often worry that divestitures will reduce their company's size and thus cut its value in the capital markets. There follows a misconception that the markets value larger companies more than smaller ones. But this notion holds only for very small firms, with some evidence that companies with a market capitalization of less than $500 million might have slightly higher costs of capital.[3]

Finally, executives shouldn't worry that a divestiture will dilute EPS multiples. A company selling a business with a lower P/E ratio than that of its remaining businesses will see an overall reduction in earnings per share. But don't forget that a divested underperforming unit's lower growth and return on invested capital (ROIC) potential would have previously depressed the entire company's P/E. With this unit gone, the company that remains will have a higher growth and ROIC potential—and will be valued at

a correspondingly higher P/E ratio.[4] As the core-of-value principle would predict, financial mechanics, on their own, do not create or destroy value. By the way, the math works out regardless of whether the proceeds from a sale are used to pay down debt or to repurchase shares. What matters for value is the business logic of the divestiture.

## Project analysis and downside risks

Reviewing the financial attractiveness of project proposals is a common task for senior executives. The sophisticated tools used to support them—discounted cash flows, scenario analyses—often lull top management into a false sense of security. For example, one company we know analyzed projects by using advanced statistical techniques that always showed a zero probability of a project with negative net present value (NPV). The organization did not have the ability to discuss failure, only varying degrees of success.

Such an approach ignores the core-of-value principle's laserlike focus on the future cash flows underlying returns on capital and growth, not just for a project but for the enterprise as a whole. Actively considering downside risks to future cash flows for both is a crucial subtlety of project analysis—and one that often isn't undertaken.

For a moment, put yourself in the mind of an executive deciding whether to undertake a project with an upside of $80 million, a downside of –$20 million, and an expected value of $60 million. Generally accepted finance theory says that companies should take on all projects with a positive expected value, regardless of the upside-versus-downside risk.

But what if the downside would bankrupt the company? That might be the case for an electric-power utility considering the construction of a nuclear facility for $15 billion (a rough 2009 estimate for a facility with two reactors). Suppose there is an 80 percent chance the plant will be successfully constructed, brought in on time, and worth, net of investment costs, $13 billion. Suppose further that there is also a 20 percent chance that the utility company will fail to receive regulatory approval to start operating the new facility, which will then be worth –$15 billion. That means the net expected value of the facility is more than $7 billion—seemingly an attractive investment.[5]

The decision gets more complicated if the cash flow from the company's existing plants will be insufficient to cover its existing debt plus the debt on the new plant if it fails. The economics of the nuclear plant will then spill over into the

value of the rest of the company—which has $25 billion in existing debt and $25 billion in equity market capitalization. Failure will wipe out all the company's equity, not just the $15 billion invested in the plant.

As this example makes clear, we can extend the core-of-value principle to say that a company should not take on a risk that will put its future cash flows in danger. In other words, don't do anything that has large negative spillover effects on the rest of the company. This caveat should be enough to guide managers in the earlier example of a project with an $80 million upside, a –$20 million downside, and a $60 million expected value. If a $20 million loss would endanger the company as a whole, the managers should forgo the project. On the other hand, if the project doesn't endanger the company, they should be willing to risk the $20 million loss for a far greater potential gain.

## Executive compensation

Establishing performance-based compensation systems is a daunting task, both for board directors concerned with the CEO and the senior team and for human-resource leaders and other executives focused on, say, the top 500 managers. Although an entire industry has grown up around the compensation of executives, many companies continue to reward them for short-term total returns to shareholders (TRS). TRS, however, is driven more by movements in a company's industry and in the broader market (or by stock market expectations) than by individual performance. For example, many executives who became wealthy from stock options during the 1980s and 1990s saw these gains wiped out in 2008. Yet the underlying causes of share price changes—such as falling interest rates in the earlier period and the financial crisis more recently—were frequently disconnected from anything managers did or didn't do.

Using TRS as the basis of executive compensation reflects a fundamental misunderstanding of the third cornerstone of finance: the expectations treadmill. If investors have low expectations for a company at the beginning of a period of stock market growth, it may be relatively easy for the company's managers to beat them. But that also increases the expectations of new shareholders, so the company has to improve ever faster just to keep up and maintain its new stock price. At some point, it becomes difficult if not impossible for managers to deliver on these accelerating expectations without faltering, much as anyone would eventually stumble on a treadmill that kept getting faster.

This dynamic underscores why it's difficult to use TRS as a performance-measurement tool: extraordinary managers may deliver only ordinary TRS because it is extremely difficult to keep beating ever-higher share price expectations. Conversely, if markets have low performance expectations for a company, its managers might find it easy to earn a high TRS, at least for a short time, by raising market expectations up to the level for its peers.

Instead, compensation programs should focus on growth, returns on capital, and TRS performance, relative to peers (an important point) rather than an absolute target. That approach would eliminate much of the TRS that is not driven by company-specific performance. Such a solution sounds simple but, until recently, was made impractical by accounting rules and, in some countries, tax policies. Prior to 2004, for example, companies using US generally accepted accounting principles (GAAP) could avoid listing stock options as an expense

on their income statements provided they met certain criteria, one of which was that the exercise price had to be fixed. To avoid taking an earnings hit, companies avoided compensation systems based on relative performance, which would have required more flexibility in structuring options.

Since 2004, a few companies have moved to share-based compensation systems tied to relative performance. GE, for one, granted its CEO a performance award based on the company's TRS relative to the TRS of the S&P 500 index. We hope that more companies will follow this direction.

• • •

Applying the four cornerstones of finance sometimes means going against the crowd. It means accepting that there are no free lunches. It means relying on data, thoughtful analysis, and a deep understanding of the competitive dynamics of an industry. None of this is easy, but the payoff—the creation of value for a company's stakeholders and for society at large—is enormous. ○

[1] J. Mulherin and Audra Boone, "Comparing acquisitions and divestitures," *Journal of Corporate Finance*, 2000, Volume 6, Number 2, pp. 117–39.

[2] Patrick Cusatis, James Miles, and J. Woolridge, "Some new evidence that spinoffs create value," *Journal of Applied Corporate Finance*, 1994, Volume 7, Number 2, pp. 100–107.

[3] See Robert S. McNish and Michael W. Palys, "Does scale matter to capital markets?" *McKinsey on Finance*, Number 16, Summer 2005, pp. 21–23.

[4] Similarly, if a company sells a unit with a high P/E relative to its other units, the earnings per share (EPS) will increase but the P/E will decline proportionately.

[5] The expected value is $7.4 billion, which represents the sum of 80 percent of $13 billion ($28 billion, the expected value of the plant, less the $15 billion investment) and 20 percent of –$15 billion ($0, less the $15 billion investment).

Excerpt from
# Stock options—the right debate

**Neil W. C. Harper**

**Number 4, Summer 2002**

A valuable debate for shareholders would be to examine the structure of stock options. Consider that in recent years stock options have reached 50 to 60 percent of the total compensation of CEOs of large US corporations. Most are issued with an exercise price at or above current market price, and as the share price rises, the management team earns additional compensation. At first glance, this seems a logical way to align the interests of managers and shareholders, since in theory option-holding executives would have a common interest with shareholders in seeing stock price appreciation. But the theory can be thwarted in two important ways.

Not all stock price appreciation is equal. When a stock rises as a result of good strategic or operational decision making by the management team, additional compensation through option value gains is well deserved. However, stock options can also gain significantly in value as a result of several additional factors—the general economic environment, interest rates, leverage, and business risk. All else being equal, as the economic environment improves, as interest rates fall, as leverage rises, and as business risk rises, the value of an executive's options will also rise. However, many such gains are not the result of management's actions, and increasing leverage or business risk is not necessarily in the best interests of shareholders.

There are limits to downside risk. Even if option contracts were structured to more closely tie executive reward to value-creating actions, the current structure of most company options plans places less risk on managers in the case of poor performance than on shareholders. If unsuccessful strategic and operational decision making leads to a stock price decline, shareholders continue to lose until the decline bottoms out. Managers, though, have a limit to their downside exposure through option holdings; once the stock price falls significantly below option exercise price, their options are essentially worthless (unless there remains a significant time period before exercise date). Their downside to this extent is limited. Furthermore, they can frequently expect to be issued repriced options at the new lower stock price, further limiting their overall downside. Correcting for interest rate movements, economic cycles, and other environmental issues is not as straightforward as it appears.

Many have pondered the issue for decades without coming up with easy solutions, precisely because fully aligning incentives via a compensation plan is so complex. Executive option contracts could be structured to adjust for economic conditions as reflected, for example, by overall market or sector performance, interest rates, leverage, and risk. Some have even proposed so-called outperformance options, in which value creation is linked to an executive's ability to generate returns above their peers. These approaches can improve alignment between shareholder and manager interests, but only to some extent.

# Making capital structure support strategy

**Marc H. Goedhart, Tim Koller, and Werner Rehm**

**Number 18, Winter 2006**

A company's ratio of debt to equity should support its business strategy, not help it pursue tax breaks. Here's how to get the balance right.

CFOs invariably ask themselves two related questions when managing their balance sheets: should they return excess cash to shareholders or invest it, and should they finance new projects by adding debt or drawing on equity? Indeed, achieving the right capital structure—the composition of debt and equity that a company uses to finance its operations and strategic investments—has long vexed academics and practitioners alike.[1] Some focus on the theoretical tax benefit of debt, since interest expenses are often tax deductible. More recently, executives of public companies have wondered if they, like some private-equity firms, should use debt to increase their returns. Meanwhile, many companies are holding substantial amounts of cash and deliberating on what to do with it.

The issue is more nuanced than some pundits suggest. In theory, it may be possible to reduce capital structure to a financial calculation—to get the most tax benefits by favoring debt, for example, or to boost earnings per share superficially through share buybacks. The result, however, may not be consistent with a company's business strategy, particularly if executives add too much debt.[2] In the 1990s, for example, many telecommunications companies financed the acquisition of third-generation (3G) licenses entirely with debt, instead of with equity or some combination of debt and equity, and they found their strategic options constrained when the market fell.

Indeed, the potential harm to a company's operations and business strategy from a bad capital structure is greater than the potential benefits from tax and financial leverage. Instead of relying on capital structure to create value on its own, companies should try to make it work hand in hand with their business strategy, by striking a balance between the discipline and tax savings that debt can deliver and the greater flexibility of equity. In the end, most industrial companies can create more value by making their operations more efficient than they can with clever financing.[3]

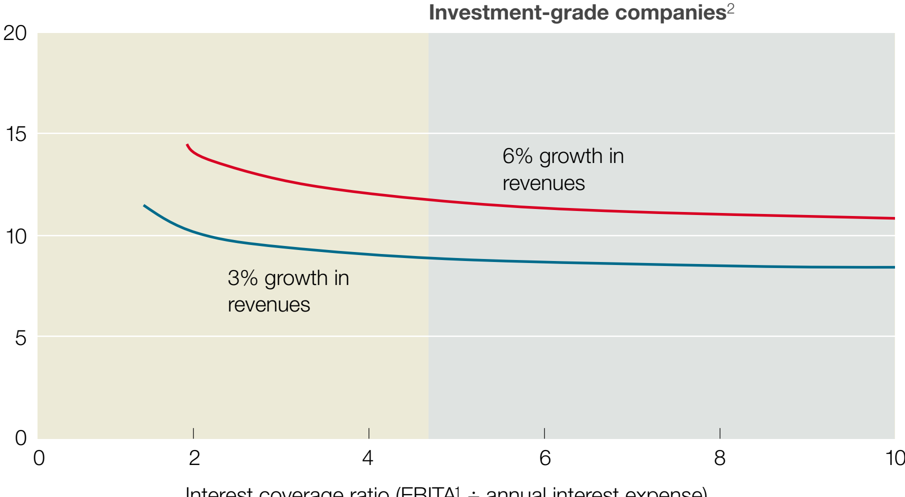
## Capital structure's long-term impact

Capital structure affects a company's overall value through its impact on operating cash flows and the cost of capital. Since the interest expense on debt is tax deductible in most countries, a company can reduce its after-tax cost of capital

Exhibit 1

### Tax benefits of debt are often negligible.

Ratio of enterprise value to EBITA[1]




[1] Earnings before interest, taxes, and amortization.
[2] Companies with ~A to BBB rating.

## The trade-off a company makes between financial flexibility and fiscal discipline is the most important consideration in determining its capital structure.

by increasing debt relative to equity, thereby directly increasing its intrinsic value. While finance textbooks often show how the tax benefits of debt have a wide-ranging impact on value, they often use too low a discount rate for those benefits. In practice, the impact is much less significant for large investment-grade companies (which have a small relevant range of capital structures). Overall, the value of tax benefits is quite small over the relevant levels of interest coverage (Exhibit 1). For a typical investment-grade company, the change in value over the range of interest coverage is less than 5 percent.

The effect of debt on cash flow is less direct but more significant. Carrying some debt increases a company's intrinsic value because debt imposes discipline; a company must make regular interest and principal payments, so it is less likely to pursue frivolous investments or acquisitions that don't create value. Having too much debt, however, can reduce a company's intrinsic value by limiting its flexibility to make value-creating investments of all kinds, including capital expenditures, acquisitions, and, just as important, investments in intangibles such as business building, R&D, and sales and marketing.

Managing capital structure thus becomes a balancing act. In our view, the trade-off a company makes between financial flexibility and fiscal discipline is the most important consideration in determining its capital structure and far outweighs any tax benefits, which are negligible for most large companies unless they have extremely low debt.[4]

Mature companies with stable and predictable cash flows as well as limited investment opportunities should include more debt in their capital structure, since the discipline that debt often brings outweighs the need for flexibility. Companies that face high uncertainty because of vigorous growth or the cyclical nature of their industries should carry less debt, so that they have enough flexibility to take advantage of investment opportunities or to deal with negative events.

Not that a company's underlying capital structure never creates intrinsic value; sometimes it does. When executives have good reason to believe that a company's shares are under- or overvalued, for example, they might change the company's underlying capital structure to create value—either by buying back undervalued shares or by using overvalued shares instead of cash to pay for acquisitions. Other examples can be found in cyclical industries, such as commodity chemicals, where investment spending typically follows profits. Companies invest in new manufacturing capacity when their profits are high and they have cash.[5] Unfortunately, the chemical industry's historical pattern has been that all players invest at the same time, which leads to excess capacity when all of

the plants come on line simultaneously. Over the cycle, a company could earn substantially more than its competitors if it developed a countercyclical strategic capital structure and maintained less debt than might otherwise be optimal. During bad times, it would then have the ability to make investments when its competitors couldn't.

## A practical framework for developing capital structure

A company can't develop its capital structure without understanding its future revenues and investment requirements. Once those prerequisites are in place, it can begin to consider changing its capital structure in ways that support the broader strategy. A systematic approach can pull together steps that many companies already take, along with some more novel ones.

The case of one global consumer product business is illustrative. Growth at this company—we'll call it Consumerco—has been modest. Excluding the effect of acquisitions and currency movements, its revenues have grown by about 5 percent a year over the past five years. Acquisitions added a further 7 percent annually, and the operating profit margin has been stable at around 14 percent. Traditionally, Consumerco held little debt: until 2001, its debt to enterprise value was less than 10 percent. In recent years, however, the company increased its debt levels to around 25 percent of its total enterprise value in order to pay for acquisitions. Once they were complete, management had to decide whether to use the company's cash flows, over the next several years, to restore its previous low levels of debt or to return cash to its shareholders and hold debt stable at the higher level. The company's decision-making process included the following steps.

1. Estimate the financing deficit or surplus. First, Consumerco's executives forecast the financing deficit or surplus from its operations and strategic investments over the course of the industry's business cycle—in this case, three to five years.

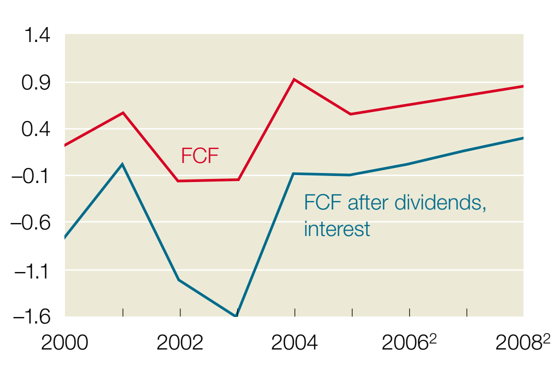
In the base case forecasts, Consumerco's executives projected organic revenue growth of 5 percent at profit margins of around 14 percent. They did not plan for any acquisitions over the next four years, since no large target companies remain in Consumerco's relevant product segments. As Exhibit 2 shows, the company's cash flow after dividends and interest will be positive in 2006 and then grow steadily until 2008. You can see on the right-hand side of Exhibit 2 that EBITA (earnings before interest, taxes, and amortization) interest

Exhibit 2

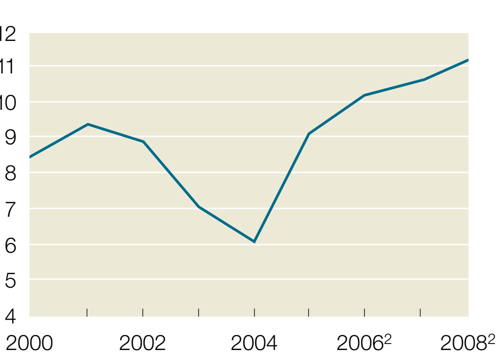
## Consumerco started by forecasting its financing debt or surplus.

Disguised global consumer product company

**Free cash flow (FCF),**
€ billion




**Interest coverage ratio (EBITA[1] ÷ annual interest expense)**




| | Base case scenario[3] | Downside scenario[3] |
|---|---|---|
| Projected 2008 EBITA,[1] € billion | 1.9 | 1.4 |
| Target interest coverage ratio | 4.5x | 4.5x |
| Target 2008 interest expense, € billion | 0.4 | 0.3 |
| Interest rate on debt | 5% | 5% |
| 2008 debt at target coverage, € billion | 8.3 | 6.2 |
| Extra cushion, € billion | –0.5 | –0.5 |
| **Target 2008 debt level,** € billion | **7.8** | **5.7** |

[1]Earnings before interest, taxes, and amortization.
[2]Projected.
[3]Assumes organic revenue growth of 5% at profit margins of around 14% and no acquisitions over next 4 years.
Source: Analysts' reports; Standard & Poor's; McKinsey analysis

coverage will quickly return to historically high levels—even exceeding ten times interest expenses.

2. Set a target credit rating. Next, Consumerco set a target credit rating and estimated the corresponding capital structure ratios. Consumerco's operating performance is normally stable. Executives targeted the high end of a BBB credit rating because the company, as an exporter, is periodically exposed to significant currency risk (otherwise they might have gone further, to a low BBB rating). They then translated the target credit rating to a target interest coverage ratio (EBITA to interest expense) of 4.5. Empirical analysis shows that credit ratings can be modeled well with three factors: industry, size, and interest coverage. By analyzing other large consumer product companies, it is possible to estimate the likely credit rating at different levels of coverage.

3. Develop a target debt level over the business cycle. Finally, executives set a target debt level of €5.7 billion for 2008. For the base case scenario in the left-hand column at the bottom half of Exhibit 2, they projected €1.9 billion of EBITA in 2008. The target coverage ratio of 4.5 results in a debt level of €8.3 billion. A financing cushion of spare debt capacity for contingencies and unforeseen events adds €0.5 billion, for a target 2008 debt level of €7.8 billion.

   Executives then tested this forecast against a downside scenario, in which EBITA would reach only €1.4 billion in 2008. Following the same logic, they arrived at a target debt level of €5.7 billion in order to maintain an investment-grade rating under the downside scenario.

In the example of Consumerco, executives used a simple downside scenario relative to the base case to adjust for the uncertainty of future cash flows. A more sophisticated approach might be useful in some industries such as commodities, where future cash flows could be modeled using stochastic-simulation techniques to estimate the probability of financial distress at various debt levels.

The final step in this approach is to determine how the company should move to the target capital structure. This transition involves deciding on the appropriate mix of new borrowing, debt repayment, dividends, share repurchases, and share issuances over the ensuing years.

A company with a surplus of funds, such as Consumerco, would return cash to shareholders either as dividends or share repurchases. Even in the downside scenario, Consumerco will generate €1.7 billion of cash above its target EBITA-to-interest-expense ratio.

For one approach to distributing those funds to shareholders, consider the dividend policy of Consumerco. Given its modest growth and strong cash flow, its dividend payout ratio is currently low. The company could easily raise that ratio to 45 percent of earnings, from 30 percent. Increasing the regular dividend sends the stock market a strong signal that Consumerco thinks it can pay the higher dividend comfortably. The remaining €1.3 billion would then typically be returned to shareholders through share repurchases over the next several years. Because of liquidity issues in the stock market, Consumerco might be able to repurchase only about €1 billion, but it could consider issuing a one-time dividend for the remainder.

The signaling effect[6] is probably the most important consideration in deciding between dividends and share repurchases. Companies should also consider differences in the taxation of dividends and share buybacks, as well as the fact that shareholders have the option of not participating in a repurchase, since the cash they receive must be reinvested.

• • •

While these tax and signaling effects are real, they mainly affect tactical choices about how to move toward a defined long-term target capital structure, which should ultimately support a company's business strategies by balancing the flexibility of lower debt with the discipline (and tax savings) of higher debt.

[1] Franco Modigliani and Merton Miller, "The cost of capital, corporate finance, and the theory of investment," *American Economic Review*, June 1958, Volume 48, Number 3, pp. 261–97.
[2] There is also some potential for too little debt, though the consequences aren't as dire.
[3] Richard Dobbs and Werner Rehm, "The value of share buybacks," *McKinsey on Finance*, Number 16, Summer 2005, pp. 16–20.
[4] At extremely low levels of debt, companies can create greater value by increasing debt to more typical levels.
[5] Thomas Augat, Eric Bartels, and Florian Budde, "Multiple choice for the chemical industry," mckinseyquarterly.com, August 2003.
[6] The market's perception that a buyback shows how confident management is that the company's shares are undervalued, for example, or that it doesn't need the cash to cover future commitments, such as interest payments and capital expenditures.

Excerpt from

# The value of share buybacks

**Richard Dobbs and Werner Rehm**

**Number 16, Summer 2005**

The share price increase from a buyback in theory results purely from the tax benefits of a company's new capital structure rather than from any underlying operational improvement. Take, for example, a company with €200 million in excess cash, a 3 percent interest rate, a 30 percent tax rate, and a discount rate at the cost of equity (10 percent). Assuming that the amount of cash doesn't grow and that it is held in perpetuity, the company incurs a value penalty of €18 million from additional taxes on the income of its cash reserves. A buyback removes this tax penalty and so results in a 1.4 percent rise in the share price. In this case, repurchasing more than 13 percent of the shares results in an increase of less than 2 percent. A similar boost occurs when a company takes on more debt to buy back shares.

Yet while such increases in earnings per share help managers hit EPS-based compensation targets, boosting EPS in this way doesn't signify an increase in underlying performance or value. Moreover, a company's fixation on buybacks might come at the cost of investments in its long-term health.

Share buyback analysis (including tax), hypothetical example

| | Before | After |
|---|---|---|
| **Balance sheet** | | |
| Cash, € million | 200 | 0 |
| Operating assets, € million | 580 | 580 |
| Total assets, € million | 780 | 580 |
| Equity, € million | 780 | 580 |
| **Value** | | |
| Value of operations, € million | 1,300 | 1,300 |
| Cash, € million | 200 | 0 |
| Tax penalty of cash, € million | –18 | 0 |
| **Total equity value,** € million | **1,482** | **1,300** |

| | Before | After |
|---|---|---|
| **Income statement** | | |
| Earnings before interest, taxes (EBIT), € million | 134 | 134 |
| Interest, € million | 6 | 0 |
| Earnings before taxes, € million | 140 | 134 |
| Tax, € million | –42 | –40 |
| **Net income,** € million | **98** | **94** |
| Shares outstanding, million | 100 | 86.5 |
| Share price, € | 14.80 | 15.00 |
| Earnings per share (EPS), € | 0.98 | 1.09 |
| P/E | 15.1 | 13.8 |
| **Return on invested capital (ROIC)**[1] | **16%** | **16%** |

[1] Posttax EBIT ÷ operating capital.

Excerpt from

# Paying back your shareholders

**Bin Jiang and Tim Koller**

**Number 39, Spring 2011**

In most cases, simple math leaves successful companies with little choice: if they have moderate growth and high returns on capital, it's functionally impossible for them to reinvest every dollar they earn. Consider this example: a company earning $1 billion a year in after-tax profits, with a 25 percent return on invested capital (ROIC) and projected revenue growth of 5 percent a year, needs to invest about $200 million annually to continue growing at the same rate. That leaves $800 million of additional cash flow available for still more investment or returning to shareholders. Yet finding $800 million of new value-creating investment opportunities every year is no simple task—in any sector of the economy. Furthermore, at a 25 percent ROIC, the company would need to increase its revenues by 25 percent a year to absorb all of its cash flow. It has no choice but to return a substantial amount of cash to shareholders.

Does it matter whether distributions take the form of dividends or share repurchases? Empirically, the answer is no. Whichever method is used, earnings multiples are essentially the same for companies when compared with others that have similar total payouts (Exhibit A). Total returns to shareholders (TRS) are also the same regardless of the mix of dividends and share repurchases (Exhibit B). These results should not be surprising. What drives value is the cash flow generated by operations. That cash flow is in turn driven by the combination of growth and returns on capital—not the mix of how excess cash is paid out.

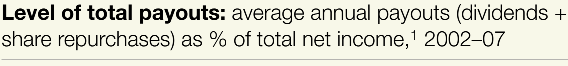
So how should a company decide between repurchases and dividends? That depends on how confident management is of future cash flows—and how much flexibility it needs. Share repurchases offer companies more flexibility to hold onto cash for unexpected investment opportunities or shifts in a volatile economic environment. In contrast, companies that pay dividends enjoy less flexibility because investors have been conditioned to expect cuts in them only in the most dire circumstances. Thus, managers should employ dividends only when they are certain they can continue to do so. Even increasing a dividend sends signals to investors that managers are confident that they will be able to continue paying the new, higher dividend level.

Share repurchases also signal confidence but offer more flexibility because they don't create a tacit commitment to additional purchases in future years. As you would expect, changing the proportion of dividends to share buybacks has no impact on a company's valuation multiples or TRS, regardless of payout level.

Exhibit A

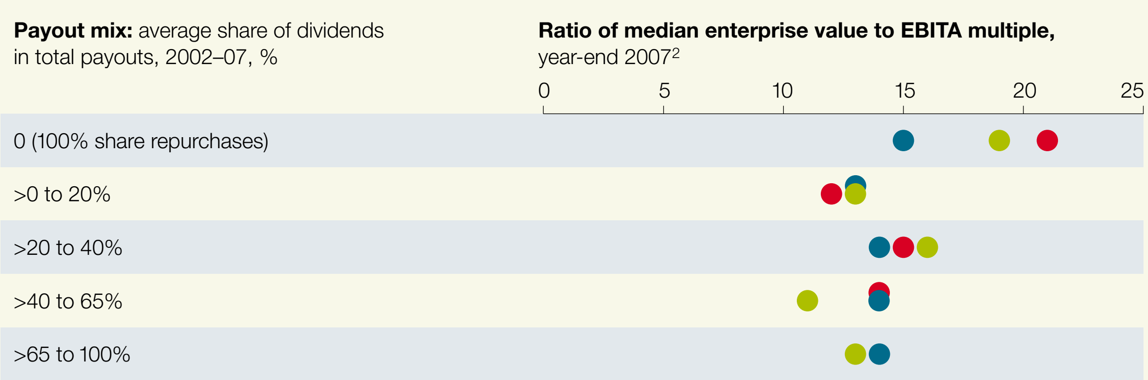
## Earnings multiples are not affected by the payout mix.

**Level of total payouts:** average annual payouts (dividends + share repurchases) as % of total net income,[1] 2002–07




**Payout mix:** average share of dividends in total payouts, 2002–07, %

**Ratio of median enterprise value to EBITA multiple,** year-end 2007[2]




[1]Insufficient data for payout levels of 96–130% at payout mix of >65 to 100% dividends and for payout levels of >130% for all payout mixes.
[2]For 279 nonfinancial companies that were in the S&P 500 at the end of 2009, were continuously in operation since 1999, and paid dividends or repurchased shares. EBITA = earnings before interest, taxes, and amortization.

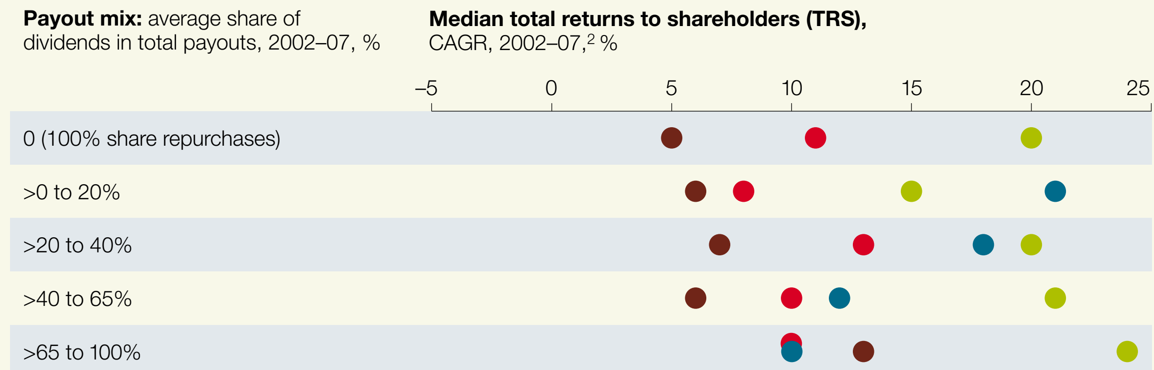
Exhibit B

## Returns to shareholders are unrelated to the payout mix.

**Level of total payouts:** average annual payouts (dividends + share repurchases) as % of total net income,[1] 2002–07

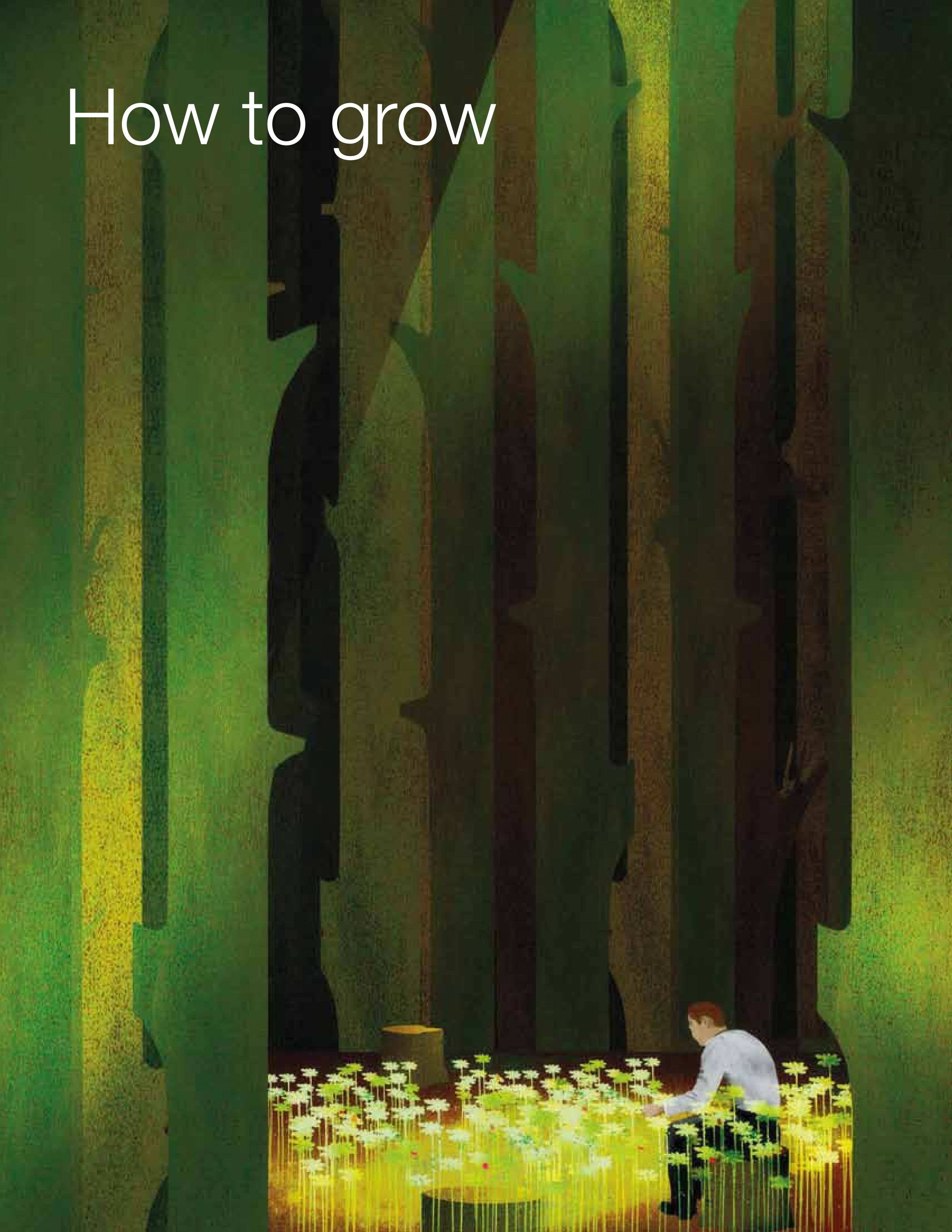
**Payout mix:** average share of dividends in total payouts, 2002–07, %

**Median total returns to shareholders (TRS),** CAGR, 2002–07,[2] %




[1]Insufficient data for payout level of 66–95% at payout mix of zero dividends (100% share repurchase).
[2]For 293 nonfinancial companies that were in the S&P 500 at the end of 2009, were continuously in operation since 1999, and paid dividends or repurchased shares. CAGR = compound annual growth rate.

# How to grow



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# Why the biggest and best struggle to grow

**Nicholas F. Lawler, Robert S. McNish, and Jean-Hugues J. Monier**

**Number 10, Winter 2004**

The largest companies eventually find size itself an impediment to creating new value. They must recognize that not all forms of growth are equal.

The largest, most successful companies would seem to be ideally positioned to create value for their shareholders through growth. After all, they command leading market and channel positions in multiple industries and geographies; they employ deep benches of top management talent utilizing proven management processes; and they often have healthy balance sheets to fund the investments most likely to produce growth.

Yet after years of impressive top- and bottom-line growth that propelled them to the top of their markets, these companies eventually find they can no longer sustain their pace. Indeed, over the past 40 years North America's largest companies—those, say, with more than about $25 billion in market capitalization—have consistently underperformed the S&P 500,[1] with only two short-lived exceptions.

Talk to senior executives at these organizations, however, and it is difficult to find many willing to back off from ambitious growth programs that are typically intended to double their company's share price over three to five years. Yet in all but the rarest of cases, such aggressive targets are unreasonable as a way to motivate growth programs that create value for shareholders—and may even be risky, tempting executives to scale back value creating organic growth initiatives that may be small or long-term propositions, sometimes in favor of larger, nearer-term, but less reliable acquisitions.

In our experience, executives would be better off recognizing the limitations of size and revisiting the fundamentals of how growth creates shareholder value. By understanding that not all types of growth are equal when it comes to creating value for shareholders, even the largest companies can avoid bulking up on the business equivalent of empty calories and instead nourish themselves on the types of growth most likely to create shareholder value.

## What holds them back?

At even well-run big companies, growth slows or stops—and for complex reasons. Ironically, for some it's the natural result of past success: their portfolios are weighed down by large, leading businesses that may have once delivered considerable growth, but that have since matured with their industries and now have fewer natural avenues for growth. At others, management talent and processes are more grooved to maintain, not build, businesses; and their equity- and cash-rich balance sheets dampen the impact growth has on shareholder value. For all of them, their most formidable growth challenge may be their sheer size: it takes large increments of value creation to have a meaningful impact on their share price.

The other crucial factor is how management responds when organic growth starts to falter. This is often a function of compensation that ties bonuses to bottom-line growth. In any case, management is often tempted to respond as if the slowing organic growth were merely temporary, rejecting any downward adjustment to near-term bottom-line growth.

That may work in the short run, but as individual businesses strip out controllable costs, they soon begin to cut into the muscle and bone behind whatever value-rich organic growth potential remains—sales and marketing, new-product development, new business development, R&D. At one industrial company we are familiar with, management proudly points to each savings initiative that allows them to meet quarterly earnings forecasts.

But the short-term focus on meeting unrealistically high growth expectations can undermine long-term growth. Ultimately, the scramble to meet quarterly numbers will continue to intensify as cost cutting further decelerates organic growth. If the situation gets more desperate, management may turn to acquisitions to keep bottom-line growth going. But acquisitions, on average, create relatively little value compared to the investment required, while adding enormous integration challenges and portfolio complexity into the mix. Struggling under the workload, management can lose focus on operations. In this downward spiral management chases growth in ways that create less and less value—and in the end winds up effectively trading value for growth.

Some companies seem to have recognized the danger in constantly striving to exceed expectations. One company's recent decision to vest half of its CEO's stock award for

simply meeting (rather than handily beating) the five-year share price appreciation of the S&P 500 may be one such bow to good reason. Ironically, relieving the CEO of the pressure to substantially outperform the market may have given him the freedom he needs to focus on longer-term investments in value-creating organic growth.

### All growth is not created equal

The right way for large companies to focus on growth, we believe, is to differentiate among entire classes of growth on the basis of what we call their value creation intensity.[2] The value creation intensity of a dollar of top-line growth directly depends on how much invested capital is required to fuel that growth—the more invested capital, the lower the value creation intensity. Sorting growth initiatives this way requires understanding the time frame in which shareholder value can be created—as short as a matter of months for some acquisitions or more than a decade for some R&D investments. It also requires assessing the size of an opportunity by the amount of value it creates for shareholders, not merely how much top-line revenues it adds. These are the particularly crucial factors for very large companies, where smaller investments can get lost on the management agenda, long-term investments fail to capture management's imagination, and the temptation is to invest in highly visible near-term projects with low value creation intensity.

To illustrate, we dipped into M&A research to see how much value creation even top-notch acquirers can reasonably expect. We have also modeled the value creation intensity of four different modes of organic growth, by estimating results for prototypical organic growth opportunities in the consumer goods industry. While this specific hierarchy of value creation intensity may not hold for every industry, it can serve as a useful example.

New product/market development tends to have the highest value creation intensity. It provides top-line growth at attractive margins, since competition is limited and the market is growing. We estimate that the prototypical new product in the consumer goods industry can create between $1.75 and $2.00 in shareholder value for every dollar of new revenue. Ironically, while this type of growth creates the most value, it's particularly difficult for really large companies. Creating new demand for a product that did not previously exist requires outstanding innovation capabilities—and big companies that have tightened the screws on operational performance are notorious for cutting away at research and development spending.

Expanding into adjacent markets typically requires incremental invested capital that leads to lower, though still very attractive, value creation intensity in the range of $0.30 to $0.75 per dollar of new revenue. Facilitating adjacent market expansion requires outstanding execution skills and organizational flexibility.

Maintaining or growing share in a growing market requires substantial incremental investments to make the product and its value distinctive. But as long as the market is still growing, margins are not competed away. As a result, we estimate value creation in the range of $0.10 to $0.50 per dollar of new revenue.

Growing share in a stable market does not always create value. While incremental investments are not always material, competition for share in order to maintain scale is typically intense, leading to lower margins. We estimate that

increasing share in a relatively mature market may destroy as much as $0.25 or create as much as $0.40 of shareholder value for every dollar of new revenue. And for companies whose growth is already stalling, growth in a stable market merely postpones the inevitable.

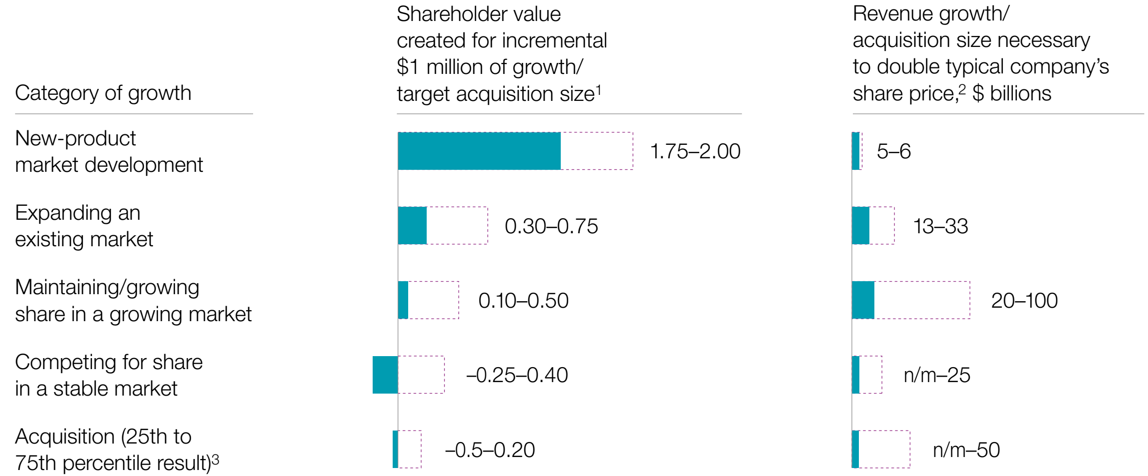
Acquisitions. While they can drive a material amount of top-line growth in the relatively short order, it is now widely accepted that the average acquirer captures relatively little shareholder value from its deals.[3] In fact, the numbers suggest that even an acquirer who consistently enjoys a top-quartile market reaction in each of its deals will create only about $0.20 in shareholder value for every $1 million in revenues acquired.[4]

Obviously, the size and timing of growth opportunities are determined by business fundamentals within each industry. Typically, though, they tend to come in relatively small increments and mature over multiple years. In the consumer goods industry, one study[5] found that almost half of product launches had first-year sales of less than $25 million, and the largest was only a little more than $200 million. The number of these sorts of top-line growth projects needed to move the needle for the biggest companies is daunting. When we stand back from this analysis, we can't help but draw a very dispiriting obser-

Exhibit

## The intensity of value creation varies by mode of growth.

**Consumer goods industry**




[1]Stylized results based on consumer products examples.
[2]Assumes a $50 billion market cap, all-stock company with $23 billion of revenue expected to grow at GDP rates and constant return on invested capital (ROIC).
[3]Examination of 338 deals revealed short-term value creation for acquirer of 11% for 75th percentile deals and –1% for 50th percentile deals.

vation for very large companies: there are remarkably few growth opportunities that are large and near-term and highly value creating all at the same time. Put another way, the amount of top-line growth required to achieve a doubling in shareholder value varies dramatically by mode of growth, and is huge in even the most favorable modes of growth (exhibit).

Some executives will no doubt find uncomfortable the shift to a perspective that emphasizes the value creation intensity of growth initiatives. Though such a shift would serve shareholders well, it may also lead to lower overall levels of top-line and earnings-per-share (EPS) growth.

Executive credibility will be on the line in communicating this message to the markets. One executive we've worked with, for example, recognized that his company lacked the credibility to quickly lower his overall EPS growth targets in favor of a richer mix of value-creating growth without getting pummeled by the markets. Instead, the company made one more big push on operations, letting only enough of the savings fall to the bottom line to meet the company's short-term growth projections. The rest of the savings was redirected toward slower, but more value creating, organic growth, with the expectation that once the company had built some credibility in that respect with shareholders, it could more easily make its case to the markets.

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When growing gets tough in the largest companies, tough executives must learn to get growing in value-creating ways. Rather than bulk up on the business equivalent of empty calories, they should explore the value creation intensity of different modes of growth to build shareholder value muscle.

[1] Credit Suisse First Boston, "The pyramid of numbers," *The Consilient Observer*, Volume 2, Number 17, September 23, 2003.
[2] Shareholder value creation per dollar of top-line revenue growth.
[3] See, for example, Hans Bieshaar, Jeremy Knight, and Alexander van Wassenaer, "Deals that create value," mckinseyquarterly.com, February 2001.
[4] It is important to note, however, that market-entering or capability-building acquisitions designed to fuel subsequent organic growth are more likely to create value than market-consolidating acquisitions designed to capture cost efficiencies.
[5] Steve Innen, "Innovation awards 2002," *Food Processing*, December 2002, pp. 35–40.

# Excerpt from
# How to choose between growth and ROIC

**Bin Jiang and Tim Koller**

**Number 25, Autumn 2007**

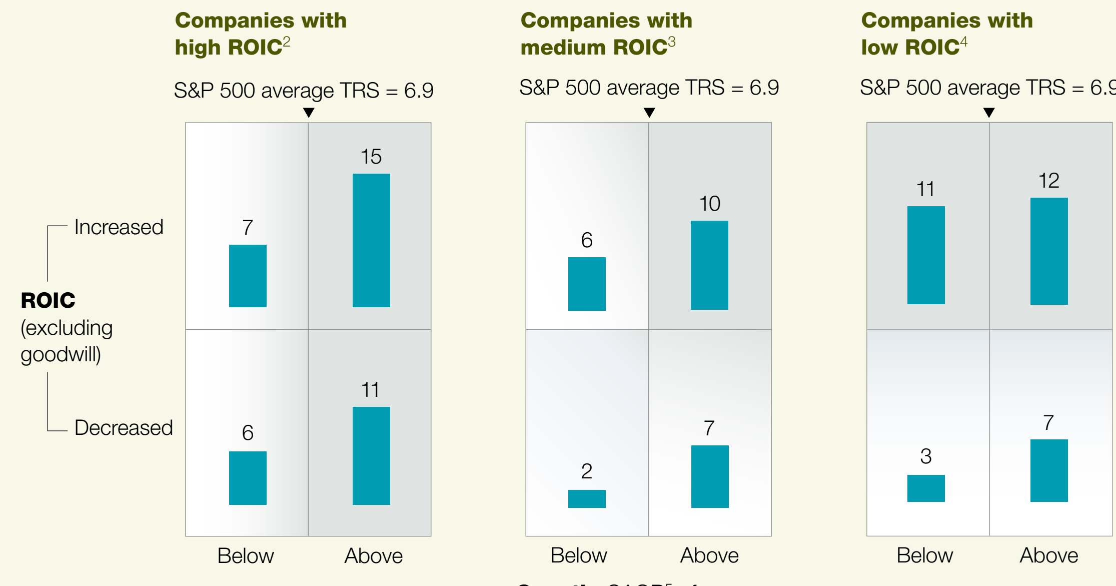
Value-minded executives know that although growth is good, returns on invested capital (ROIC) can be an equally—or still more—important indicator of value creation. To understand better how value is created over time, we identified all nonfinancial US companies that had a market cap over $2 billion[1] in 1995 and had been listed for at least a decade as of that year. When we examined their growth and ROIC performance over the subsequent decade, we found clear patterns in the interaction between the two measures. These patterns can help guide value creation strategies suited to a company's current performance. For companies that already have high ROICs,[2] raising revenues faster than the market generates higher total returns to shareholders (TRS) than further improvements to ROIC do.

This finding doesn't mean that companies with high ROICs can disregard the impact of growth on their profitability and capital returns. But executives do have the latitude to invest in growth even if ROIC and profitability erode as a result—as long as they can keep ROIC levels in or above the medium band. Companies that fall in the middle of the ROIC scale[3] have no latitude to let their performance on either measure decline. For these companies, improving ROIC without maintaining growth at the pace of the market or generating growth at the cost of a lower ROIC usually results in a below-market TRS. In most cases, the market rewarded these companies with above-market returns only when they maintained their growth and improved their ROIC.[4]

The pattern continues for companies with a low ROIC.[5] Although both ROIC and growth are still important, an improvement in ROIC is clearly more important: companies that increased their ROIC generated, on average, a TRS 5 to 8 percent higher than those that didn't. Growth relative to the market made less difference (1 to 4 percent) for shareholders, particularly if the company improved its ROIC. This result isn't surprising. Because such companies were generating returns at or below their weighted-average cost of capital, they would have had difficulty accessing capital to finance further growth unless they improved their operations and earned the right to grow. Indeed, nearly one-third of the companies in this category from 1995 were acquired or went bankrupt within the following decade.

[1] Normalized to 2003 dollars.
[2] Those with a ten-year average ROIC greater than or equal to 20 percent in 1995.
[3] Those with a ten-year average ROIC in 1995 greater than or equal to 9 percent but less than 20 percent.
[4] Because our data represent the median of a group, a company could achieve above-market TRS even though its growth was below market or its ROIC had declined.
[5] Those with a ten-year average ROIC in 1995 greater than or equal to 6 percent but less than 9 percent.

Total returns to shareholders (TRS),[1] 1996–2005, compared with returns on invested capital (ROIC)




[1]Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).
[2]78 companies with 10-year average ROIC ≥20% and market capitalization >$2 billion in 1995.
[3]129 companies with 10-year average ROIC ≥9% and market capitalization >$2 billion in 1995.
[4]64 companies with 10-year average ROIC ≥6% but <9% and market capitalization >$2 billion in 1995.
[5]Compound annual growth rate.

# Excerpt from
# All P/Es are not created equal

**Nidhi Chadda, Robert S. McNish, and Werner Rehm**

**Number 11,
Spring 2004**

The relationship between P/E multiples and growth is basic arithmetic:[1] high multiples can result from high returns on capital in average- or low-growth businesses just as easily as they can result from high growth. But beware: any amount of growth at low returns on capital will not lead to a high P/E, because such growth does not create shareholder value.

To illustrate, consider two companies with identical P/E multiples of 17 but with different mechanisms for creating value. Growth, Inc., is expected to grow at an average annual rate of 13 percent over the next ten years, while generating a 14 percent return on invested capital (ROIC), which is modestly higher than its 10 percent cost of capital. To sustain that level of growth, it must reinvest 93 cents from each dollar of income. The relatively high reinvestment rate means that Growth, Inc., turns only a small amount of earnings growth into free cash flow growth. Many companies fit this growth profile, including some that need to reinvest more than 100 percent of their earnings to support their growth rate. In contrast, Returns, Inc., is expected to grow at only 5 percent per year, a rate similar to long-term nominal GDP growth in the United States.[2] Unlike Growth, Inc., however, Returns, Inc., invests its capital extremely efficiently. With a return on capital of 35 percent, it needs to reinvest only 14 cents of each dollar to sustain its growth. As its earnings grow, Returns, Inc., methodically turns them into free cash flow.

| | **Growth, Inc**[1] | | **Returns, Inc**[1] | |
|---|---|---|---|---|
| | Year 1 | Year 2 | Year 1 | Year 2 |
| Operating profit less taxes | 100 | 113 | 100 | 105 |
| Reinvestment | 93 | 105 | 14 | 15 |
| Free cash flow | 7 | 8 | 86 | 90 |
| | Reinvestment rate 93% | | Reinvestment rate 14% | |

[1]Assuming 10% cost of equity, no debt, and 10 year's excessive growth followed by 5% growth at historic levels of ROIC.

Because Growth, Inc., and Returns, Inc., take very different routes to the same P/E multiple, it would make sense for a savvy executive to pursue different growth and investment strategies to increase each business's P/E. Obviously, the rare company that can combine high growth with high returns on capital should enjoy extremely high multiples.

[1]For instance, assuming perpetuity growth for a company without any financial leverage, P/E = (1 – growth ÷ return on capital) ÷ (cost of capital – growth).
[2]Real GDP growth over the past 40 years in the United States was 3.5 percent.

# Running a winning M&A shop

**Robert T. Uhlaner and Andrew S. West**

**Number 27, Spring 2008**

Picking up the pace of M&A requires big changes in a company's processes and organization—even if the deals are smaller.

Corporate deal making has a new look—smaller, busier, and focused on growth. Not so long ago, M&A experts sequenced, at most, 3 or 4 major deals a year, typically with an eye on the benefits of industry consolidation and cost cutting. Today we regularly come across executives hoping to close 10 to 20 smaller deals in the same amount of time, often simultaneously. Their objective: combining a number of complementary deals into a single strategic platform to pursue growth—for example, by acquiring a string of smaller businesses and melding them into a unit whose growth potential exceeds the sum of its parts.

Naturally, when executives try to juggle more and different kinds of deals simultaneously, productivity may suffer as managers struggle to get the underlying process right.[1] Most companies, we have found, are not prepared for the intense work of completing so many deals—

Excerpt from

# M&A teams: When small is beautiful

**Patrick Beitel and Werner Rehm**

**Number 34, Winter 2010**

Executives at companies that don't have large, standing teams may wonder if they are really essential for successful deal making. We don't think they are. If the essentials for the governance and execution of M&A are in place, many companies can carry it out successfully with a small, experienced team that pulls in resources project by project. In an ongoing series of executive interviews on M&A, we've run across a number of companies that have small M&A teams—with as few as two to three core team members, led by the head of M&A—which take this kind of project-driven approach.

Indeed, it may even be more suitable than the use of large, standing teams—at least for companies in certain industries, depending on the number of strategic M&A opportunities.

and fumbling with the process can jeopardize the very growth companies seek. In fact, most of them lack focus, make unclear decisions, and identify potential acquisition targets in a purely reactive way. Completing deals at the expected pace just can't happen without an efficient end-to-end process.

Even companies with established deal-making capabilities may have to adjust them to play in this new game. Our research shows that successful practitioners follow a number of principles that can make the adjustment easier and more rewarding. They include linking every deal explicitly to the strategy it supports and forging a process that companies can readily adapt to the fundamentally different requirements of different types of deals.

### Eyes on the (strategic) prize

One of the most often overlooked, though seemingly obvious, elements of an effective M&A program is ensuring that every deal supports the corporate strategy. Many companies, we have found, believe that they are following an M&A strategy even if their deals are only generally related to their strategic direction and the connections are neither specific nor quantifiable.

Instead, those who advocate a deal should explicitly show, through a few targeted M&A themes, how it advances the growth strategy. A specific deal should, for example, be linked to strategic goals, such as market share and the company's ability to build a leading position. Bolder, clearer goals encourage companies to be truly proactive in sourcing deals and help to establish the scale, urgency, and valuation approach for growth platforms that require a number of them. Executives should also ask themselves if they have enough people developing and evaluating the deal pipeline, which might include small companies to be assembled into a single business, carve-outs, and more obvious targets, such as large public companies actively shopping for buyers.

Furthermore, many deals underperform because executives take a one-size-fits-all approach to them—for example, by using the same process to integrate acquisitions for back-office cost synergies and acquisitions for sales force synergies. Certain deals, particularly those focused on raising revenues or building new capabilities, require fundamentally different approaches to sourcing, valuation, due diligence, and integration. It is therefore

critical for managers not only to understand what types of deals they seek for shorter-term cost synergies or longer-term top-line synergies (exhibit) but also to assess candidly which types of deals they really know how to execute and whether a particular transaction goes against a company's traditional norms or experience.

Companies with successful M&A programs typically adapt their approach to the type of deal at hand. For example, over the past six years, IBM has acquired 50 software companies, nearly 20 percent of them market leaders in their segments. It executes many different types of deals to drive its software strategy, targeting companies in high-value, high-growth segments that would extend its current portfolio into new or related markets. IBM also looks for technology acquisitions that would accelerate the development of the capabilities it needs. Deal sponsors use a comprehensive software-segment strategy review and gap analysis to determine when M&A (rather than in-house development) is called for, to identify targets,

Exhibit

**Managers must understand not only which types of deals they desire but also which they know how to execute.**

Types of M&A deals

| Size of acquired company relative to acquirer | | | |
|---|---|---|---|
| **Large** | **Overcapacity**<br>• Reduce industry capacity and overhead<br>• Present fundamentally similar product offering<br><br>Pay mainly for clear cost synergies | **Product/market consolidation**<br>• Create economies of scale and consolidate back office; expand market presence<br><br>Pay for some growth and channel access | **Transformation/ convergence**<br>• Use deal to transform the way industry works<br>• Create new value proposition<br><br>Pay for opportunity to attack new markets and grow through new capabilities |
| **Small** | **Roll-up**<br>• Transfer core strengths to target business(es)<br><br>Pay for lower cost of operating new businesses, potential to increase revenue by leveraging brand strength | **Acquire products/markets**<br>• Expansion of market offering and/or geographic reach<br><br>Pay largely for growth and channel access; revenue synergy potential via pull-through also exists | **Strategic-growth bet**<br>• Seek skill transfer into new and/or noncore business<br><br>Pay for high-risk option value and ability to act in market space |

Stand-alone cost improvements | Cross-selling existing products | Building new customer relationships | Creating new products | Building a new business

**Low** Short-term cost synergies → **High** Long-term top-line synergies

**Need to expand current capabilities**

and to determine which acquisitions should be executed.

IBM has developed the methods, skills, and resources needed to execute its growth strategy through M&A and can reshape them to suit different types of deals. A substantial investment of money, people, and time has been necessary. In 2007, IBM's software group alone was concurrently integrating 18 acquisitions; more than 100 full-time experts in a variety of functions and geographies were involved, in addition to specialized teams mobilized for each deal. IBM's ability to tailor its approach has been critical in driving the performance of these businesses. Collectively, IBM's 39 acquisitions below $500 million from 2002 to 2005 doubled their direct revenue within two years.

## Organization and process

When companies increase the number and pace of their acquisitions, the biggest practical challenge most of them face is getting not only the right people but also the right number of people involved in M&A. If they don't, they may buy the wrong assets, underinvest in appropriate ones, or manage their deals and integration efforts poorly. Organizations must invest to build their skills and capabilities before launching an aggressive M&A agenda.

### Support from senior management

In many companies, senior managers are often too impressed by what appears to be a low price for a deal or the allure of a new product. They then fail to look beyond the financials or to provide support for integration. At companies that handle M&A more productively, the CEO and senior managers explicitly identify it as a pillar of the overall corporate strategy. At GE, for example, the CEO requires all business units to submit a review of each deal. In addition to the financial justification, the review must articulate a rationale that fits the story line of the entire organization and spell out the requirements for integration. A senior vice president then coaches the business unit through each phase of a stage gate process. Because the strict process preceding the close of the deal outlines what the company must do to integrate the acquisition, senior management's involvement with it after the close is defined clearly.

The most common challenge executives face in a deal is remaining involved with it and accountable for its success from inception through integration. They tend to focus on sourcing deals and ensuring that the terms are acceptable, quickly moving on to other things once the letter of intent is signed and leaving the integration work to anyone who happens to have the time. To improve the process and the outcome, executives must give more thought to the appointment of key operational players, such as the deal owner and the integration manager.[2]

### The deal owner

Deal owners are typically high-performing managers or executives accountable for specific acquisitions, beginning with the identification of a target and running through its eventual integration. The most successful acquirers appoint the deal owner very early in the process, often as a prerequisite for granting approval to negotiate with a target. This assignment, which may be full or part time, could go to someone from the business-development team or even a line organization, depending on the type of deal. For a large one regarded as a possible platform for a new business unit or geography, the right deal owner might be a vice president who can continue to lead the business once the acquisition is complete. For a smaller deal focused on acquiring a specific technology, the right person might be

Excerpt from
## Managing your integration manager

**Michael J. Shelton**

**Number 8, Summer 2003**

No surprise that the effectiveness of integration managers varies widely. Many CEOs see them simply as process coordinators or project managers. But the best play a far more pivotal role, helping mergers to succeed by keeping everyone focused on the issues that have the greatest potential for creating value and by infusing integration efforts with the necessary momentum. Unfortunately, however, too many integration managers never assume such a role or, if they do, find it hard to succeed in it. Our experience during the past five years with more than 300 integration efforts—most involving Global 500 corporations—suggests three reasons: CEOs fail to recruit the right people for the job, integration managers don't become involved in the merger process early enough, and CEOs fail to give them adequate support.

a director in the R&D function or someone from the business-development organization.

### The integration manager

Often, the most underappreciated and poorly resourced role is that of the integration manager—in effect, the deal owner's chief of staff. Typically, integration managers are not sufficiently involved early in the deal process. Moreover, many of them are chosen for their skills as process managers, not as general managers who can make decisions, work with people throughout the organization, and manage complicated situations independently.

Integration managers, our experience shows, ought to become involved as soon as the target has been identified but before the evaluation or negotiations begin. They should drive the end-to-end merger-management process to assure that the strategic rationale of a deal informs the due diligence as well as the planning and implementation of the integration effort. During IBM's acquisition of Micromuse, for example, a vice president–level executive was chosen to take responsibility for integration. This executive was brought into the process well before due diligence and remains involved almost two years after the deal closed. IBM managers attribute its strong performance to the focused leadership of the integration executive.

### Sizing a professional merger-management function

Companies that conclude deals only occasionally may be able to tap functional and business experts to conduct due diligence and then build integration teams around specific deals. But a more ambitious M&A program entails a volume of work—to source and screen candidates, conduct preliminary and final due diligence, close deals, and drive integration—that demands capabilities and processes on the scale of any other corporate function. Indeed, our experience with several active acquirers has taught us that the number of resources required can be quite large. To do 10 deals a year, a company must identify roughly 100 candidates, conduct due diligence on around 40, and ultimately integrate the final 10. This kind of effort requires the capacity to sift through many deals while simultaneously managing three or four data rooms and several parallel integration efforts. Without a sufficient (and effective) investment in resources, individual deals are doomed to fail.

### A rigorous stage gate process

A company that transacts large numbers of deals must take a clearly defined stage gate approach to making and managing decisions. Many organizations have poorly defined processes or are plagued with choke points, and either fault can make good targets walk away or turn to competitive bids. Even closed deals can get off to a bad start if a target's management team assumes that a sloppy M&A process shows what life would be like under the acquirer.

An effective stage gate system involves three separate phases of review and evaluation. At the strategy approval stage, the business-development team (which includes one or two members from both the business unit and corporate development) evaluates targets outside-in to assess whether they could help the company grow, how much they are worth, and their attractiveness as compared with other targets. Even at this point, the team should discuss key due diligence objectives and integration issues. A subset of the team then drives the process and assigns key roles, including that of the deal owner. The crucial decision at this point is whether a target is compatible with the corporate strategy, has strong support from the acquiring company, and can be integrated into it.

At the approval-to-negotiate stage, the team decides on a price range that will allow the company to maintain pricing discipline. The results of preliminary due diligence (including the limited exchange of data and early management discussions with the target) are critical here, as are integration issues that have been reviewed, at least to some extent, by the corporate functions. A vision for incorporating the target into the acquirer's business plan, a clear operating program, and an understanding of the acquisition's key synergies are important as well, no matter what the size or type of deal. At the end of this stage, the team should have produced a nonbinding term sheet or letter of intent and a roadmap for negotiations, confirmatory due diligence, and process to close.

The board of directors must endorse the definitive agreement in the deal approval stage. It should resemble the approval-to-negotiate stage if the process has been executed well; the focus ought to be on answering key questions rather than raising new strategic issues, debating valuations, or looking ahead to integration and discussing how to estimate the deal's execution risk.

Each stage should be tailored to the type of deal at hand. Small R&D deals don't have to pass through a detailed board approval process but may instead be authorized at the business or product unit level. Large deals that require significant regulatory scrutiny must certainly meet detailed approval criteria before moving forward. Determining in advance what types of deals a company intends to pursue and how to manage them will allow it to articulate the trade-offs and greatly increase its ability to handle a larger number of deals with less time and effort.

• • •

As companies adapt to a faster-paced, more complicated era of M&A deal making, they must fortify themselves with a menu of process and organizational skills to accommodate the variety of deals available to them. ○

[1] These results were among the findings of our June 2007 survey of business-development and merger integration leaders.

[2] In some smaller deals, the integration manager and deal owner can be the same person in complementary roles.

Excerpt from

# The five types of successful acquisitions

**Marc H. Goedhart, Tim Koller, and David Wessels**

**Number 36, Summer 2010**

In our experience, the strategic rationale for an acquisition that creates value typically conforms to at least one of the following five archetypes.

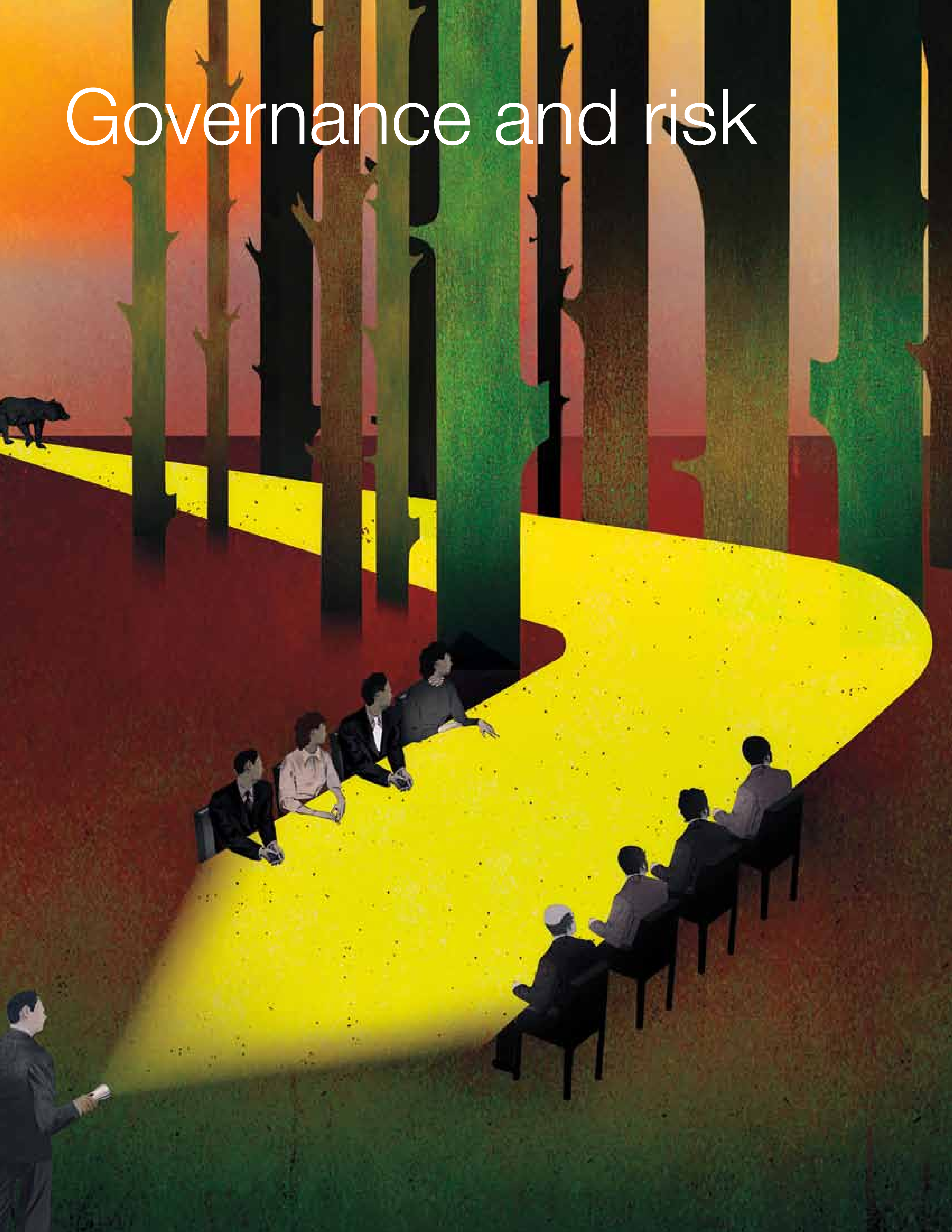
Improve the target company's performance. This is one of the most common value-creating acquisition strategies. Put simply, you buy a company and radically reduce costs to improve margins and cash flows. In some cases, the acquirer may also take steps to accelerate revenue growth.

Consolidate to remove excess capacity from industry. The combination of higher production from existing capacity and new capacity from recent entrants often generates more supply than demand. It is in no individual competitor's interest to shut a plant, however. Companies often find it easier to shut plants across the larger combined entity resulting from an acquisition than to shut their least productive plants without one and end up with a smaller company.

Accelerate market access for the target's (or buyer's) products. Often, relatively small companies with innovative products have difficulty reaching the entire potential market for their products. Small pharmaceutical companies, for example, typically lack the large sales forces required to cultivate relationships with the many doctors they need to promote their products. Bigger pharmaceutical companies sometimes purchase these smaller companies and use their own large-scale sales forces to accelerate the sales of the smaller companies' products.

Get skills or technologies faster or at lower cost than they can be built. Cisco Systems has used acquisitions to close gaps in its technologies, allowing it to assemble a broad line of networking products and to grow very quickly from a company with a single product line into the key player in Internet equipment. From 1993 to 2001, Cisco acquired 71 companies, at an average price of approximately $350 million. Cisco's sales increased from $650 million in 1993 to $22 billion in 2001, with nearly 40 percent of its 2001 revenue coming directly from these acquisitions. By 2009, Cisco had more than $36 billion in revenues and a market cap of approximately $150 billion.

Pick winners early and help them develop their businesses. The final winning strategy involves making acquisitions early in the life cycle of a new industry or product line, long before most others recognize that it will grow significantly. Johnson & Johnson pursued this strategy in its early acquisitions of medical-device businesses. When J&J bought device manufacturer Cordis, in 1996, Cordis had $500 million in revenues. By 2007, its revenues had increased to $3.8 billion, reflecting a 20 percent annual growth rate. J&J purchased orthopedic device manufacturer DePuy in 1998, when DePuy had $900 million in revenues. By 2007, they had grown to $4.6 billion, also at an annual growth rate of 20 percent.


Governance and risk

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# The voice of experience: Public versus private equity

**Viral Acharya, Conor Kehoe, and Michael Reyner**

**Number 31, Spring 2009**

Few directors have served on the boards of both private and public companies. Those who have give their views here about which model works best.

Advocates of the private-equity model have long argued that the better PE firms perform better than public companies do. This advantage, these advocates say, stems not only from financial engineering but also from stronger operational performance.

Directors who have served on the boards of both public and private companies agree—and add that the behavior of the board is one key element in driving superior operational performance. Among the 20 chairmen or CEOs we recently interviewed as part of a study in the United Kingdom,[1] most said that PE boards were significantly more effective than were those of their public counterparts. The results are not comprehensive, nor do they fully reflect the wide diversity of public- and private-company boards. Nevertheless, our findings raise some important issues for public boards and their chairmen.

When asked to compare the overall effectiveness of PE and public boards, 15 of the 20 respondents said that PE boards clearly added more value; none said that their public counterparts were better. This sentiment was reflected in the scores the respondents gave each type of board, on a five-point scale (where 1 was poor and 5 was world class): PE boards averaged 4.6, public boards 3.5.

Clearly, public boards cannot (and should not) seek to replicate all elements of the PE model: the public-company one offers superior access to capital and liquidity but in return requires a more extensive and transparent approach to governance and a more explicit balancing of stakeholder interests. Nevertheless, our survey raises many questions about the two ownership models and how best to enhance a board's effectiveness. How, for example, can public boards be structured so that their members can put more time into managing strategy and performance? Moreover, can—and should—the interests of public-board members be better aligned with those of executives?

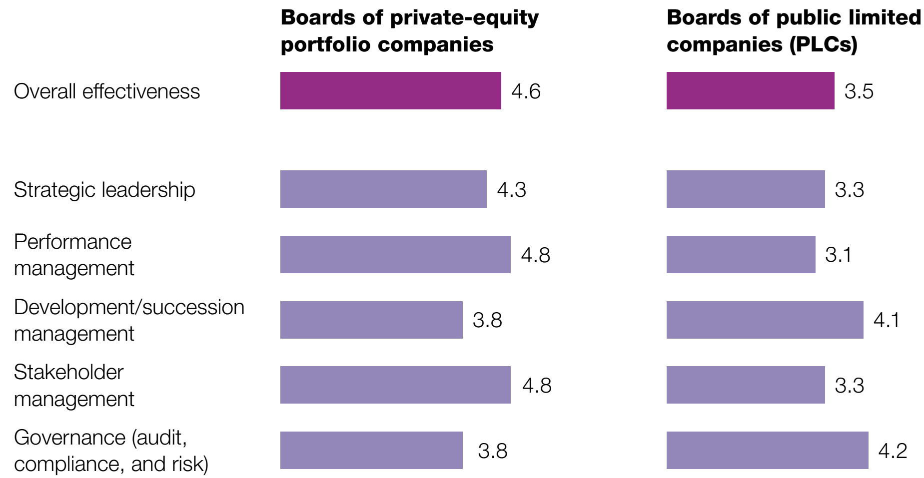
## How both models add value

Respondents observed that the differences in the way public and PE boards operate—and are expected to operate—arise from differences in ownership structure and governance expectations. Because public companies need to protect the interests of arm's-length shareholders and ensure the flow of accurate and equal information to the capital markets, governance issues such as audit, compliance, remuneration, and risk management inevitably (and appropriately) loom much larger in the minds of public-board members. Our research did indeed suggest that public-company boards scored higher on

Exhibit 1

**Private-equity boards are considered effective overall even if public boards have some advantages.**

Interviewees' rating of boards (on a scale of 1 to 5, where 1 = poor, 5 = world class)




Source: Interviews with about 20 UK-based directors who have served, over the past 5 years, on the boards of both private and public companies (FTSE 100 or FTSE 250 businesses and private-equity owned), most with an enterprise value of >£500 million

governance and on management development. However, respondents saw PE boards as more effective overall because of their stronger strategic leadership and more effective performance oversight, as well as their management of key stakeholders (Exhibit 1).

### Strategic leadership

In almost all cases, our respondents described PE boards as leading the formulation of strategy, with all directors working together to shape it and define the resulting priorities. Key elements of the strategic plan are likely to have been laid out during the due-diligence process. Private-equity boards are often the source of strategic initiatives and ideas (for example, on M&A) and assume the role of stimulating the executive team to think more broadly and creatively about opportunities. The role of the executive-management team is to implement this plan and report back on the progress.

By contrast, though most public companies state that the board's responsibility includes overseeing strategy, the reality is that the executive team typically takes the lead in proposing and developing it, and the board's role is to challenge and shape management's proposals. None of our interviewees said that their public boards led strategy: 70 percent described the board as "accompanying" management in defining it, while 30 percent said that the board played only a following role. Few respondents saw these boards as actively and effectively shaping strategy.

### Performance management

Interviewees also believed that PE boards were far more active in managing performance than were their public counterparts: indeed the nature and intensity of the performance-management culture is perhaps the most striking difference between the two environments.

Private-equity boards have what one respondent described as a "relentless focus on value creation levers," and this focus leads them to identify critical initiatives and to decide which key performance indicators (KPIs) to monitor. These KPIs not only are defined more explicitly than they are in public companies but also focus much more strongly on cash metrics and speed of delivery. Having set these KPIs, PE boards monitor them much more intensively—reviewing progress in great detail, focusing intently on one or two areas at each meeting, and intervening in cases of underperformance. "This performance-management focus is the board's real *raison d'être*," one respondent commented.

In contrast, public boards were described as much less engaged in detail: their scrutiny was seen at best as being on a higher level ("more macro than micro," one interviewee said) and at worst as superficial. Moreover, public boards focus much less on fundamental value creation levers and much more on meeting quarterly profit targets and market expectations. Given the importance of ensuring that shareholders get an accurate picture of a business's short-term performance prospects, this emphasis is perhaps understandable. But what it produces is a board focused more on budgetary control, the delivery of short-term accounting profits, and avoiding surprises for investors.

### Management development and succession

Private-equity boards scored less well on their development of human capital—both absolutely and relative to public boards. PE boards do focus intensely on the quality of the top-executive team, in particular the CEO and the CFO, and are quick to replace underperformers. But such boards invest little or no time exploring broader and longer-term issues, such as the

strength of the management team, succession plans, and developing management. "Their interest in management development is frustratingly narrow," one interviewee said.

Public boards, by comparison, were seen as more committed to and effective for people issues. Such boards insist on thorough management-review processes, discuss not only the top team but also its potential successors, debate the key capabilities needed for long-term success, are more likely to challenge and influence management-development processes, and play a more active role in defining remuneration policies and plans. There are weaknesses, however: public boards can be slower to react when change is needed, and their voice on everything but the CEO succession tends to be more advisory than directive. Remuneration discussions are thorough, but public boards can seem more concerned about the reaction of external stakeholders to potential plans than about their impact on performance. Overall, however, public boards are more focused on people, tackle a broader range of issues, and work in a more sophisticated way.

### Stakeholder management

Our respondents felt that PE boards were much more effective at managing stakeholders, largely as a result of structural differences between the two models. Public boards operate in a more complex environment, managing a broader range of stakeholders and dealing with a disparate group of investors, including large institutions and small shareholders, value and growth investors, and long-term stockholders and short-term hedge funds. These groups have different priorities and demands (and, in the case of short-selling hedge funds, fundamentally misaligned interests). The chairmen and CEOs of public companies therefore have to put a lot of effort into communicating with diverse groups.

The challenge for PE boards is more straightforward. Their effective shareholders (the investors in PE funds) are locked in for the duration of the fund. The shareholders' representatives (the PE house) are in effect a single bloc (or a very small number of blocs in a club deal) and so act in alignment. Furthermore, these representatives are more engaged than board members in the public world are—they are literally "in the room" with executives and are much better informed about business realities than are investors in public companies. Unsurprisingly, therefore, the burden of investor management is much less onerous for PE boards and the quality of the dialogue much better.

Yet PE boards are much less experienced in engaging with broader stakeholders, such as the media, unions, and other pressure groups. This inexperience was evident in the initial response of these boards to the greater scrutiny they attracted in 2007. The Walker Report[2] and the changes PE houses subsequently made to increase the frequency and transparency of their communications do go some way in addressing the shortcomings, but public boards typically are still more sophisticated and effective in this area.

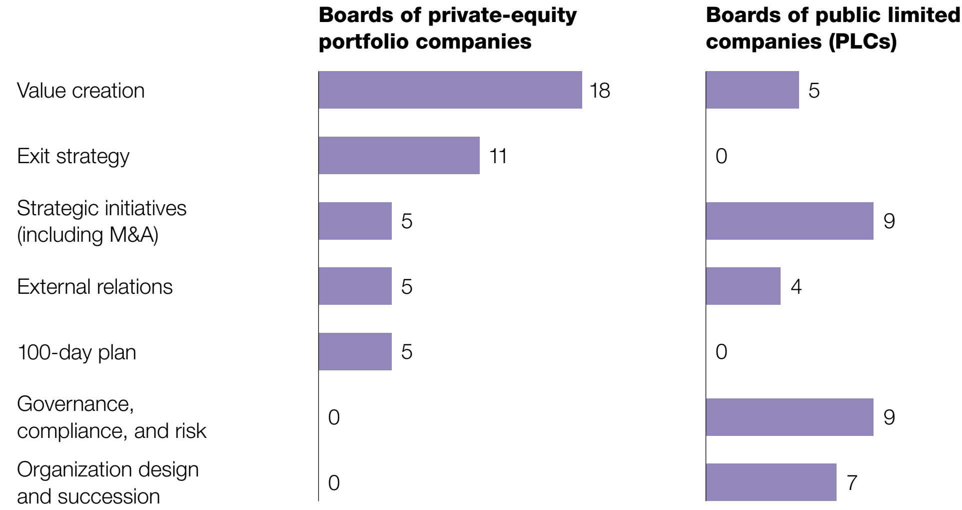
## Governance and risk management

Public boards earned their best scores in governance and risk management, a result that reflected the drive to improve governance standards and controls in the wake of the various scandals that led to the Sarbanes–Oxley legislation and the initiatives suggested in the Higgs Report.[3] The typical board subcommittees (audit, nomination, remuneration, and

Exhibit 2

**Private-equity boards lead on value creation, while public boards excel at governance and risk management.**

Top 3 board priorities, number of respondents




Source: Interviews with about 20 UK-based directors who have served, over the past 5 years, on the boards of both private and public companies (FTSE 100 or FTSE 250 businesses and private-equity owned), most with an enterprise value of >£500 million

corporate social responsibility) are seen as conducting a thorough, professional scrutiny of the agreed-upon areas of focus, while the overall board supervises effectively and can draw on a broad range of insights and experiences to identify potential risks. Compliance with the United Kingdom's Combined Code on Corporate Governance is high—an important factor in building investor confidence.

Yet there are important underlying concerns. Unsurprisingly, many respondents held that some elements of governance are overengineered and, as a result, consume much time while generating little value. Of greater concern, perhaps, many respondents felt that, in emphasizing governance, public boards had become too conservative. "Boards seek to follow precedent and avoid conflict with investors rather than exploring what could maximize value," commented one respondent. "The focus is on box-ticking and covering the right inputs, not delivering the right outputs," said another.

Private-equity boards scored lower on governance, reflecting their lower level of emphasis on it and their typically less sophisticated processes for managing it. In every case, governance efforts focused on a narrower set of activities, though almost all PE boards embraced the need for a formal audit committee. Interestingly, though, PE boards in general were seen as having a deeper understanding of operational business risks and financial risks. They were also perceived to be more focused on, and skilled in, risk management as opposed to risk avoidance.

## Sources of difference?

Since our respondents felt that PE boards were typically more effective than public ones were

in adding value, we sought to learn why. The comments of the respondents suggest two key differences. First, nonexecutive directors of public companies are more focused on risk avoidance than on value creation (Exhibit 2). This attitude isn't necessarily illogical: such directors are not financially rewarded by a company's success, and they may lose their hard-earned reputations if investors are disappointed.

Second, our respondents noted a greater level of engagement by nonexecutive directors at PE-backed companies. The survey suggested that PE directors spend, on average, nearly three times as many days on their roles as do those at public companies (54 versus 19). Even in the bigger FTSE 100 companies, the average commitment is only 25 days a year. Respondents also observed differences in the way non-executive directors invest their time. In both models of ownership, they spend around 15 to 20 days a year on formal sessions, such as board and committee meetings. However, PE nonexecutives devote an additional 35 to 40 days to hands-on, informal interactions (such as field visits, ad hoc meetings with executives, phone calls, and e-mails), compared with only 3 to 5 days a year for nonexecutive directors at public companies. ○

[1] We interviewed directors who had, over the past five years, served on the boards both of FTSE 100 or FTSE 250 businesses and PE-owned companies with a typical value of more than £500 million. While the number of interviewees may seem small, it is probably a large proportion of the limited population of such directors.

[2] See David Walker, *Guidelines for Disclosure and Transparency in Private Equity*, Walker Working Group, 2007.

[3] See Derek Higgs, *Review on the Role and Effectiveness of Non-Executive Directors*, UK Department of Trade and Industry, 2003.

# The right way to hedge

**Bryan Fisher and Ankush Kumar**

**Number 36, Summer 2010**

Deciding how and what to hedge requires a company-wide look at the total costs and benefits.

Hedging is hot. Shifts in supply-and-demand dynamics and global financial turmoil have created unprecedented volatility in commodity prices in recent years. Meanwhile, executives at companies that buy, sell, or produce commodities have faced equally dramatic swings in profitability. Many have stepped up their use of hedging to attempt to manage this volatility and, in some instances, to avoid situations that could put a company's survival in jeopardy.

When done well, the financial, strategic, and operational benefits of hedging can go beyond merely avoiding financial distress, by opening up options to preserve and create value as well. But done poorly, hedging in commodities often overwhelms the logic behind it and can actually destroy more value than was originally at risk. Perhaps individual business units hedge opposite sides of the same risk, or managers expend too much effort hedging risks that are

immaterial to a company's health. Managers can also underestimate the full costs of hedging or overlook natural hedges in deference to costly financial ones. No question, hedging can entail complex calculations and difficult trade-offs. But in our experience, keeping in mind a few simple pointers can help nip problems early and make hedging strategies more effective.

## Hedge net economic exposure

Too many hedging programs target the nominal risks of "siloed" businesses rather than a company's net economic exposure—aggregated risk across the broad enterprise that also includes the indirect risks.[1] This siloed approach is a problem, especially in large multibusiness organizations: managers of business units or divisions focus on their own risks without considering risks and hedging activities elsewhere in the company.

At a large international industrial company, for example, one business unit decided to hedge its foreign-exchange exposure from the sale of $700 million in goods to Brazil, inadvertently increasing the company's net exposure to fluctuations in foreign currency. The unit's managers hadn't known that a second business unit was at the same time sourcing about $500 million of goods from Brazil, so instead of the company's natural $200 million exposure, it ended up with a net exposure of $500 million—a significant risk for this company.

Elsewhere, the purchasing manager of a large chemical company used the financial markets to hedge its direct natural-gas costs—which amounted to more than $1 billion, or half of its input costs for the year. However, the company's sales contracts were structured so that natural-gas prices were treated as a pass-through (for example, with an index-based pricing mechanism). The company's natural position had little exposure to gas price movements, since price fluctuations were adjusted, or hedged, in its sales contracts. By adding a financial hedge to its input costs, the company was significantly increasing its exposure to natural-gas prices—essentially locking in an input price for gas with a floating sales price. If the oversight had gone unnoticed, a 20 percent decrease in gas prices would have wiped out all of the company's projected earnings.

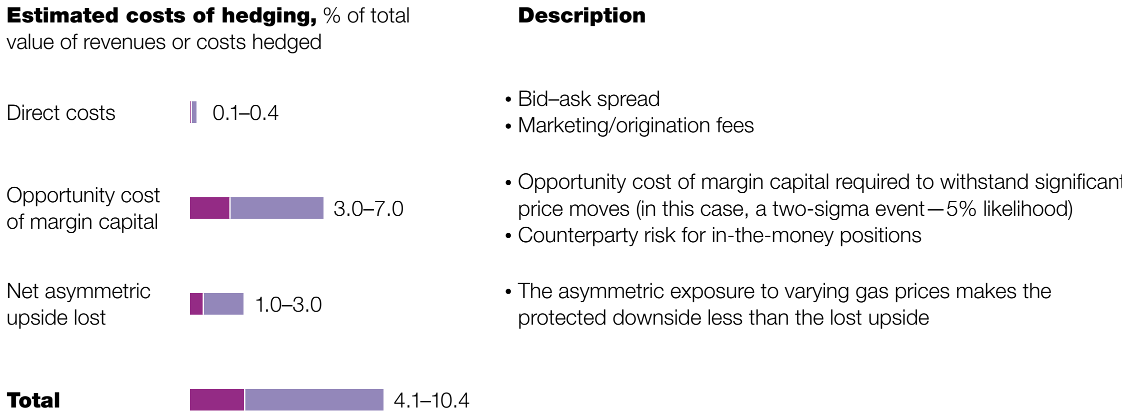
Keep in mind that net economic exposure includes indirect risks, which in some cases account for the bulk of a company's total risk exposure.[2] Companies can be exposed to indirect risks through both business practices (such as contracting terms with customers) and market factors (for instance, changes in the competitive environment). When a snowmobile manufacturer in Canada hedged the foreign-exchange exposure of its supply costs, denominated in Canadian dollars, for example, the hedge successfully protected it from cost increases when the Canadian dollar rose against the US dollar. However, the costs for the company's US competitors were in depreciating US dollars. The snowmobile maker's net economic exposure to a rising Canadian dollar therefore came not just from higher manufacturing costs but also from lower sales as Canadian customers rushed to buy cheaper snowmobiles from competitors in the United States.

In some cases, a company's net economic exposure can be lower than its apparent nominal exposure. An oil refinery, for example, faces a large nominal exposure to crude-oil costs, which make up about 85 percent of the cost of its output, such as gasoline and diesel. Yet the company's true economic exposure is much lower, since the refineries across the industry largely face the same crude price exposure (with some minor

Exhibit 1

## Direct costs account for only a fraction of the total cost of hedging.

Example: A gas producer hedged 3 years of its gas production with a forward contract on a financial exchange




differences for configuration) and they typically pass changes in crude oil prices through to customers. So in practice, each refinery's true economic exposure is a small fraction of its nominal exposure because of the industry structure and competitive environment.

To identify a company's true economic exposure, start by determining the natural offsets across businesses to ensure that hedging activities don't actually increase it. Typically, the critical task of identifying and aggregating exposure to risk on a company-wide basis involves compiling a global risk "book" (similar to those used by financial and other trading institutions) to see the big picture—the different elements of risk—on a consistent basis.

### Calculate total costs and benefits

Many risk managers underestimate the true cost of hedging, typically focusing only on the direct transactional costs, such as bid–ask spreads and broker fees. These components are often only a small portion of total hedge costs (Exhibit 1), leaving out indirect ones, which can be the largest portion of the total. As a result, the cost of many hedging programs far exceeds their benefit.

Two kinds of indirect costs are worth discussing: the opportunity cost of holding margin capital and lost upside. First, when a company enters into some financial-hedging arrangements, it often must hold additional capital on its balance sheet against potential future obligations. This requirement ties up significant capital that might have been better applied to other projects, creating an opportunity cost that managers often overlook. A natural-gas producer that hedges its entire annual production output, valued at $3 billion in sales, for example, would be required to hold or post capital of around $1 billion, since gas prices can fluctuate up to 30 to 35 percent in a given year. At a 6 percent interest rate, the cost of holding or posting margin capital translates to $60 million per year.

Another indirect cost is lost upside. When the probability that prices will move favorably (rise, for example) is higher than the probability that they'll move unfavorably (fall, for example), hedging to lock in current prices can cost more in forgone upside than the value of the downside protection. This cost depends on an organization's view of commodity price floors and ceilings. A large independent natural-gas producer, for example, was evaluating a hedge for its production during the coming two years. The price of natural gas in the futures markets was $5.50 per million British thermal units (BTUs). The company's fundamental perspective was that gas prices in the next two years would stay within a range of $5.00 to $8.00 per million BTUs. By hedging production at $5.50 per million BTUs, the company protected itself from only a $0.50 decline in prices and gave up a potential upside of $2.50 if prices rose to $8.00.

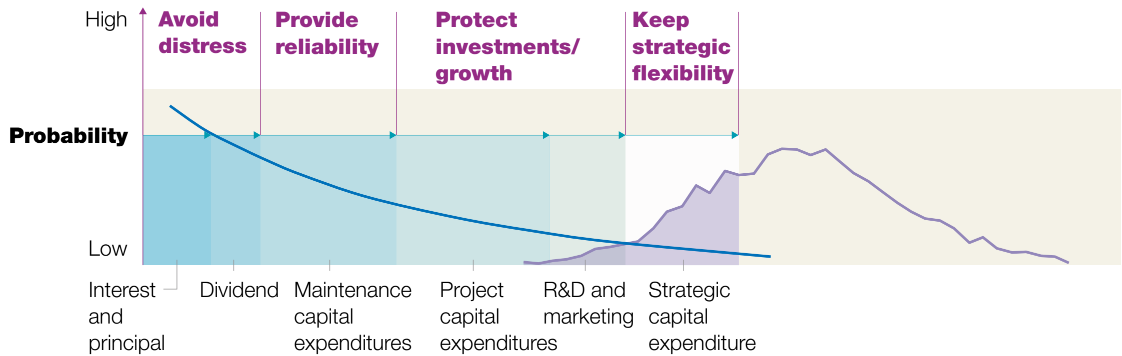
## Hedge only what matters

Companies should hedge only exposures that pose a material risk to their financial health or threaten their strategic plans. Yet too often we find that companies (under pressure from the capital markets) or individual business units (under pressure from management to provide earnings certainty) adopt hedging programs that create little or no value for shareholders. An integrated aluminum company, for example, hedged its exposure to crude oil and natural gas for years, even though they had a very limited impact on its overall margins. Yet it did not hedge its exposure to aluminum, which drove more than 75 percent of margin volatility. Large conglomerates are particularly susceptible to this problem when individual business units hedge to protect their performance against risks that are immaterial at a portfolio level. Hedging these smaller exposures affects a company's risk profile only

Exhibit 2

**Companies should develop a profile of probable cash flows—one that reflects a company-wide calculation of risk exposures and sources of cash.**

Cash flow distribution and cash needs



marginally—and isn't worth the management time and focus they require.

To determine whether exposure to a given risk is material, it is important to understand whether a company's cash flows are adequate for its cash needs. Most managers base their assessments of cash flows on scenarios without considering how likely those scenarios are. This approach would help managers evaluate a company's financial resilience if those scenarios came to pass, but it doesn't determine how material certain risks are to the financial health of the company or how susceptible it is to financial distress. That assessment would require managers to develop a profile of probable cash flows—a profile that reflects a company-wide calculation of risk exposures and sources of cash. Managers should then compare the company's cash needs (starting with the least discretionary and moving to the most discretionary) with the cash flow profile to quantify the likelihood of a cash shortfall. They should also be sure to conduct this analysis at the portfolio level to account for the diversification of risks across different business lines (Exhibit 2).

A high probability of a cash shortfall given nondiscretionary cash requirements, such as debt obligations or maintenance capital expenditures, indicates a high risk of financial distress. Companies in this position should take aggressive steps, including hedging, to mitigate risk. If, on the other hand, a company finds that it can finance its strategic plans with a high degree of certainty even without hedging, it should avoid (or unwind) an expensive hedging program.

## Look beyond financial hedges

An effective risk-management program often includes a combination of financial hedges and nonfinancial levers to alleviate risk. Yet few companies fully explore alternatives to financial hedging, which include commercial or operational tactics that can reduce risks more effectively and inexpensively. Among them: contracting decisions that pass risk through to a counterparty; strategic moves, such as vertical integration; and operational changes, such as revising product specifications, shutting down manufacturing facilities when input costs peak, or holding additional cash reserves. Companies should test the effectiveness of different risk mitigation strategies by quantitatively comparing the total cost of each approach with the benefits.

• • •

The complexity of day-to-day hedging in commodities can easily overwhelm its logic and value. To avoid such problems, a broad strategic perspective and a commonsense analysis are often good places to start. ○

[1] See Eric Lamarre and Martin Pergler, "Risk: Seeing around the corners," *McKinsey on Finance*, Number 33, Autumn 2009, pp. 2–7.

[2] Indirect risks arise as a result of changes in competitors' cost structures, disruption in the supply chain, disruption of distribution channels, and shifts in customer behavior.

# Excerpt from
# Risk: Seeing around the corners

**Eric Lamarre and Martin Pergler**

**Number 33, Autumn 2009**

Clearly, companies must look beyond immediate, obvious risks and learn to evaluate aftereffects that could destabilize whole value chains, including all direct as well as indirect risks in several areas:

Competitors. Often the most important area to investigate is the way risks might change a company's cost position versus its competitors or substitute products. Companies are particularly vulnerable when their currency exposures, supply bases, or cost structures differ from those of their rivals. In fact, all differences in business models create the potential for a competitive risk exposure, favorable or unfavorable. The point isn't that a company should imitate its competitors but rather that it should think about the risks it implicitly assumes when its strategy departs from theirs.

Supply chains. Classic examples of risk cascading through supply chains include disruptions in the availability of parts or raw materials, changes in the cost structures of suppliers, and shifts in logistics costs. When the price of oil reached $150 a barrel in 2008, for example, many offshore suppliers became substantially less cost competitive in the US market. Consider the case of steel. Since Chinese imports were the marginal price setters in the United States, prices for steel rose 20 percent there as the cost of shipping it from China rose by nearly $100 a ton. The fact that logistics costs depend significantly on oil prices is hardly surprising, but few companies that buy substantial amounts of steel considered their second-order oil price exposure through the supply chain.

Distribution channels. Indirect risks can also lurk in distribution channels, and effects may include an inability to reach end customers, changed distribution costs, or even radically redefined business models. For example, the bankruptcy and liquidation of the major US big-box consumer electronics retailer Circuit City, in 2008, had a cascading impact on the industry. Most directly, electronics manufacturers held some $600 million in unpaid receivables that were suddenly at risk. The bankruptcy also created indirect risks for these companies, in the form of price pressures and bargain-hunting behavior as liquidators sold off discounted merchandise right in the middle of the peak Christmas buying season.

Customer response. Often, the most complex knock-on effects are the responses from customers, because those responses can be so diverse and involve so many factors. One typical cascading effect is a shift in buying patterns, as in the case of the Canadians who went shopping in the United States with their stronger currency. Another is changed demand levels, such as the impact of higher fuel prices on the auto market: as the price of gasoline increased in recent years, there was a clear shift from large SUVs to compact cars, with hybrids rapidly becoming serious contenders.

Excerpt from
# Emerging markets aren't as risky as you think

**Marc H. Goedhart and Peter Haden**

**Number 7, Spring 2003**

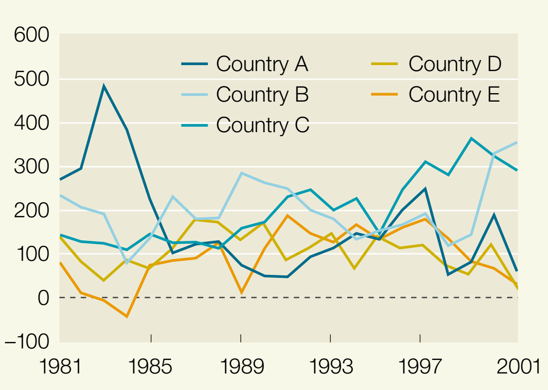
No question, emerging-market investments are exposed to additional risks, including accelerated inflation, exchange rate changes, adverse repatriation and fiscal measures, and macroeconomic and political distress. These elements clearly call for a different approach to investment decisions.

However, while individual country risks may be high, they actually have low correlations with each other. As a result, the overall performance of an emerging-market portfolio can be quite stable if investments are spread out over several countries. At one international consumer goods company, for example, returns on invested capital for the combined portfolio of emerging-market businesses have been as stable as those for developed markets in North America and Europe over the last 20 years.[1] We found similarly low correlations of GDP growth across emerging-market economies and the United States and Europe over the last 15 years (exhibit). These findings, we believe, also hold for other sectors.

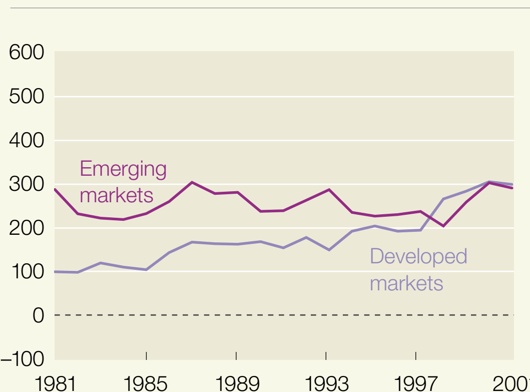
Country-specific risks can also affect different businesses differently. For one parent company, sustaining its emerging-market businesses during a crisis not only demonstrated that it could counter country specific risk but also strengthened its position as local funding for competitors dried up. For this company, sales growth, when measured in a stable currency, tended to pick up strongly after a crisis, a pattern that played out consistently through all the crises it encountered in emerging markets.

Return on invested capital (ROIC) for international consumer goods company; index: combined-portfolio ROIC for developed markets = 100 in 1981

**ROIC[1] for selected individual emerging markets**

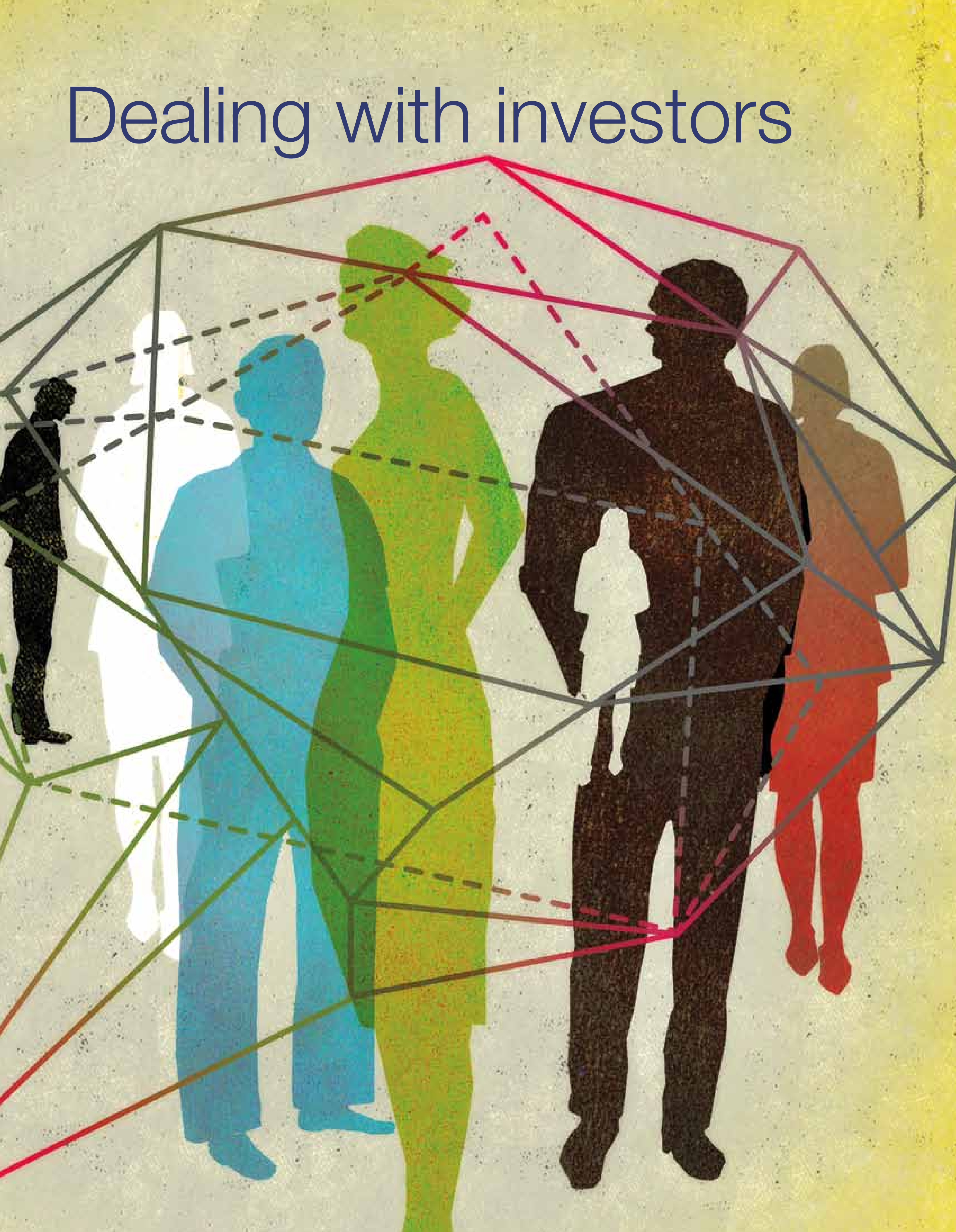



**ROIC[1] for combined portfolios**




[1]Expressed in stable currency prior to indexing and adjusted for local accounting differences; combined portfolio includes additional countries not reflected in exhibit.

# Dealing with investors



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# Communicating with the right investors

**Robert N. Palter, Werner Rehm, and Jonathan Shih**

**Number 27, Spring 2008**

Executives spend too much time talking with investors who don't matter. Here's how to identify those who do.

Many executives spend too much time communicating with investors they would be better off ignoring. CEOs and CFOs, in particular, devote an inordinate amount of time to one-on-one meetings with investors, investment conferences, and other shareholder communications,[1] often without having a clear picture of which investors really count.

The reason, in part, is that too many companies segment investors using traditional methods that yield only a shallow understanding of their motives and behavior; for example, we repeatedly run across investor relations groups that try to position investors as growth or value investors—mirroring the classic approach that investors use to segment companies. The expectation is that growth investors will pay more, so if a company can persuade them to buy its stock, its share price will rise. That expectation is false: many growth investors buy after an increase in share

prices. More important, traditional segmentation approaches reveal little about the way investors decide to buy and sell shares. How long does an investor typically hold onto a position, for example? How concentrated is the investor's portfolio? Which financial and operational data are most helpful for the investor? We believe that the answers to these and similar questions provide better insights for classifying investors.

Once a company segments investors along the right lines, it can quickly identify those who matter most. These important investors, whom we call "intrinsic" investors, base their decisions on a deep understanding of a company's strategy, its current performance, and its potential to create long-term value. They are also more likely than other investors to support management through short-term volatility. Executives who reach out to intrinsic investors, leaving others to the investor relations department,[2] will devote less time to investor relations and communicate a clearer, more focused message. The result should be a better alignment between a company's intrinsic value and its market value, one of the core goals of investor relations.[3]

## A better segmentation

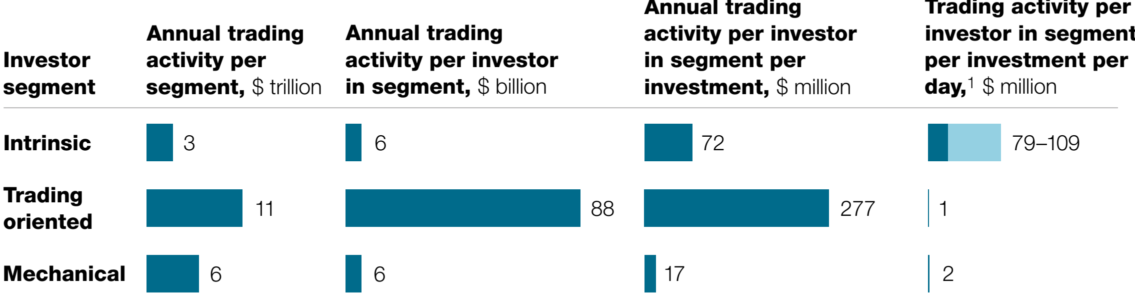
No executive would talk to important customers without understanding how they make purchase decisions, yet many routinely talk to investors without understanding their investment criteria. Our analysis of typical holding periods, investment portfolio concentrations, the number of professionals involved in decisions, and average trading volumes—as well as the level of detail investors require when they undertake research on a company—suggests that investors can be distributed among three broad categories.

### Intrinsic investors

Intrinsic investors take a position in a company only after rigorous due diligence of its intrinsic ability to create long-term value. This scrutiny typically takes more than a month.

Exhibit

**When intrinsic investors trade, they trade more per day than other investors do.**




[1]Includes only days when investor traded.

We estimate that these investors hold 20 percent of US assets and contribute 10 percent of the trading volume in the US market.

In interviews with more than 20 intrinsic investors, we found that they have concentrated portfolios—each position, on average, makes up 2 to 3 percent of their portfolios and perhaps as much as 10 percent; the average position of other investors is less than 1 percent. Intrinsic investors also hold few positions per analyst (from four to ten companies) and hold shares for several years. Once they have invested, these professionals support the current management and strategy through short-term volatility. In view of all the effort intrinsic investors expend, executives can expect to have their full attention while reaching out to them, for they take the time to listen, to analyze, and to ask insightful questions.

These investors also have a large impact on the way a company's intrinsic value lines up with its market value—an effect that occurs mechanically because when they trade, they trade in high volumes (exhibit). They also have a psychological effect on the market because their reputation for very well-timed trades magnifies their influence on other investors. One indication of their influence: there are entire Web sites (such as GuruFocus.com, Stockpickr.com, and Mffais.com) that follow the portfolios of well-known intrinsic investors.

### Mechanical investors

Mechanical investors, including computer-run index funds and investors who use computer models to drive their trades, make decisions based on strict criteria or rules. We also include in this category the so-called closet index funds. These are large institutional investors whose portfolios resemble those of an index fund because of their size, even though they don't position themselves in that way.[4]

We estimate that around 32 percent of the total equity in the United States sits in purely mechanical investment funds of all kinds. Because their approach offers no real room for qualitative decision criteria, such as the strength of a management team or a strategy, investor relations can't influence them to include a company's shares in an index fund. Similarly, these investors' quantitative criteria, such as buying stocks with low price-to-equity ratios or the shares of companies below a certain size, are based on mathematical models of greater or lesser sophistication, not on insights about fundamental strategy and value creation.

In the case of closet index funds, each investment professional handles, on average, 100 to 150 positions, making it impossible to do in-depth research that could be influenced by meetings with an investment target's management. In part, the high number of positions per professional reflects the fact that most closet index funds are part of larger investment houses that separate the roles of fund manager and researcher. The managers of intrinsic investors, by contrast, know every company in their portfolios in depth.

### Traders

The investment professionals in the trader group seek short-term financial gain by betting on news items, such as the possibility that a company's quarterly earnings per share (EPS) will be above or below the consensus view or, in the case of a drug maker, recent reports that a clinical trial has gone badly. Traders control about 35 percent of US equity holdings. Such investors don't really want to understand companies

Excerpt from
## Inside a hedge fund

**Number 19, Spring 2006**

"First and foremost, we're trying to understand the business. How sustainable is growth? How sustainable are returns on capital? How intelligently is it deploying that capital? Our goal is to know more about every one of the companies in which we invest than any noninsider does. On average, we hold fewer than five positions per investment professional—a ratio that is far lower than most hedge funds and even large mutual-fund complexes. And our sector heads, who on average have over 15 years of investment experience, have typically spent their entire careers focused on just one industry, allowing them to develop long-term relationships not only with the senior management of most of the significant companies but also with employees several levels below."

**Lee Ainslie**
Managing partner of Maverick Capital

on a deep level—they just seek better information for making trades. Not that traders don't understand companies or industries; on the contrary, these investors follow the news about them closely and often approach companies directly, seeking nuances or insights that could matter greatly in the short term. The average investment professional in this segment has 20 or more positions to follow, however, and trades in and out of them quickly to capture small gains over short periods—as short as a few days or even hours. Executives therefore have no reason to spend time with traders.

### Focused communications

Most investor relations departments could create the kind of segmentation we describe. They should also consider several additional layers of information, such as whether an investor does (or plans to) hold shares in a company or has already invested elsewhere in its sector. A thorough segmentation that identifies sophisticated intrinsic investors will allow companies to manage their investor relations more successfully.

#### Don't oversimplify your message

Intrinsic investors have spent considerable effort to understand your business, so don't boil down a discussion of strategy and performance to a ten-second sound bite for the press or traders. Management should also be open about the relevant details of the company's current performance and how it relates to strategy. Says one portfolio manager, "I don't want inside information. But I do want management to look me in the eye when they talk about their performance. If they avoid a discussion or explanation, we will not invest, no matter how attractive the numbers look."

#### Interpret feedback in the right context

Most companies agree that it is useful to understand the views of investors while developing strategies and investor communications. Yet management often relies on simple summaries of interviews with investors and sell-side analysts about everything from strategy to quarterly earnings to share repurchases. This approach gives management no way of linking the views of investors to their importance for the company or to their investment strategies. A segmented approach, which clarifies each investor's goals and needs, lets executives interpret feedback in context and weigh messages accordingly.

## Prioritize management's time

A CEO or CFO should devote time to communicating only with the most important and knowledgeable intrinsic investors that have professionals specializing in the company's sector. Moreover, a CEO should think twice before attending conferences if equity analysts have arranged the guest lists, unless management regards those guests as intrinsic investors. When a company focuses its communications on them, it may well have more impact in a shorter amount of time.

In our experience, intrinsic investors think that executives should spend no more than about 10 percent of their time on investor-related activities, so management should be actively engaging with 15 to 20 investors at most. The investor relations department ought to identify the most important ones, review the list regularly, and protect management from the telephone calls of analysts and mechanical investors, who are not a high priority. Executives should talk to equity analysts only if their reports are important channels for interpreting complicated news; otherwise, investor relations can give them any relevant data they require, if available.

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Marketing executives routinely segment customers by the decision processes those customers use and tailor the corporate image and ad campaigns to the most important ones. Companies could benefit from a similar kind of analytic rigor in their investor relations. ○

[1] Including a wide range of communications activities, such as annual shareholder meetings, conferences with sell-side analysts, quarterly earnings calls, and market updates.

[2] This article deals only with institutional investors, since management usually spends the most time with them. We also exclude activist investors, as they represent a different investor relations issue for management.

[3] If this goal sounds counterintuitive, consider the alternatives. Clearly, undervaluation isn't desirable. An overvaluation is going to be corrected sooner or later, and the correction will, among other things, distress board members and employees with worthless stock options issued when the shares were overvalued.

[4] For more on closet index funds, see Martijn Cremers and Antti Petajist, "How active is your fund manager? A new measure that predicts performance," AFA Chicago Meetings Paper, January 15, 2007.

# Excerpt from
# **Numbers investors can trust**

**Tim Koller**

**Number 8, Summer 2003**

Financial statements should be organized with more detail and with an aim to clearly separating operating from nonoperating items. It's not easy. In fact, current accounting rules exhibit something less than common sense in defining operating versus nonoperating or nonrecurring items. As a start, however, company income statements should close the biggest gaps in the current system by separately identifying the following items.

Nonrecurring pension expense adjustments. These often have more to do with the performance of the pension fund than the operating performance of the company. Investors would benefit from being able to assess a company's operating performance compared to peers over time separately from its skills at managing its pension assets.

Gains and losses from assets sales that are not recurring. Large companies like to bury gains from asset sales in operating results because it makes their operating performance look better, often arguing that the impact is immaterial. But investors should be the ones who decide what is material. Companies should also separate out gains from losses. Now companies sometimes sell assets to create gains to offset losses from asset sales, and some top-ranked multinationals are well known for doing this on a regular basis. This is a perverse incentive that would go away if companies were required to disclose gains and losses.

In a more useful income statement, complex or nonrecurring items such as pension expenses, stock options, changes in restructuring reserves, and asset gains or losses would be separately disclosed, regardless of materiality. Similarly, balance sheets should separate assets and liabilities that are used in the operations of the business from other assets and liabilities, such as excess cash not needed to fund the operations, or investments in unrelated activities.

A more useful approach to reporting would also include a focus on business units. Today's large companies are complex, with multiple business units that rarely have the same growth potential and profitability. Sophisticated investors will try to value each business unit separately or build up consolidated forecasts from the sum of the individual business units. Yet many companies report only the minimum required information and often not enough for investors to understand the underlying health of the business units. Nearly always, business unit results are relegated to the footnotes at the back of the annual report, though a good case can be made that business unit reporting is in fact more important than the consolidated results and should be the focus of corporate reporting. At a minimum, companies should produce a clear operating-income statement.

Excerpt from
# The misguided practice of earnings guidance

**Peggy Hsieh, Tim Koller, and S. R. Rajan**

**Number 19, Spring 2006**

Most companies view the quarterly ritual of issuing earnings guidance as a necessary, if sometimes onerous, part of investor relations. The benefits, they hope, are improved communications with financial markets, lower share price volatility, and higher valuations. At the least, companies expect frequent earnings guidance to boost their stock's liquidity.

Yet our analysis of companies across all sectors and an in-depth examination of two mature representative industries—consumer packaged goods (CPG) and pharmaceuticals—found no evidence to support those expectations. The findings fell into three categories:

Valuations. Contrary to what some companies believe, frequent guidance does not result in superior valuations in the marketplace; indeed, guidance appears to have no significant relationship with valuations—regardless of the year, the industry, or the size of the company in question.

Volatility. When a company begins to issue earnings guidance, its share price volatility is as likely to increase as to decrease compared with that of companies that don't issue guidance.

Liquidity. When companies begin issuing quarterly earnings guidance, they experience increases in trading volumes relative to companies that don't provide it. However, the relative increase in trading volumes—which is more prevalent for companies with revenues in excess of $2 billion—wears off the following year.

With scant evidence of any shareholder benefits to be gained from providing frequent earnings guidance but clear evidence of increased costs, managers should consider whether there is a better way to communicate with analysts and investors.

We believe there is. Instead of providing frequent earnings guidance, companies can help the market to understand their business, the underlying value drivers, the expected business climate, and their strategy—in short, to understand their long-term health as well as their short-term performance. Analysts and investors would then be better equipped to forecast the financial performance of these companies and to reach conclusions about their value.

# Do fundamentals—or emotions—drive the stock market?

**Marc H. Goedhart, Tim Koller, and David Wessels**

**Number 15, Spring 2005**

Emotions can drive market behavior in a few short-lived situations. But fundamentals still rule.

There's never been a better time to be a behaviorist. During four decades, the academic theory that financial markets accurately reflect a stock's underlying value was all but unassailable. But lately, the view that investors can fundamentally change a market's course through irrational decisions has been moving into the mainstream.

With the exuberance of the high-tech stock bubble and the crash of the late 1990s still fresh in investors' memories, adherents of the behaviorist school are finding it easier than ever to spread the belief that markets can be something less than efficient in immediately distilling new information and that investors, driven by emotion, can indeed lead markets awry. Some behaviorists would even assert that stock markets lead lives of their own, detached from economic growth and business profitability. A number of finance scholars and practitioners have argued that stock markets are not efficient—that is, that they

don't necessarily reflect economic fundamentals.[1] According to this point of view, significant and lasting deviations from the intrinsic value of a company's share price occur in market valuations.

The argument is more than academic. In the 1980s, the rise of stock market index funds, which now hold some $1 trillion in assets, was caused in large part by the conviction among investors that efficient-market theories were valuable. And current debates in the United States and elsewhere about privatizing Social Security and other retirement systems may hinge on assumptions about how investors are likely to handle their retirement options.

We agree that behavioral finance offers some valuable insights—chief among them the idea that markets are not always right, since rational investors can't always correct for mispricing by irrational ones. But for managers, the critical question is how often these deviations arise and whether they are so frequent and significant that they should affect the process of financial decision making. In fact, significant deviations from intrinsic value are rare, and markets usually revert rapidly to share prices commensurate with economic fundamentals. Therefore, managers should continue to use the tried-and-true analysis of a company's discounted cash flow to make their valuation decisions.

## When markets deviate

Behavioral-finance theory holds that markets might fail to reflect economic fundamentals under three conditions. When all three apply, the theory predicts that pricing biases in financial markets can be both significant and persistent.

### Irrational behavior

Investors behave irrationally when they don't correctly process all the available information while forming their expectations of a company's future performance. Some investors, for example, attach too much importance to recent events and results, an error that leads them to overprice companies with strong recent performance. Others are excessively conservative and underprice stocks of companies that have released positive news.

### Systematic patterns of behavior

Even if individual investors decided to buy or sell without consulting economic fundamentals, the impact on share prices would still be limited. Only when their irrational behavior is also systematic (that is, when large groups of investors share particular patterns of behavior) should persistent price deviations occur. Hence behavioral-finance theory argues that patterns of overconfidence, overreaction, and overrepresentation are common to many investors and that such groups can be large enough to prevent a company's share price from reflecting underlying economic fundamentals—at least for some stocks, some of the time.

### Limits to arbitrage in financial markets

When investors assume that a company's recent strong performance alone is an indication of future performance, they may start bidding for shares and drive up the price. Some investors might expect a company that surprises the market in one quarter to go on exceeding expectations. As long as enough other investors notice this myopic overpricing and respond by taking short positions, the share price will fall in line with its underlying indicators.

This sort of arbitrage doesn't always occur, however. In practice, the costs, complexity, and risks involved in setting up a short position can be too high for individual investors. If, for example, the share price doesn't return to

its fundamental value while they can still hold on to a short position—the so-called noise-trader risk—they may have to sell their holdings at a loss.

## Persistent mispricing in carve-outs and dual-listed companies

Two well-documented types of market deviation—the mispricing of carve-outs and of dual-listed companies—are used to support behavioral-finance theory. The classic example is the pricing of 3Com and Palm after the latter's carve-out in March 2000.

In anticipation of a full spin-off within nine months, 3Com floated 5 percent of its Palm subsidiary. Almost immediately, Palm's market capitalization was higher than the entire market value of 3Com, implying that 3Com's other businesses had a negative value. Given the size and profitability of the rest of 3Com's businesses, this result would clearly indicate mispricing. Why did rational investors fail to exploit the anomaly by going short on Palm's shares and long on 3Com's? The reason was that the number of available Palm shares was extremely small after the carve-out: 3Com still held 95 percent of them. As a result, it was extremely difficult to establish a short position, which would have required borrowing shares from a Palm shareholder.

During the months following the carve-out, the mispricing gradually became less pronounced as the supply of shares through short sales increased steadily. Yet while many investors and analysts knew about the price difference, it persisted for two months—until the Internal Revenue Service formally approved the carve-out's tax-free status in early May 2002. At that point, a significant part of the uncertainty around the spin-off was removed and the price discrepancy disappeared. This correction suggests that at least part of the mispricing was caused by the risk that the spin-off wouldn't occur.

Additional cases of mispricing between parent companies and their carved-out subsidiaries are well documented.[2] In general, these cases involve difficulties setting up short positions to exploit the price differences, which persist until the spin-off takes place or is abandoned. In all cases, the mispricing was corrected within several months.

A second classic example of investors deviating from fundamentals is the price disparity between the shares of the same company traded on two different exchanges. Does this indict the market for mispricing? We don't think so. In recent years, the price differences for Royal Dutch/Shell and other twin-share stocks have all become smaller. Furthermore, some of these share structures (and price differences) disappeared because the corporations formally merged, a development that underlines the significance of noise-trader risk: as soon as a formal date was set for definitive price convergence, arbitrageurs stepped in to correct any discrepancy. This pattern provides additional evidence that mispricing occurs only under special circumstances—and is by no means a common or long-lasting phenomenon.

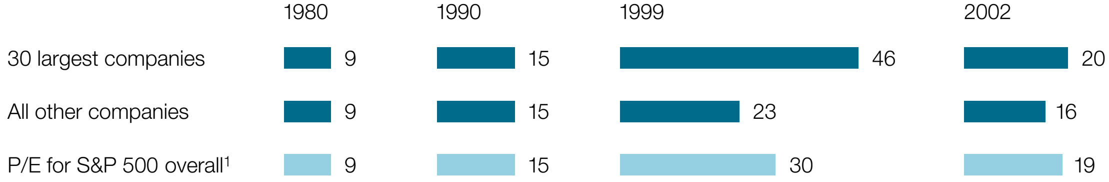
## Markets and fundamentals: The bubble of the 1990s

Do markets reflect economic fundamentals? We believe so. Long-term returns on capital and growth have been remarkably consistent for the past 35 years, in spite of some deep recessions and periods of very strong economic growth. The median return on equity for all US companies has been a very stable 12 to 15 percent, and long-term GDP growth for the US economy in real

Exhibit

## Trends for P/E ratios reveal some fluctuation followed by a return to intrinsic valuation levels.

P/E ratio for listed companies in United States




[1]Weighted average P/E of constituent companies.
Source: Standard & Poor's; McKinsey analysis

terms has been about 3 percent a year since 1945.[3] We also estimate that the inflation-adjusted cost of equity since 1965 has been fairly stable, at about 7 percent.[4]

We used this information to estimate the intrinsic P/E ratios for the US and UK stock markets and then compared them with the actual values.[5] This analysis has led us to three important conclusions. The first is that US and UK stock markets, by and large, have been fairly priced, hovering near their intrinsic P/E ratios. This figure was typically around 15, with the exception of the high-inflation years of the late 1970s and early 1980s, when it was closer to 10 (exhibit).

Second, the late 1970s and late 1990s produced significant deviations from intrinsic valuations. In the late 1970s, when investors were obsessed with high short-term inflation rates, the market was probably undervalued; long-term real GDP growth and returns on equity indicate that it shouldn't have bottomed out at P/E levels of around 7. The other well-known deviation occurred in the late 1990s, when the market reached a P/E ratio of around 30—a level that couldn't be justified by 3 percent long-term real GDP growth or by 13 percent returns on book equity.

Third, when such deviations occurred, the stock market returned to its intrinsic-valuation level within about three years. Thus, although valuations have been wrong from time to time—even for the stock market as a whole—eventually they have fallen back in line with economic fundamentals.

### Focus on intrinsic value

What are the implications for corporate managers? Paradoxically, we believe that such market deviations make it even more important for the executives of a company to understand the intrinsic value of its shares. This knowledge allows it to exploit any deviations, if and when they occur, to time the implementation of strategic decisions more successfully. Here are some examples of how corporate managers can take advantage of market deviations:

- issuing additional share capital when the stock market attaches too high a value to the company's shares relative to their intrinsic value

- repurchasing shares when the market underprices them relative to their intrinsic value
- paying for acquisitions with shares instead of cash when the market overprices them relative to their intrinsic value
- divesting particular businesses at times when trading and transaction multiples are higher than can be justified by underlying fundamentals

Bear two things in mind. First, we don't recommend that companies base decisions to issue or repurchase their shares, to divest or acquire businesses, or to settle transactions with cash or shares solely on an assumed difference between the market and intrinsic value of their shares. Instead, these decisions must be grounded in a strong business strategy driven by the goal of creating shareholder value. Market deviations are more relevant as tactical considerations when companies time and execute such decisions—for example, when to issue additional capital or how to pay for a particular transaction.

Second, managers should be wary of analyses claiming to highlight market deviations. Most of the alleged cases that we have come across in our client experience proved to be insignificant or even nonexistent, so the evidence should be compelling. Furthermore, the deviations should be significant in both size and duration, given the capital and time needed to take advantage of the types of opportunities listed previously.

• • •

Provided that a company's share price eventually returns to its intrinsic value in the long run, managers would benefit from using a discounted-cash-flow approach for strategic decisions. What should matter is the long-term behavior of the share price of a company, not whether it is undervalued by 5 or 10 percent at any given time. For strategic business decisions, the evidence strongly suggests that the market reflects intrinsic value.

[1] For an overview of behavioral finance, see Jay R. Ritter, "Behavioral finance," *Pacific-Basin Finance Journal*, 2003, Volume 11, Number 4, pp. 429–37; and Nicholas Barberis and Richard H. Thaler, "A survey of behavioral finance," in *Handbook of the Economics of Finance: Financial Markets and Asset Pricing*, G. M. Constantinides et al. (eds.), New York: Elsevier North-Holland, 2003, pp. 1054–123.
[2] Owen A. Lamont and Richard H. Thaler, "Can the market add and subtract? Mispricing in tech stock carve-outs," *Journal of Political Economy*, 2003, Volume 111, Number 2, pp. 227–68; and Mark L. Mitchell, Todd C. Pulvino, and Erik Stafford, "Limited arbitrage in equity markets," *Journal of Finance*, 2002, Volume 57, Number 2, pp. 551–84.
[3] US corporate earnings as a percentage of GDP have been remarkably constant over the past 35 years, at around 6 percent.
[4] Marc H. Goedhart, Timothy M. Koller, and Zane D. Williams, "The real cost of equity," *McKinsey on Finance*, Number 5, Autumn 2002, pp. 11–5.
[5] Marc H. Goedhart, Timothy M. Koller, and Zane D. Williams, "Living with lower market expectations," *McKinsey on Finance*, Number 8, Summer 2003, pp. 7–11.

# Excerpt from
# The truth about growth and value stocks

**Bin Jiang and Tim Koller**

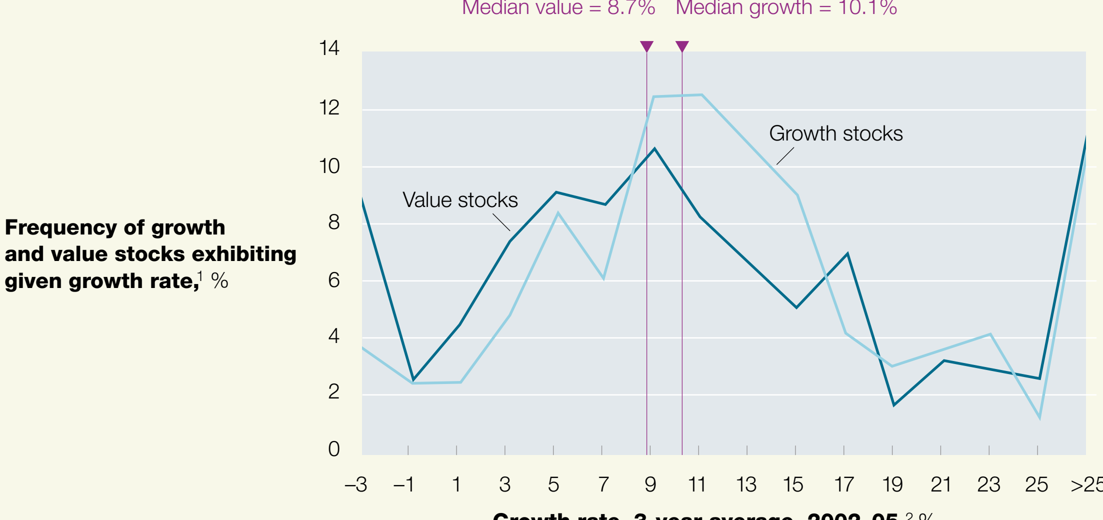
**Number 22, Winter 2007**

What's in a name? In the vernacular of equity markets, the words "growth" and "value" convey the specific characteristics of stock categories that are deeply embedded in the investment strategies of investors and fund managers. Leading US market indexes, such as the S&P 500, the Russell 1000, and the Dow Jones Wilshire 2500, all divide themselves into growth- and value-style indexes.

It's not illogical to assume that having the label growth or value attached to a company's shares can actually drive prices up or push them lower. In our experience, many executives have expended considerable effort plotting to attract more growth investors, believing that an influx of growth investors leads to higher valuations of a stock. Some executives even turn this assumption into a rationale for using a high share price to defend risky acquisition programs—for example, in deference to presumed shareholder expectations of growth.

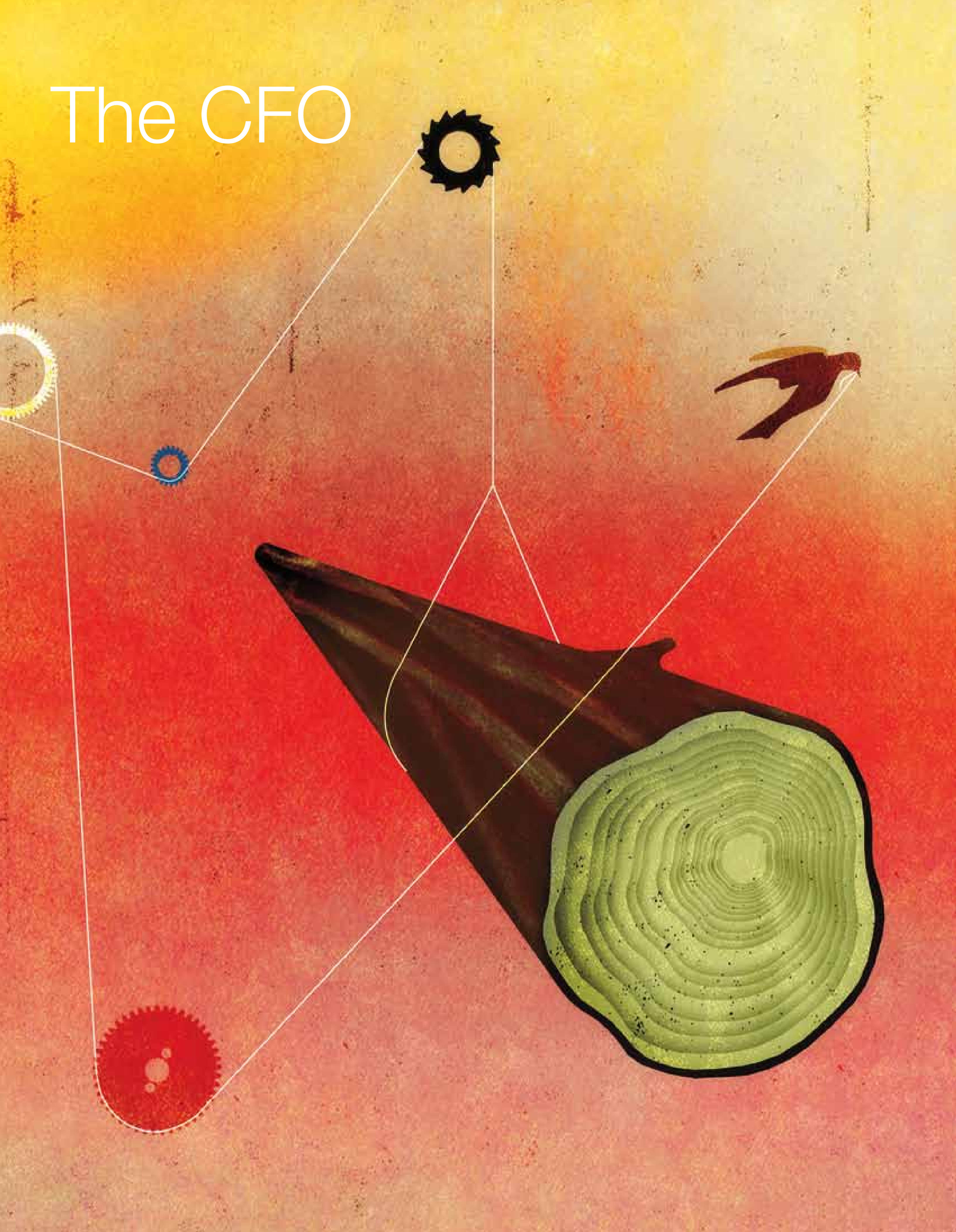
The trouble is that such thinking is wrong in both cases. Although growth stocks are indeed valued at a higher level than value stocks on average, as measured by market-to-book ratios (M/Bs), their revenue growth rates are virtually indistinguishable from those of value stocks (exhibit). The growth index's 10.1 percent median compounded revenue growth rate for 2002 to 2005 is not statistically different from the 8.7 percent median of the value index. Thus, the probability that a company designated as a growth stock will deliver a given growth rate is virtually indistinguishable from the probability that a value company will do so.

**Frequency of growth and value stocks exhibiting given growth rate,**[1] %




[1]S&P 500/Barra Growth Index and S&P 500/Barra Value Index as of Dec 2005.
[2]Excluding goodwill; does not include financial-sector stocks; 3-year average adjusts for annual volatility.

# The CFO



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# Starting up as CFO

**Bertil E. Chappuis, Aimee Kim, and Paul J. Roche**

**Number 27, Spring 2008**

There are a few critical tasks that all finance chiefs must tackle in their first hundred days.

In recent years, CFOs have assumed increasingly complex, strategic roles focused on driving the creation of value across the entire business. Growing shareholder expectations and activism, more intense M&A, mounting regulatory scrutiny over corporate conduct and compliance, and evolving expectations for the finance function have put CFOs in the middle of many corporate decisions—and made them more directly accountable for the performance of companies.

Not only is the job more complicated, but a lot of CFOs are new at it—turnover in 2006 for Fortune 500 companies was estimated at 13 percent.[1] Compounding the pressures, companies are also more likely to reach outside the organization to recruit new CFOs, who may therefore have to learn a new industry as well as a new role.

To show how it is changing—and how to work through the evolving expectations—we surveyed

Excerpt from
# Toward a leaner finance department

**Richard Dobbs, Herbert Pohl, and Florian Wolff**

**Number 19, Spring 2006**

Three ideas from the lean-manufacturing world are particularly helpful in eliminating waste and improving efficiency in the finance function:

Focusing on external customers. Many finance departments can implement a more efficiency-minded approach by making the external customers of their companies the ultimate referee of which activities add value and which create waste. By contrast, the finance function typically relies on some internal entity to determine which reports are necessary—an approach that often unwittingly produces waste.

Exploiting chain reactions. The value of introducing a more efficiency-focused mind-set isn't always evident from just one step in the process—in fact, the payoff from a single step may be rather disappointing. The real power is cumulative, for a single initiative frequently exposes deeper problems that, once addressed, lead to a more comprehensive solution.

Drilling down to root causes. No matter what problem an organization faces, the finance function's default answer is often to add a new system or data warehouse to deal with complexity and increase efficiency. While such moves may indeed help companies deal with difficult situations, they seldom tackle the real issues.

164 CFOs of many different tenures[2] and interviewed 20 of them. From these sources, as well as our years of experience working with experienced CFOs, we have distilled lessons that shed light on what it takes to succeed. We emphasize the initial transition period: the first three to six months.

## Early priorities

Newly appointed CFOs are invariably interested, often anxiously, in making their mark. Where they should focus varies from company to company. In some, enterprise-wide strategic and transformational initiatives (such as value-based management, corporate-center strategy, or portfolio optimization) require considerable CFO involvement. In others, day-to-day business needs can be more demanding and time sensitive—especially in the Sarbanes–Oxley environment—creating significant distractions unless they are carefully managed. When CFOs inherit an organization under stress, they may have no choice but to lead a turnaround, which requires large amounts of time to cut costs and reassure investors.

Yet some activities should make almost every CFO's short list of priorities. Getting them defined in a company-specific way is a critical step in balancing efforts to achieve technical excellence in the finance function with strategic initiatives to create value.

## Conduct a value creation audit

The most critical activity during a CFO's first hundred days, according to more than 55 percent of our survey respondents, is understanding what drives their company's business. These drivers include the way a company makes money, its margin advantage, its returns on invested capital (ROIC), and the reasons for them. At the same time, the CFO must also consider potential ways to improve these drivers, such as sources of growth, operational improvements, and changes in the business model, as well as how much the company might gain from all of them. To develop that understanding, several CFOs we interviewed conducted a strategy and value audit soon after assuming the position. They evaluated their companies from an investor's perspective to understand how the capital markets would value the relative impact of revenue versus higher margins or capital efficiency and assessed whether efforts to adjust prices, cut costs, and the like would create value, and if so how much.

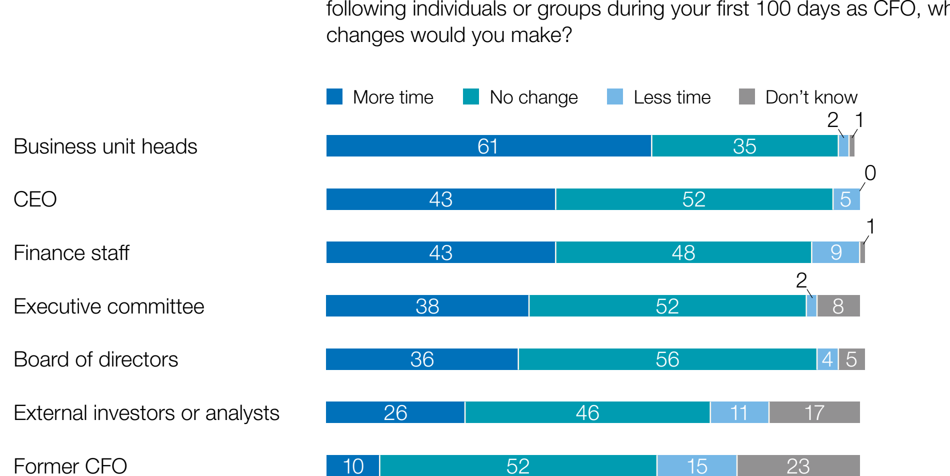
Although this kind of effort would clearly be a priority for external hires, it can also be useful for internal ones. As a CFO promoted internally at one high-tech company explained, "When I was the CFO of a business unit, I never worried about corporate taxation. I never thought about portfolio-level risk exposure in terms of products and geographies. When I became corporate CFO, I had to learn about business drivers that are less important to individual business unit performance."

The choice of information sources for getting up to speed on business drivers can vary. As CFOs

Exhibit 1

**The majority of CFOs in our survey wished they'd had even more time with business unit heads.**

% of respondents,[1] n = 164




[1]Figures may not sum to 100%, because of rounding.

conducted their value audit, they typically started by mastering existing information, usually by meeting with business unit heads, who not only shared the specifics of product lines or markets but are also important because they use the finance function's services. Indeed, a majority of CFOs in our survey, and particularly those in private companies, wished that they had spent even more time with this group (Exhibit 1). Such meetings allow CFOs to start building relationships with these key stakeholders of the finance function and to understand their needs. Other CFOs look for external perspectives on their companies and on the marketplace by talking to customers, investors, or professional service providers. The CFO at one pharma company reported spending his first month on the job "riding around with a sales rep and meeting up with our key customers. It's amazing how much I actually learned from these discussions. This was information that no one inside the company could have told me."

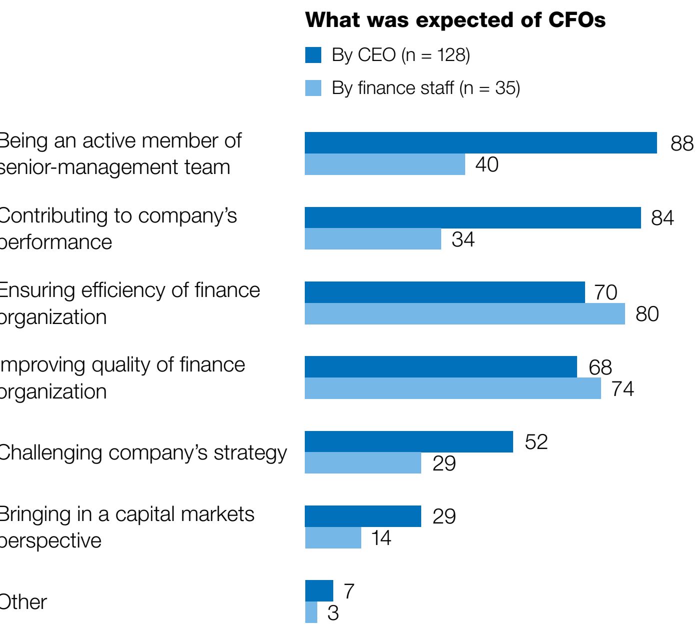
## Lead the leaders

Experienced CFOs not only understand and try to drive the CEO's agenda but also know they must help to shape it. CFOs often begin aligning themselves with the CEO and board members well before taking office. During the recruiting process, most CFOs we interviewed received very explicit guidance from them about the issues they considered important, as well as where

Exhibit 2

**Many CFOs received very explicit guidance from their CEOs on the key issues of concern.**

% of responses[1] from respondents who said CEO and financial staff gave explicit guidance on expectations, n = 163




[1] Respondents could select more than 1 answer.

Excerpt from
## Organizing for value

**Massimo Giordano and Felix Wenger**

**Number 28, Summer 2008**

One way companies can compensate for the blunt tools of traditional planning is to take a finer-grained perspective on businesses within large divisions. By identifying and defining smaller units built around activities that create value by serving related customer needs, executives can better assess and manage performance by focusing on growth and value creation. These units, which we call "value cells," offer managers a more detailed, more tangible way of gauging business value and economic activity, allow CEOs to spend more time on in-depth strategy discussions, and make possible more finely tuned responses to the demands of balancing growth and short-term earnings. In our experience, a company of above $10 billion market capitalization should probably be managed at the level of 20 to 50 value cells, rather than the more typical three to five divisions.

the CFO would have to assume a leadership role. Similarly, nearly four-fifths of the CFOs in our survey reported that the CEO explained what was expected from them—particularly that they serve as active members of the senior-management team, contribute to the company's performance, and make the finance organization efficient (Exhibit 2). When one new CFO asked the CEO what he expected at the one-year mark, the response was, "When you're able to finish my sentences, you'll know you're on the right track."

Building that kind of alignment is a challenge for CFOs, who must have a certain ultimate independence as the voice of the shareholder. That means they must immediately begin to shape the CEO's agenda around their own focus on value creation. Among the CFOs we interviewed, those who had conducted a value audit could immediately pitch their insights to the CEO and the board—thus gaining credibility and starting to shape the dialogue. In some cases, facts that surfaced during the process enabled CFOs to challenge business unit orthodoxies. What's more, the CFO is in a unique position to put numbers against a company's strategic options in a way that lends a sharp edge to decision making. The CFO at a high-tech company, for example, created a plan that identified several key issues for the long-term health of the business, including how large enterprises could use its product more efficiently. This CFO then prodded sales and service to develop a new strategy and team to drive the product's adoption.

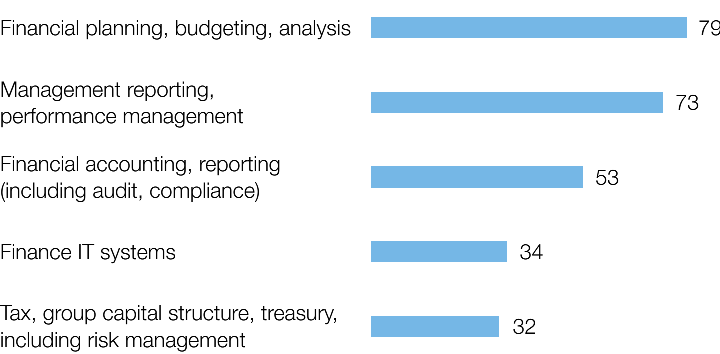
To play these roles, a CFO must establish trust with the board and the CEO, avoiding any appearance of conflict with them while challenging their decisions and the company's direction if necessary. Maintaining the right balance is an art, not a science. As the CFO at a leading software company told us, "It's important to be always aligned with the CEO and also to be able to factually call the balls and strikes as you see them. When you cannot balance the two, you need to find a new role."

### Strengthen the core

To gain the time for agenda-shaping priorities, CFOs must have a well-functioning finance group behind them; otherwise, they won't have the credibility and hard data to make the difficult

Exhibit 3

## New CFOs often initiate fundamental changes to core activities.




[1]Respondents could select more than 1 answer; those who answered "none of these" are not shown.

arguments. Many new CFOs find that disparate IT systems, highly manual processes, an unskilled finance staff, or unwieldy organizational structures hamper their ability to do anything beyond closing the quarter on time. In order to strengthen the core team, during the first hundred days about three-quarters of the new CFOs we surveyed initiated (or developed a plan to initiate) fundamental changes in the function's core activities (Exhibit 3).

Several of our CFOs launched a rigorous look at the finance organization and operations they had just taken over, and many experienced CFOs said they wished they had done so. In these reviews, the CFOs assessed the reporting structure; evaluated the fit and capabilities of the finance executives they had inherited; validated the finance organization's cost benchmarks; and identified any gaps in the effectiveness or efficiency of key systems, processes, and reports. The results of such a review can help CFOs gauge how much energy they will need to invest in the finance organization during their initial 6 to 12 months in office—and to fix any problems they find.

Transitions offer a rare opportunity: the organization is usually open to change. More than half of our respondents made at least moderate alterations in the core finance team early in their tenure. As one CFO of a global software company put it, "If there is a burning platform, then you need to find it and tackle it. If you know you will need to make people changes, make them as fast as you can. Waiting only gets you into more trouble."

### Manage performance actively

CFOs can play a critical role in enhancing the performance dialogue of the corporate center, the business units, and corporate functions. They have a number of tools at their disposal, including dashboards, performance targets, enhanced planning processes, the corporate review calendar, and even their own

relationships with the leaders of business units and functions.

Among the CFOs we interviewed, some use these tools, as well as facts and insights derived from the CFO's unique access to information about the business, to challenge other executives. A number of interviewees take a different approach, however, exploiting what they call the "rhythm of the business" by using the corporate-planning calendar to shape the performance dialogue through discussions, their own agendas, and metrics. Still other CFOs, we have observed, exert influence through their personal credibility at performance reviews.

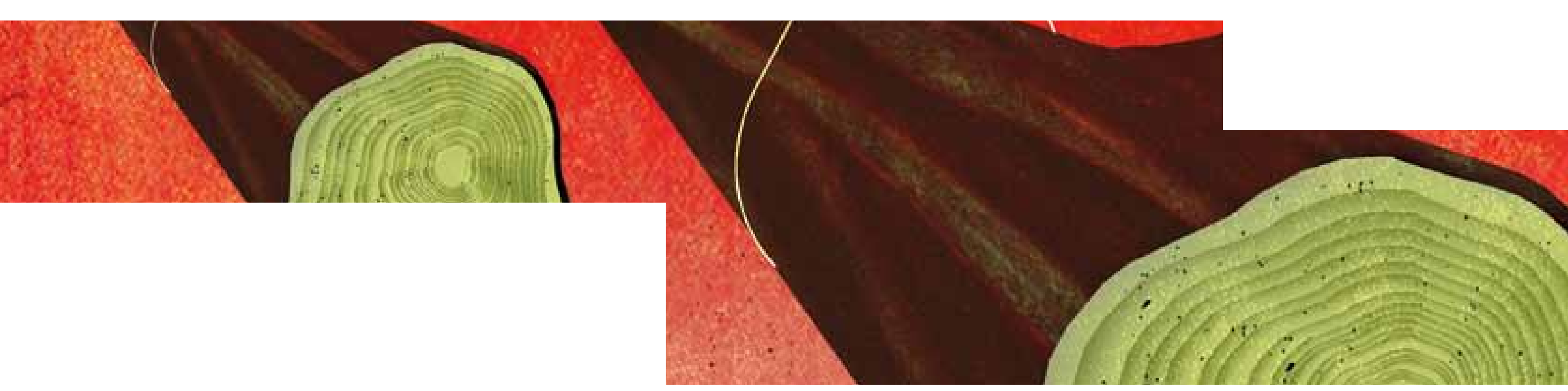
While no consensus emerged from our discussions, the more experienced CFOs stressed the importance of learning about a company's current performance dialogues early on, understanding where its performance must be improved, and developing a long-term strategy to influence efforts to do so. Such a strategy might use the CFO's ability to engage with other senior executives, as well as changed systems and processes that could spur performance and create accountability.

## First steps

Given the magnitude of what CFOs may be required to do, it is no surprise that the first 100 to 200 days can be taxing. Yet those who have passed through this transition suggest several useful tactics. Some would be applicable to any major corporate leadership role but are nevertheless highly relevant for new CFOs—in particular, those who come from functional roles.

### Get a mentor

Although a majority of the CFOs we interviewed said that their early days on the job were satisfactory, the transition wasn't without specific challenges. A common complaint we hear about is the lack of mentors—an issue that also came up in our recent survey results, which showed that 32 percent of the responding CFOs didn't have one. Forty-six percent of the respondents said that the CEO had mentored them, but the relationship appeared to be quite different from the traditional mentorship model, because many CFOs felt uncomfortable telling the boss everything about the challenges they faced. As one CFO put it during an interview, "being a CFO is probably one of the loneliest jobs out there." Many of



Finance executives often feel pressure to make their mark sooner rather than later. This pressure creates a potentially unhealthy bias toward acting with incomplete—or, worse, inaccurate—information.

the CFOs we spoke with mentioned the value of having one or two mentors outside the company to serve as a sounding board. We also know CFOs who have joined high-value roundtables and other such forums to build networks and share ideas.

### Listen first . . . then act

Given the declining average tenure in office of corporate leaders, and the high turnover among CFOs in particular, finance executives often feel pressure to make their mark sooner rather than later. This pressure creates a potentially unhealthy bias toward acting with incomplete—or, worse, inaccurate—information. While we believe strongly that CFOs should be aggressive and action oriented, they must use their energy and enthusiasm effectively. As one CFO reflected in hindsight, "I would have spent even more time listening and less time doing. People do anticipate change from a new CFO, but they also respect you more if you take the time to listen and learn and get it right when you act."

### Make a few themes your priority—consistently

Supplement your day-to-day activities with no more than three to four major change initiatives, and focus on them consistently. To make change happen, you will have to repeat your message over and over—internally, to the finance staff, and externally, to other stakeholders. Communicate your changes by stressing broad themes that, over time, could encompass newly identified issues and actions. One element of your agenda, for example, might be the broad theme of improving the efficiency of financial operations rather than just the narrow one of offshoring.

### Invest time up front to gain credibility

Gaining credibility early on is a common challenge—particularly, according to our survey, for a CFO hired from outside a company. In some cases, it's sufficient to invest enough time to know the numbers cold, as well as the company's products, markets, and plans. In other cases, gaining credibility may force you to adjust your mind-set fundamentally.

The CFOs we interviewed told us that it's hard to win support and respect from other corporate officers without making a conscious effort to think like a CFO. Clearly, one with the mentality of a lead controller, focused on compliance and control, isn't likely to make the kind of risky but thoughtful decisions needed to help a company grow. Challenging a business plan and a strategy isn't always about reducing investments and squeezing incremental margins. The CFO has an opportunity to apply a finance lens to management's approach and to ensure that

a company thoroughly examines all possible ways of accelerating and maximizing the capture of value.

• • •

As an increasing number of executives become new CFOs, their ability to gain an understanding of where value is created and to develop a strategy for influencing both executives and ongoing performance management will shape their future legacies. While day-to-day operations can quickly absorb the time of any new CFO, continued focus on these issues and the underlying quality of the finance operation defines world class CFOs.

[1] Financial Officers' Turnover, 2007 Study, Russell Reynolds Associates.
[2] We surveyed 164 current or former CFOs across industries, geographies, revenue categories, and ownership structures. For more of our conclusions, see "The CFO's first hundred days: A McKinsey Global Survey," mckinseyquarterly.com, December 2007.

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