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# THE ORGANIC PATH TO GROWTH

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# A deal-making strategy for new CEOs

New CEOs typically raise the tempo of transactions at first, then the pace slows down. Is that costly?

*by Michael Birshan, Thomas Meakin, and Andy West*

More than half of new CEOs of S&P 500 companies launch some form of transaction during their first two years in office. Whether acquisition, merger, or divestiture, deal making is the second most likely strategic action for a new CEO to undertake, we've found. Few are able to maintain the pace of deals over the course of their tenure, though, and this appears to be a missed opportunity.

## THE CASE FOR PROGRAMMATIC M&A

Our work has shown the strategic value of sustained transactions. We looked at different approaches to M&A activity and assessed the success of each in delivering shareholder returns. In "programmatic" deal making, for example, CEOs use M&A regularly (typically three to four deals per year) and meaningfully (with an average of 20 percent of companies' market capitalization acquired over ten years). That contrasts with a "large deal" approach, where companies transform themselves with one deal valued at more than 30 percent of their market capitalization. The research found that companies that pursue a programmatic M&A agenda outperformed their peers, achieving an average of 3 percent excess total returns to shareholders. "Large deal" strategies, on average, destroyed value.

## AN EARLY BURST

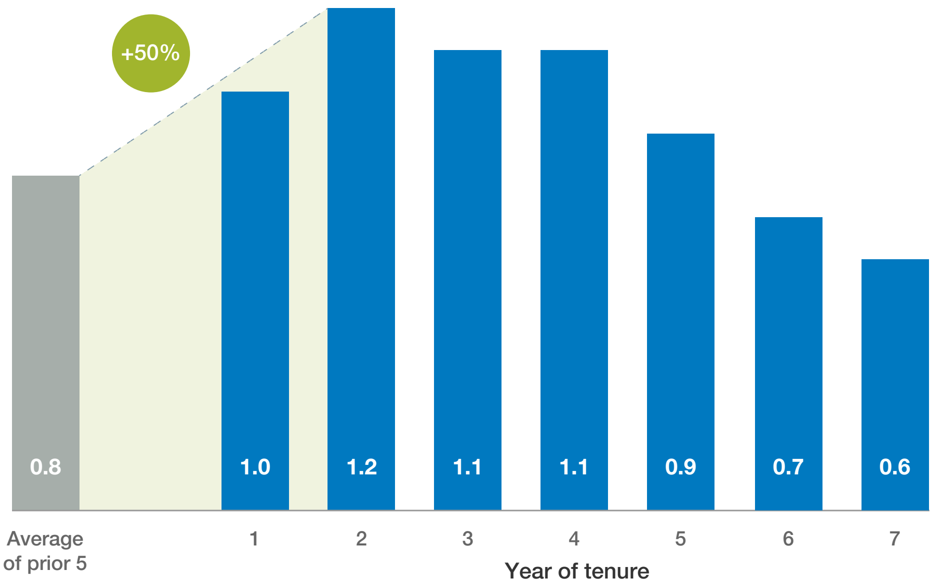
How does CEO behavior stack up against the programmatic M&A model? Fairly well during the initial years of many CEOs, according to our research. A review of all mergers, acquisitions, and divestitures by the nearly 600 CEOs who left S&P 500 companies between 2004 and 2014 showed that CEOs conducted significantly more M&A activity early in their tenures. On average, the number of deals (regardless of deal size) completed by year two of their tenure was 50 percent higher than the average number of deals done in the five years before they took the helm (Exhibit 1).

This initial drive for action is broadly consistent across industries and time periods, and it's a testament to the pressures on CEOs to make their strategic and financial mark. Research by our McKinsey colleagues similarly found that the most successful CEOs front-load their reallocation of corporate resources during the first three years of their tenure.[1]

[1] See Stephen Hall and Conor Kehoe, "How quickly should a new CEO shift corporate resources?," *McKinsey Quarterly*, October 2013, McKinsey.com.

Exhibit 1

Number of deals per year by year of tenure



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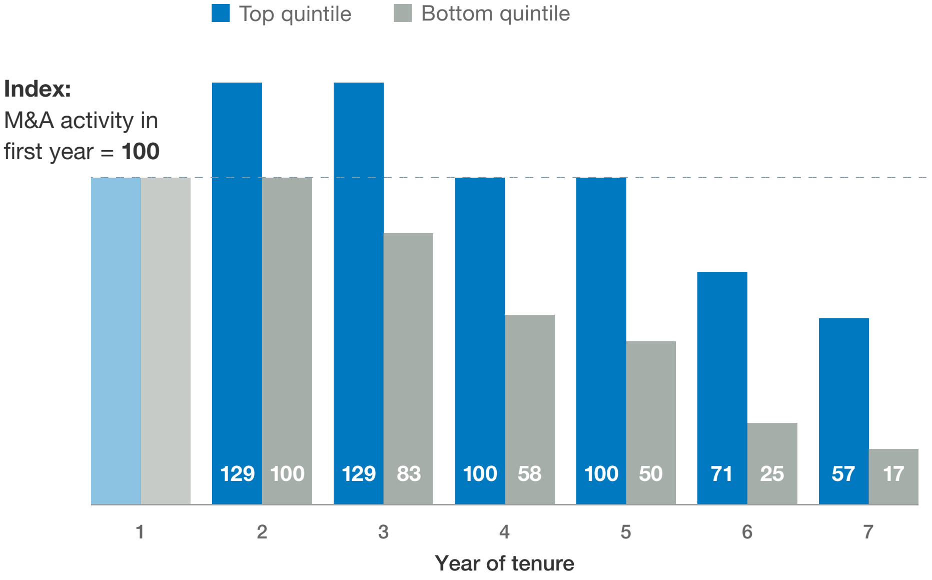
## THE CHALLENGE OF STAYING THE COURSE

Our new research shows that transaction activity subsequently drops off, especially after year five of a CEO's tenure. By year seven, the CEOs in our data set were doing roughly one deal every two years. This was true both across the board and for the highest-performing CEOs (defined as those achieving top-quintile excess total returns to shareholders, where "excess" represents returns above the industry average). Those top-quintile CEOs typically were quite aggressive early on. By year two, they were doing nearly 30 percent more mergers, acquisitions, and divestitures than in year one (Exhibit 2). By year seven, though, the deal flow of the top-quintile companies was roughly half the level of year one. (For bottom-quintile CEOs, transactions were roughly one-quarter the levels of year one—an even sharper fall off.)

Like other strategic initiatives launched by incoming CEOs, transaction momentum tends to wane.  After making big moves early on, CEOs tend to ride with the changes during the middle of their tenure. In part, that's to give the organization a break from the strains associated with integration and

Exhibit 2

M&A and divestiture activity by year of tenure



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change. Later on, however, it may reflect a penchant for conservatism and an unwillingness to take on additional risks toward the end of one's tenure. If not addressed, this creeping bias for inaction can hurt a company's performance as opportunities are missed and needed changes are not acted upon.

## MAINTAINING MOMENTUM

Programmatic use of transaction activity demands a well-defined strategy supported by precise and analytical decision making by CEOs and their teams. Leaders throughout the organization first need to understand the role of transactions, as well as their relationship to organic-growth efforts, in achieving a vision (for more on organic growth and M&A, see "The value premium of organic growth," on McKinsey.com). Then it's valuable to maintain an ongoing commitment to rapid resource reallocation and to embrace frequent market scans and portfolio reviews that identify acquisition targets and divestiture opportunities. Sustaining an aggressive transaction tempo also demands a devotion to basic transaction blocking and tackling, with well-defined deal processes at ground level, along with strong supporting capabilities in deal sourcing, due diligence, and integration. Finally, boards have an important role to play. They should encourage their CEOs to view mergers, acquisitions, and divestitures as an ongoing tool, one that will help them maintain a strategic edge—and standing among shareholders. They should also understand that a CEO's appetite for doing deals (or not) is typically related to tenure, which can create a bias that they will need to identify and manage. Q

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# The value premium of organic growth

Beware of letting acquisitions take priority over organic growth.

Marc Goedhart and Tim Koller

It's not surprising that many executives think about growth primarily in terms of acquisitions. For some, opportunities to grow organically are limited, especially in maturing or contracting product markets. Others are drawn to the allure of high-profile deal making, with its virtually instant boost to revenues and often earnings per share as well.

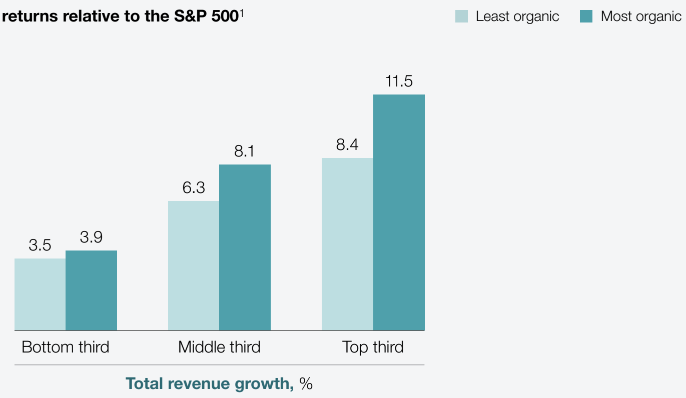
But executives shouldn't underestimate the power of organic growth. It may take more time and effort to affect a company's size, but organic growth typically generates more value. A look at the share-price performance of 550 US and European companies over 15 years reveals that for all levels of revenue growth, those with more organic growth generated higher shareholder returns than those whose growth relied more heavily on acquisitions1 (exhibit). The main reason is that companies don't have to invest as much up front for organic growth.2 In growing through acquisition, companies typically have to pay for the stand-alone value of an acquired business plus a takeover premium. This results in a lower return on invested capital compared with growing organically.

We often see companies pass up organic-growth opportunities because they take longer to boost earnings than acquisitions do. But, given an option, they should probably tip the balance toward what they can achieve organically.

Exhibit

**At comparable total growth levels, companies with more organic growth outperform those with more growth from acquisitions.**

**Annualized excess shareholder returns relative to the S&P 500**[1]
1999–2013, %



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# THE ROOTS OF ORGANIC GROWTH

There are many paths to growth, and high performers take more than one—supported by reinforcing capabilities such as advanced analytics and digital customer-experience management.

*by Kabir Ahuja, Liz Hilton Segel, and Jesko Perrey*

Growth is a tonic for most companies. It attracts talent and creates strategic options while generating financial resources to fund new moves—provided the growth is profitable. It's also been harder to come by over the past decade, as a sluggish macroeconomic environment and accelerating, technology-driven disruption have ratcheted up pressure on businesses.

Digital technologies and the pace of competition, however, also open new avenues to organic growth for those companies that have the capabilities and dexterity to take advantage of them. Today's fastest growers, for example, price products in real time; they create meaningful and positive customer experiences with digital interactions; and they refine products continually with customer feedback. To understand the relationship between organic growth approaches, capabilities, and performance in this environment, we recently surveyed approximately 600 executives at leading companies in the European Union and North America.[1] We found that companies exhibit three basic growth tendencies; that an approach combining two or more of these holds particular power in driving growth; that advanced analytics is an ingredient of standout growth; and that success depends on nurturing a set of reinforcing capabilities that fit the growth approach.

## Three growth profiles

The corporate growth goals and the behavior tracked by our survey show that companies can be described as having three broad growth profiles. *Investors* have a clear understanding of sources of growth from existing products and services and squeeze funds from a variety of areas, such as low-growth initiatives or unproductive costs, to reallocate capital and double down on winners. *Creators* build value by developing new products, services, or business models. And *performers* grow by constantly optimizing core commercial capabilities in sales, pricing, and marketing.

Understanding each profile is helpful because leaders tend to fall back on what has worked for them in the past, and this can often blind them to new growth opportunities. In our experience, companies that carefully evaluate each growth profile, and make choices based on the strategic fit, will increase their chances of achieving above-market growth rates.

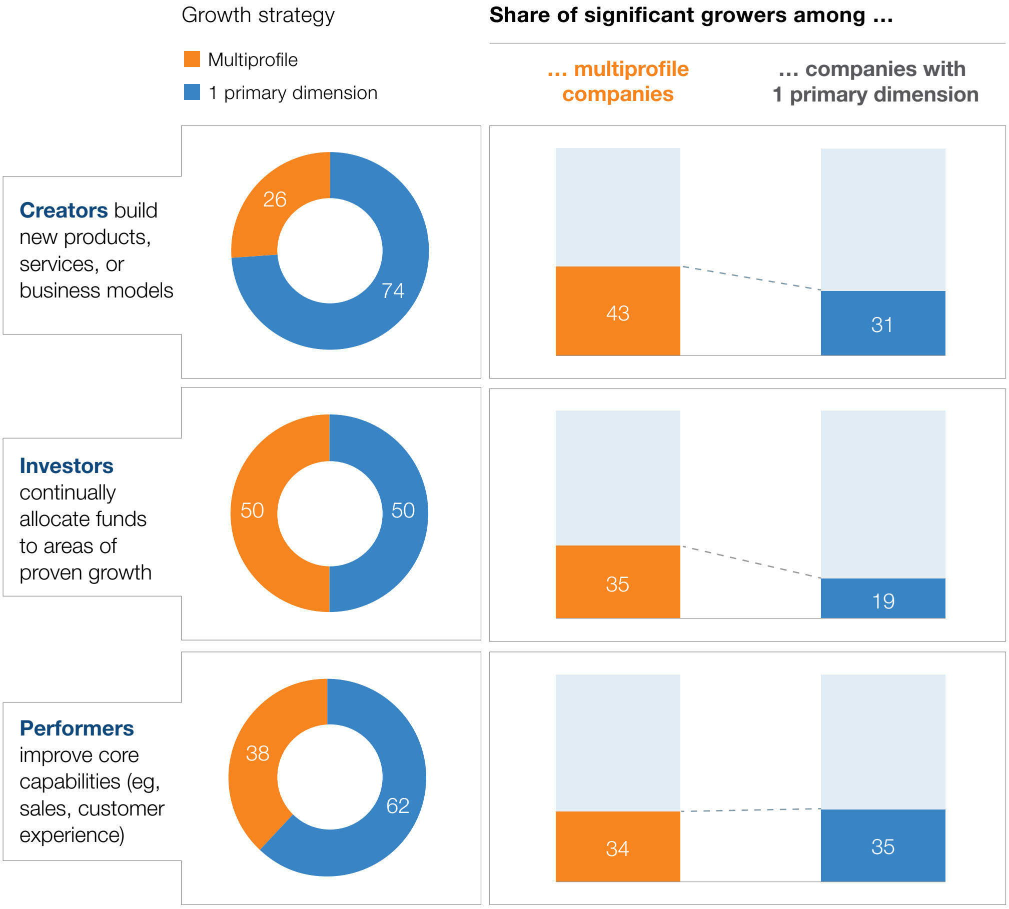
## The power of the diversified approach

While approximately 60 percent of those surveyed identified one of the approaches as their primary source of growth, the largest group in our sample—representing about 40 percent of companies surveyed—were those that diversified their organic growth portfolio. A disproportionate number of the companies that grew significantly—at 4 percent greater than the rate of their sector's over the past three years—were in this group.

These results make intuitive sense: companies creating new products or services frequently need to reallocate capital so they can place their bets, while an exceptional sales force or top-flight marketing team can accelerate a variety of new product or service initiatives. Our analysis further showed that companies exhibiting strong investor and creator tendencies particularly benefited from a diversified approach to changing their growth trajectory (Exhibit 1).

Exhibit 1

**When creators and investors embrace one or more additional growth profiles, they boost their odds of becoming top-tier growers.**



Source: 2017 McKinsey survey of 573 executives in European Union and North America

## The potential of advanced analytics

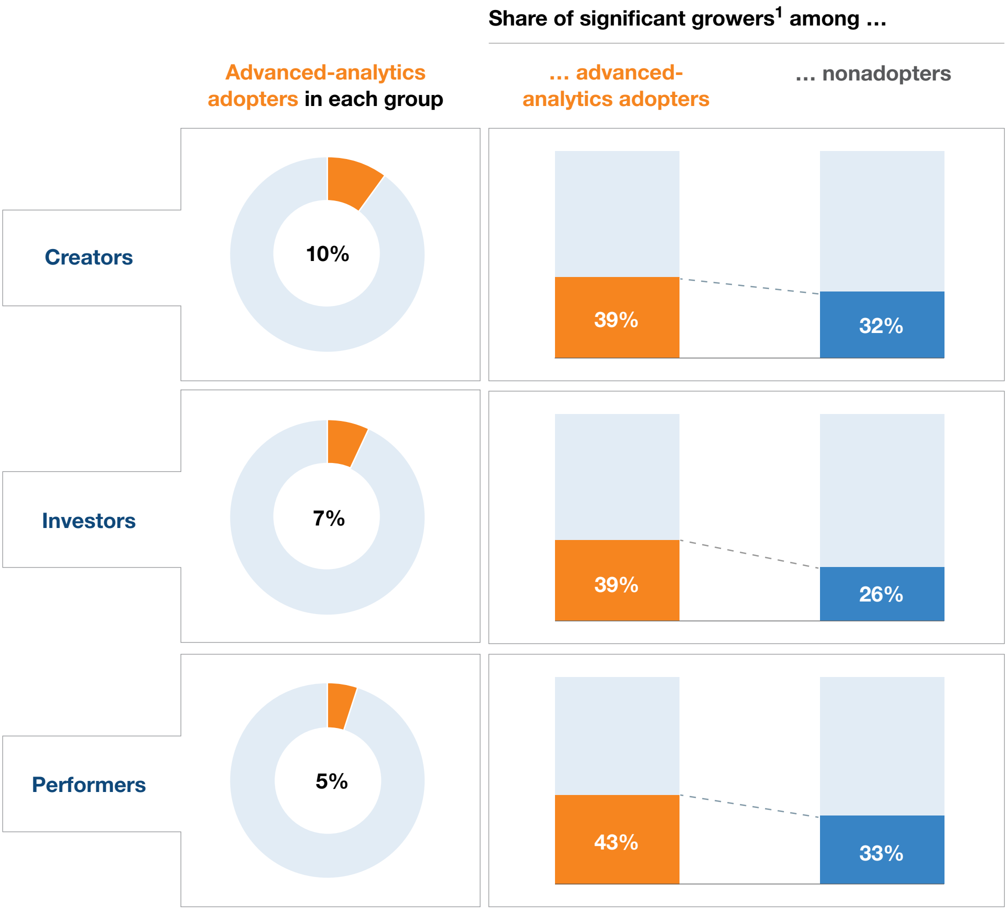
Across all the growth lenses, we found significant potential for an upside in advanced analytics. As Exhibit 2 shows, even at today's low levels of penetration, advanced-analytics capabilities were strongly associated with the highest levels of growth, suggesting they will be a critical platform for the next generation of performance.

## The importance of reinforcing capabilities

Like a triathlete who needs to develop different sets of muscles to effectively compete, delivering on a diversified growth strategy requires building the right reinforcing capabilities. Our research indicated that there are table stakes for growers across all dimensions: nimble resource reallocation, effective branding,

Exhibit 2

**Few companies have strong advanced-analytics capabilities, but those that do exhibit higher levels of growth.**



[1] Companies with 4% greater growth rate than their sector's over past 3 years.

Source: 2017 McKinsey survey of 573 executives in European Union and North America and growth-oriented organizational culture. There were other areas that, predictably, seemed more tightly linked with individual strategies. Sales and pricing were key to faster-growing performers while the ability to develop products and services differentiated investors and creators.

These capabilities, combined with an understanding of the options for activating growth, are fundamental to building up a company's growth DNA. And, as our research shows, a purposeful approach across a diverse portfolio of growth strategies increases the odds of success. Ⓠ

[1] We asked companies to determine their growth strategy, providing the option of choosing more than one. We then asked respondents to indicate how much each strategy contributed to their growth in percentage terms.

For more, see "*Invest, Create, Perform: Mastering the three dimensions of growth in the digital age*," on McKinsey.com.

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