

The strategic yardstick you can't afford to ignore

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A systematic scan of the economic-profit performance of nearly 3,000 global companies yields fresh insight about where and how to compete.

At first blush, “beating the market” might sound like an expression better suited to investing or financial management than to business strategy. When you think about it, though, overcoming the profit-depleting effects of market forces is the essence of good strategy—what separates winners from losers, headline makers from also-rans.¹ A focus on the presence, absence, or possibility of market-beating value creation should therefore help transform any discussion of strategy from something vague and conceptual into something specific and concrete.

While there are many indicators of market-beating strategies, in our experience economic profit (EP)—what’s left over after subtracting the cost of capital from net operating profit—is highly revealing. Using this lens, individual companies can take a hard-boiled look at the effectiveness of their strategies. Recently, we undertook a large-scale analysis of economic profit for nearly 3,000 large nonfinancial companies in McKinsey’s proprietary corporate-performance database.² That effort enabled us to test some deeply held truths and distill generalizable lessons about what it takes to win consistently.

¹For more, see Chris Bradley, Martin Hirt, and Sven Smit, “Have you tested your strategy lately?,” *McKinsey Quarterly*, January 2011, mckinsey.com.

²For technical details on the calculation of economic profit, including its relationship with the key drivers of corporate value (ROIC and growth), see chapter six and appendix A of Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010.

For example, we saw that the corporate world, like the world beyond it, has a relatively small number of elites and that, just as society grapples with the contemporary challenge of limited social mobility, many companies seem stuck in their strategic “class.” Escaping the gravity of the corporate middle class, indeed, requires businesses to expand or reinvent themselves unusually rapidly, often in the context of an industry whose overall performance is improving.

This article focuses on eight analyses emerging from our economic-profit exercise.

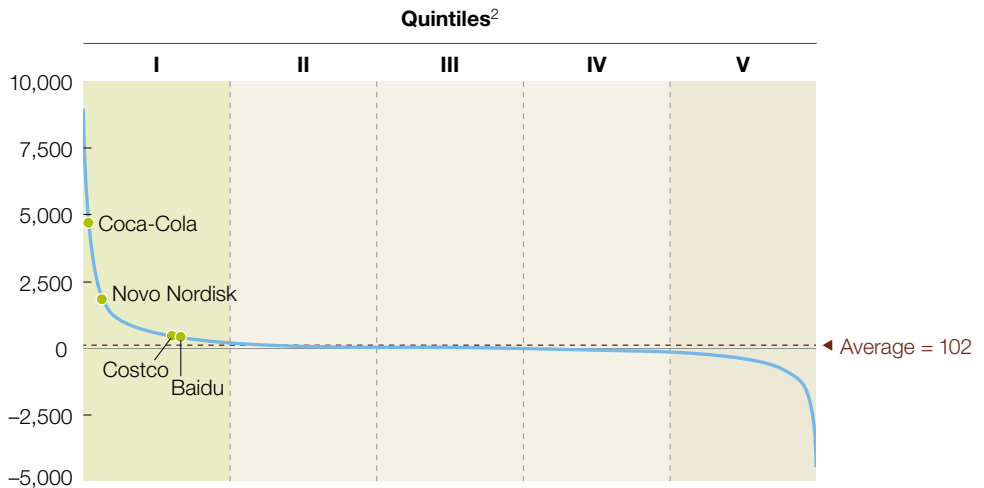
Strategy is rife with inequality

Economic profit is distributed in a far from democratic way (Exhibit 1). The 60 percent of companies in the middle three quintiles generate

Exhibit 1

Distribution of economic profit

Average economic profit for top 3,000 companies by FY2011 revenues, (excluding outliers),¹ 2007–11, \$ million



By quintile

By quintile	I	II	III	IV	V
Average	1,180	121	10	-80	-709
Total	677,298	69,724	5,704	-45,991	-410,963
Total of 3 middle quintiles = \$29,437 million					

¹Actual sample = 2,875; excludes outliers and companies with insufficient data to calculate average economic profit for given period. Outliers are companies with economic profit >\$10 billion (ie, Apple, BHP Billiton, China Mobile, Exxon Mobil, Gazprom, and Microsoft) and those with <-\$5 billion.

²Defined as: I = average economic profit >\$262 million; II = \$262 million to \$49 million; III = \$49 million to -\$24 million; IV = -\$24 million to -\$160 million; V = below -\$160 million.

a little over \$29 billion in economic profit, or around \$17 million each—only 10 percent of the total pie. This share is dwarfed by the \$677 billion generated in the top quintile, where each company creates almost 70 times more economic profit than do companies in the middle three, and by the nearly \$411 billion destroyed in the bottom quintile.

For companies in the majority group, at least, market forces appear to be a very powerful constraint to creating value.

What separates the corporate classes?

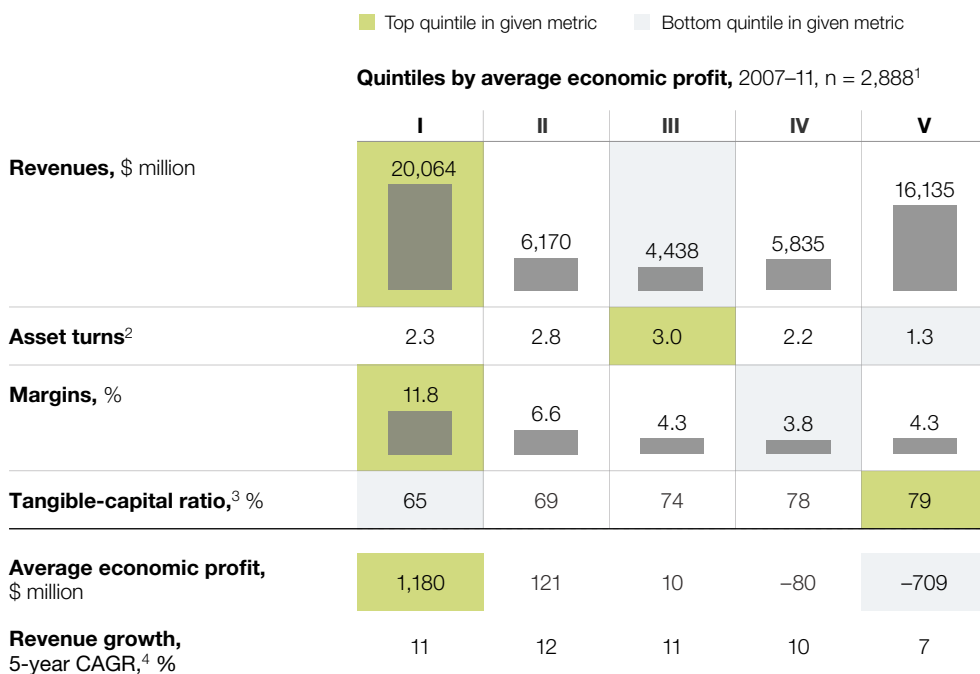
Economic profit has four components: revenues, margins, asset turns, and the tangible-capital ratio (TCR). Revenues and margins are familiar enough. Asset turns, sometimes described as asset leverage, measure the capacity to extract revenue from a given quantity of assets. TCR is the ratio of physical to total capital, including goodwill³ (the more M&A a company does, and the higher the premium it pays over book value, the lower its TCR). Every company has a “fingerprint,” hinting at its value formula, across these drivers. Exhibit 2 decomposes the four determinants of value by quintile.

Size clearly matters: both the biggest creators and the biggest destroyers of economic profit are large. Low turns are the hallmark of the bottom quintile, which includes capital-intensive industries, such as airlines, electric utilities, and railroads. High margins clearly differentiate the top class of EP outperformers. Somewhat counterintuitively, however, the weakest EP performers have the best TCR and the strongest the worst. For top companies routinely engaged in M&A, the added cost of goodwill is apparently more than recouped in profitable scale.

Finally, it’s worth noting that the average company in the first four quintiles grows by double-digit rates a year—a compelling fact in its own right. Bottom-quintile companies grow one-third more slowly. This compounds their asset-intensity problem, as higher revenues don’t offset fixed investment.

³There is, mathematically, a fifth dimension of economic value: funding. But the weight of evidence suggests that companies cannot directly influence it. For the purposes of this analysis, we use a global average cost of capital of 9 percent.

Exhibit 2

Drivers of economic profit by quintile

¹Top 3,000 companies by revenues in FY2011, minus companies with insufficient data to calculate average economic profit for given period.

²The capacity to extract revenue from a given quantity of assets.

³The ratio of physical to total capital, including goodwill.

⁴Compound annual growth rate.

Wealth stays at the top

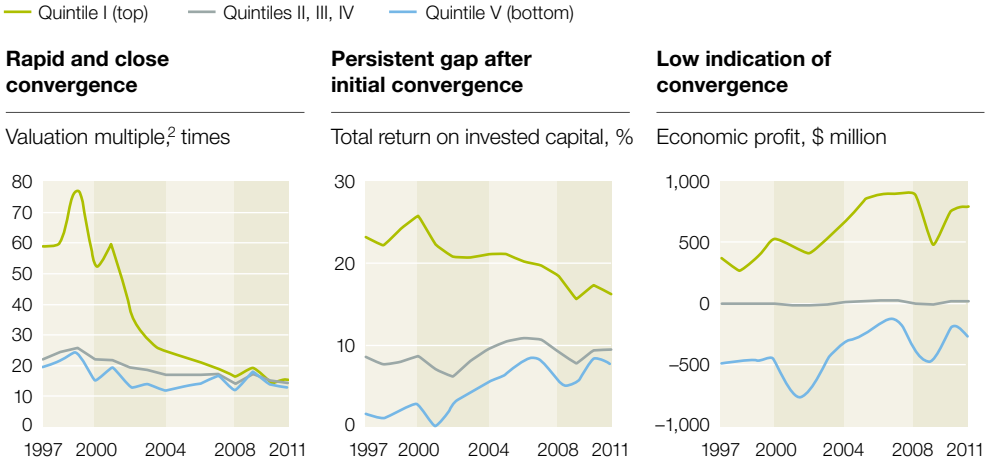
Markets are typically strong agents of mean reversion—but not when it comes to economic profit. We created cohorts based on the performance of companies from 1997 to 2001 and “followed” them to see how long the performance differential lasted (Exhibit 3).

The valuation multiple (enterprise value divided by earnings) converges rapidly and completely. Returns on invested capital (ROIC) partially converge, but the gap never fully closes. Both results reflect the impact of market forces: the strongest EP performers attract imitation, eroding their advantages, while the weakest reform. In the case of economic profit, though, a portion of the advantage persists: the rich stay rich and the poor stay poor. Why?

Exhibit 3

Three speeds of reversion to the mean

Cohort average based on companies' quintile in 1997–2001, n = 2,160¹



¹Top 3,000 companies by FY2011 revenues, minus companies with insufficient data to consistently calculate the 3 metrics for given period.

²Net enterprise value (NEV) divided by net operating profit minus adjusted taxes (NOPLAT).

To the victors . . . the capital

How does the top cohort maintain its EP outperformance? An important clue lurks in Exhibit 4, which shows how top-quintile companies offset the impact of declining ROIC by attracting a disproportionate share of investment. Two opposing forces are at work here. ROIC convergence reduces the gap between the top and bottom quintiles by \$409 million, while diverging capital flows increase the gap by \$593 million. In fact, companies in the top quintile in 1997–2001 invested 2.6 times more fresh capital than bottom-quintile businesses did over the subsequent decade. So at least on average, companies in the elite class stay ahead, mostly because they get bigger.

The economic mobility of companies

Exhibit 5 shows the likelihood that companies will change class over a subsequent decade. The force of gravity is particularly strong in the three middle quintiles: 79 percent of the companies that start

there remain ten years later. In the top and bottom classes, a small majority of companies stay at their station.

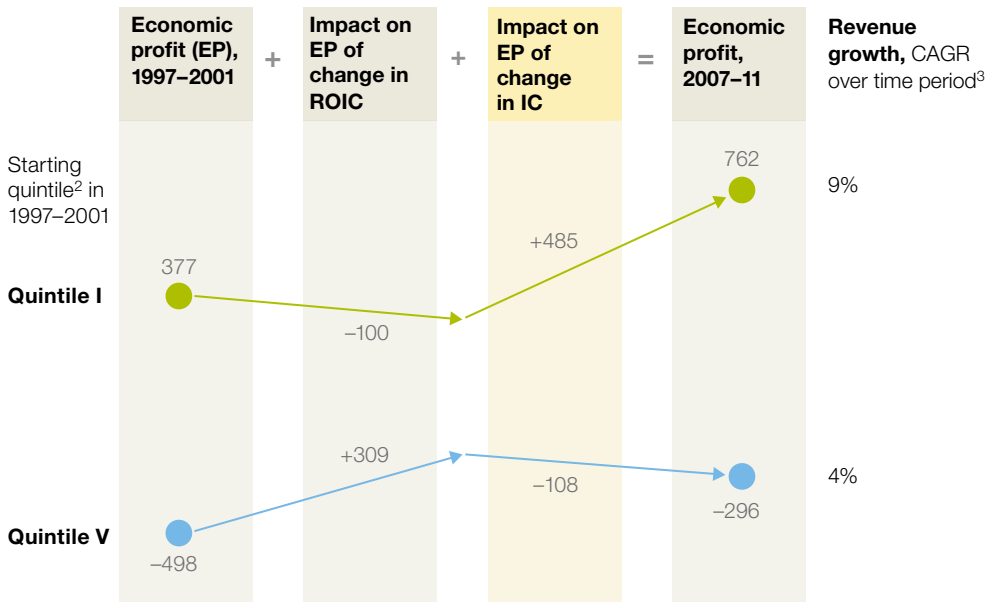
Most strikingly, only 11 percent of companies in the middle make the leap to the top league. But companies at the top cannot rest on their laurels, because almost half drop out, and one in eight slides all the way to the bottom.

To find out more about upward mobility, we looked closely at the 37 companies that started in the middle quintile in the 1997–2001 period but rose to the top over the subsequent one. This breakout group seemingly improved its performance miraculously, increasing revenues by 21 percent and adding 18 percentage points to ROIC.

Exhibit 4

Why economic profit doesn't converge

Shift in economic profit caused by changes in return on invested capital (ROIC) and invested capital (IC), n = 864,¹ \$ million



¹Actual sample = 2,160; for each quintile = 432; based on top 3,000 companies by FY2011 revenues, minus companies with insufficient data for longitudinal analysis over given period. Figures may not sum to total, because of rounding.

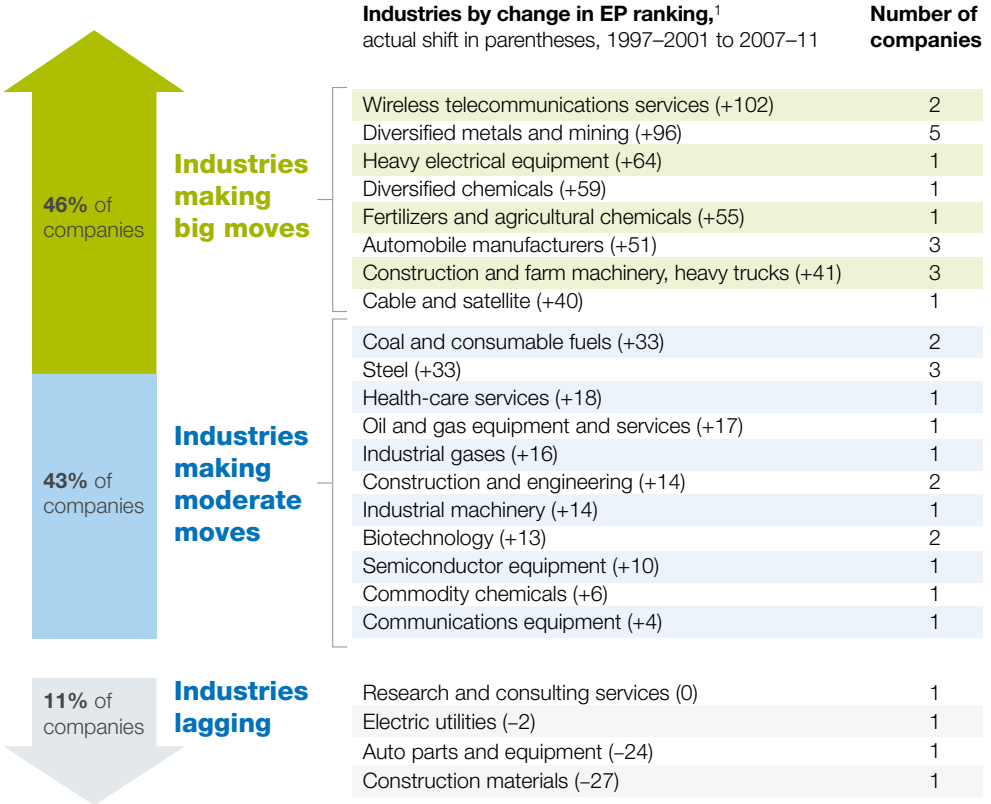
²Middle 3 quintiles showed no significant movement. Quintiles based on rankings for economic-profit generation from 1997 to 2001, averaged and held as a fixed cohort. Economic profit and total invested capital provided as total of cohort (not average).

³Compound annual growth rate from earlier time period (1997–2001) to later one (2007–11).

Exhibit 6

Contribution of industry re-ranking to economic mobility

Of the 37 companies that rose from Quintile III to Quintile I, nearly 90 percent were in industries that moved up in economic-profit (EP) ranking.



¹Ranking of 128 industries by average industry economic profit; industries with fewer than 10 breakout companies default to next level of industry classification.

37 companies came from improvements in their markets or industries. The lesson is clear: riding on the coattails of an industry-moving trend is almost essential to escaping the middle class.

The more winners, the more losers

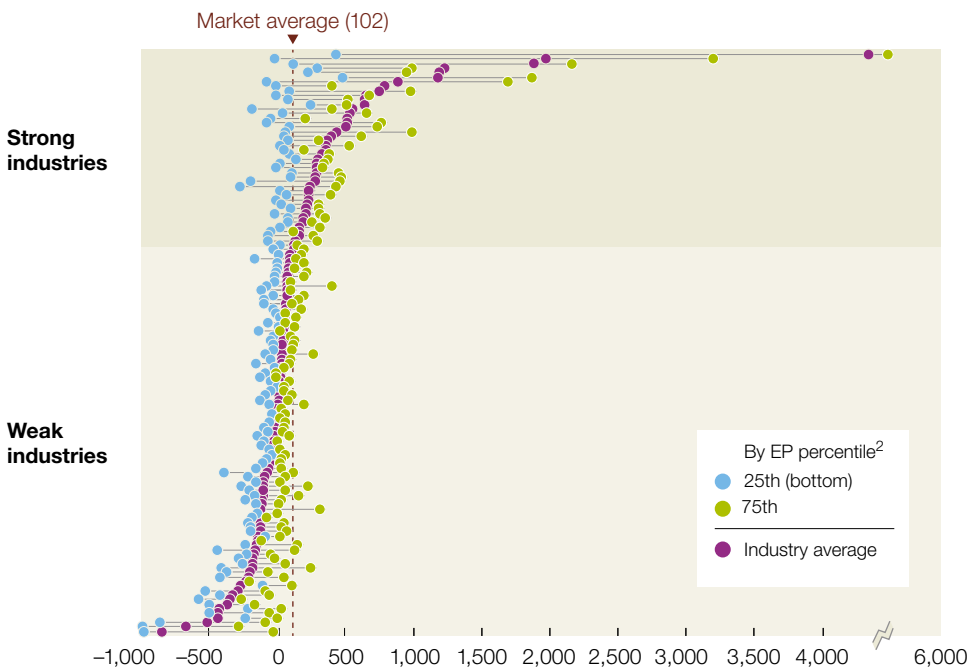
Much as we mapped companies by the economic value they create, so too we found that industries follow the same pattern of haves, have-nots, and a big, muddy middle (as shown by the S line in Exhibit 7).

Interestingly, though, the variation between companies is bigger at the top and the bottom, as indicated by the gap between the 25th- and 75th-percentile performers in the industry. In the best and worst industries, big winners and big losers have a big impact on total performance—so the graph looks like a tilted hourglass. The link between the performance of industries and companies, in other words, is more complex than meets the eye: besides facilitating

Exhibit 7

Distribution of company economic profit within industry

Companies' average economic profit (EP), 2007–11, n = 2,888,¹ \$ million



Bottom 5 industries (no. of companies)

- Electric utilities (102)
- Airlines (45)
- Multi-utilities³ (42)
- Independent power producers and energy traders (30)
- Railroads (26)

Top 5 industries (no. of companies)

- Diversified metals and mining (46)
- Wireless telecom services (45)
- Pharmaceuticals (40)
- Integrated oil and gas (39)
- Communications equipment (18)

¹Top 3,000 companies by revenues in FY2011, minus companies with insufficient data to calculate average economic profit for given period. 128 industries analyzed; those with fewer than 3 companies default to next level of industry classification.

²Analysis based on the bottom 25th and top 75th percentiles illustrates the dispersion of a highly skewed distribution (eg, in some cases, average economic profit is in the top quartile).

³Utilities offering more than 1 service—eg, telephony, cable television, and Internet services.

mobility, better performance by industries correlates with higher variance among the companies in them.

Of course, on average it is better to be in good industries, whose companies are three times more likely than others to generate a market-beating economic profit. But a below-average company in a good industry appears no more likely to win than an above-average company in a bad one. Warren Buffett once famously remarked, “With few exceptions, when a manager with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact.” But our research suggests that he is only partly right.

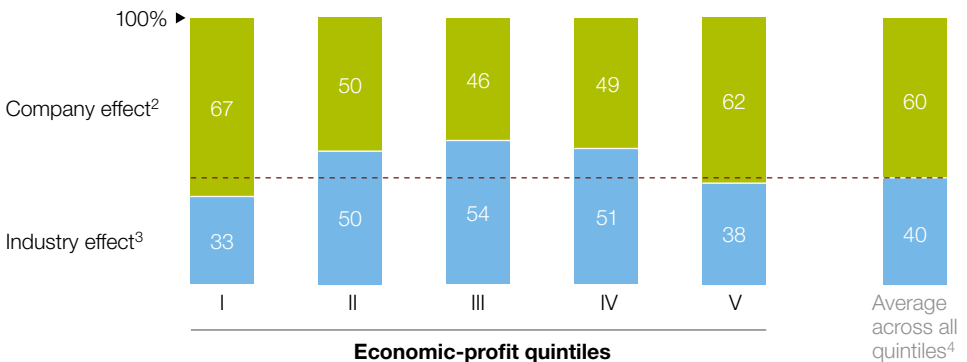
Why do you make money?

So how do we untangle the forces of market selection versus company effects in explaining performance? How much does the neighborhood determine a company’s economic fate? The question is fundamental because of the widespread confusion between performance

Exhibit 8

Industry vs company effect by quintiles

Share of contribution to company performance, 2007–11, n = 2,888¹



¹Top 3,000 companies by revenues in FY2011, minus companies with insufficient data to calculate average economic profit for given period. 128 industries analyzed; those with fewer than 3 companies default to next level of industry classification.

²Defined as difference between company’s economic profit and its industry’s average economic profit.

³Defined as difference between an industry’s average economic profit and the market average.

⁴Weighted by absolute contribution to economic profit.

and capability (see “Mastering the building blocks of strategy,” available on October 29, on mckinsey.com).

At a granularity level of 128 global industries, we can explain 40 percent of a company’s economic profit by the industry in which it competes (Exhibit 8). We make this calculation from simple but powerful math by adding the three layers of the company’s EP: the market’s average EP, plus the difference between the average EP of the company’s industry peers and the market average (the industry effect), plus the difference between the company’s EP and the industry-average EP (the company effect). The industry’s contribution is smaller in the top and bottom quintiles—idiosyncratic factors explain more of the performance differences here.

The remaining 60 percent (the company effect) represents other drivers of value. These could be attributable, first, to a company’s more granular choices about market selection—not just broad industries, but subsegments and geographies too. After those are accounted for, there will be a gap representing a company’s unique proprietary advantage, encapsulated in privileged assets and special capabilities. It takes real work to isolate these factors, but the payoff can be worthwhile: first, because market selection is in many ways a more practical lever of strategy than broad attempts to lift market share and, second, because it can clear up misconceptions about the (noisy) link between performance and capabilities.



So, what are the implications for CEOs and strategists?

- If you’re in the elite, “use it or lose it.” You have a privileged ability to mobilize capital. Really know the formula that got you there and vigilantly watch for signs of change. You can’t rest on your laurels, as the odds are almost 50–50 that you will slide down into the middle class—or lower.
- If you’re in the middle, you mostly face a battle of inches. A fortunate few companies will ride a favorable industry trend. But for the most part, it will take substantial strategic or operational shifts to escape the gravity of market forces. The odds are against you, which elevates the importance of looking at strategy with a high degree of rigor.

- If you're at the bottom, growth without better performance will be the equivalent of throwing good money after bad. You will probably need a new trend to get out of the basement, but in the meantime focus on improving ROIC, which often requires improving asset turns.

Our research offers a yardstick on the empirical reality of strategy and can help create better rules of thumb for considering and assessing it. Individual companies should start by measuring whether they beat the market and by digging into the timeless strategic question of why they make money. ○

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