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Bracing for a new era of lower investment returns

The conditions that led to three decades of exceptional returns have either weakened or reversed. A wide range of stakeholders will need to adjust their expectations.

Tim Koller, Mekala Krishnan, and Sree Ramaswamy

Despite repeated market turbulence, US and Western European stocks and bonds have delivered returns to investors over the past three decades that were considerably higher than long-term averages. From 1985 to 2014, real returns for both US and Western European equities averaged 7.9 percent, compared with the 100-year averages of 6.5 percent and 4.9 percent, respectively. Similarly, real bond returns over the period averaged 5.0 percent in the United States and 5.9 percent in Western Europe, compared with 100-year averages of 1.7 percent and 1.6 percent, respectively.¹

We believe that this golden age is now over and that investors need to brace for an era of substantially

lower investment returns. On both sides of the Atlantic, returns could even be below the longer-term 50- and 100-year averages, especially for fixed-income investors. We project that total real returns in the next 20 years could be between 4.0 and 6.5 percent for US equities and between 4.5 and 6.0 percent for Western European equities. For fixed-income returns the drop could be even bigger, falling to between 0 and 2 percent for both US and Western European bonds. While the high ends of both ranges are comparable to 100-year averages, this assumes a return to normal levels of GDP growth and interest rates—and returns would still be considerably lower than what investors have grown used to over the past three decades.

Our analysis is based on a detailed framework we have constructed that links equities and fixed-income investment returns directly to developments in the real economy. The exceptional returns of the past 30 years were underpinned by a confluence of four highly beneficial economic and business conditions: lower inflation; falling interest rates; strong global GDP growth that was fueled by positive demographics, productivity gains, and rapid growth in China; and above-GDP corporate-profit growth, driven by global expansion, falling interest rates, lower taxes, and cost containment from automation and global supply chains. Publicly listed North American companies increased their post-tax margins to 9.0 percent, from 5.6 percent, over the past three decades.

Each of these four conditions has either weakened or reversed. The steep decline in inflation and interest rates that contributed to capital gains, especially for bondholders, is unlikely to continue. The employment growth that contributed to GDP growth in the past 30 years has waned because of demographic shifts. And after a period of exceptional profit growth, the strongest since the late 1920s, US and Western European corporations face tough new margin pressures from emerging-market competitors, technology firms moving into new sectors, and smaller companies using digital platforms such as Alibaba and Amazon to turn themselves into “micromultinationals.”

If we are correct, the implications of this new era of lower returns will prove challenging for a wide range of stakeholders within the investing community but also in society more broadly.

In the United States, about 90 percent of state and local employee retirement funds already struggle with funding gaps, yet for now most of them continue to assume a continuation of the golden age for investors. At their assumed level of future

returns of about 8 percent, in nominal terms, on a blended portfolio of equities and bonds, they face a \$1.2 trillion funding gap. That gap could increase by an additional \$1 trillion to \$2 trillion if returns fall to the low end of our projections.

Households will feel the impact directly through their own stock and bond investments and indirectly through pension plans. A two-percentage-point difference in average returns over an extended period would mean that 30-year-olds today would have to work seven years longer or almost double their savings in order to live as well in retirement—and this does not factor in any increase in life expectancy.

A return that’s three percentage points lower could mean that US colleges might earn \$13 billion a year less from their endowments, requiring cuts to spending, new revenue sources, or fee increases. Asset managers will be directly affected—their fees are likely to come under pressure in a lengthy period of lower returns as investors seek to minimize costs—as will insurers that rely on investment income for earnings.

Falling returns could be addressed in a number of ways, none of them particularly palatable. All investors need to start by having a frank look at the implications of lower returns. Then they need to look at the cost of investing. In a lower-return world, being cost-efficient matters more. In the United Kingdom, 89 local-authority pension funds are merging into 6 so as to be more efficient. Investors can also consider adding to their portfolio longer-dated and less-liquid assets with potentially higher expected returns, such as emerging-market equities, infrastructure investments, commercial real estate, hedge funds, and actively managed funds. However, only a limited number of active managers are able to produce returns that are consistently superior to passively managed funds.

In the end, employers and individuals will also need to increase their pension contributions, change the benefits available in the future, or increase the retirement age. Policy makers need to prepare for a generation of people who will retire later with less income. For the global economy, falling returns could be a drag on consumption if individuals put aside large amounts to save for retirement rather than spend.

“Past performance is not necessarily indicative of future results,” reads the standard disclaimer that mutual funds routinely put on all their communications. It is time for investors of all types, individuals as well as institutions, to take that message very seriously by resetting their expectations and taking appropriate steps to avoid being caught short in the event of an extended period of lower returns. ■

¹ Including dividends and capital appreciation.

For more, see the full report from the McKinsey Global Institute, *Why investors may need to lower their sights*, on McKinsey.com.

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The ‘tech bubble’ puzzle

Public and private capital markets seem to value technology companies differently. Here’s why.

David Cogman and Alan Lau

Aggressive valuations among technology companies are hardly a new phenomenon. The widespread concerns over high pre-IPO valuations today recall debates over the technology bubble at the turn of the century—which also extended to the media and telecommunications sectors. A sharp decline in the venture-capital funding for US-based companies in the first quarter of the year feeds into that debate,¹ though the number of “unicorns”—start-up companies valued at more than \$1 billion—over that same period continued to rise.

The existence of these unicorns is just one significant difference between 2000 and 2016. Until seven years ago, no venture capital-backed company had ever achieved a \$1 billion valuation before going public, let alone the \$10 billion valuation of 14 cur-

rent “deca-corns.” Also noteworthy is the fact that high valuations predominate among private, pre-IPO companies, rather than public ones, as was the case at the turn of the millennium. And then there’s the global dimension: innovation and growth in the Chinese tech sector are much bigger forces today than they were in 2000.²

All of these factors suggest that when the curtain comes down on the current drama, the consequences are likely to look quite different from those of 16 years ago. Although the underlying economic changes taking place during this cycle are no less significant than the ones during the last cycle, valuations of public-market tech companies are, at this writing, mostly reasonable—perhaps even slightly low by historical standards. A slump in

current private-sector valuations would be unlikely to have much impact on the broader public markets. And the market dynamics in China and the United States are far from similar. In this article, we'll elaborate on the fundamentals at work, which extend beyond the strength of the current pipeline of pre-IPO tech companies, and on the funds that have washed over the venture-capital industry in recent years.

The lessons of history

The defining feature of the 2000 tech bubble was that it was a public-market bubble. At the start of 1998, valuations for tech companies were 40 percent higher than for the general market: at the peak of the bubble in early 2000, they were 165 percent higher. However, at that point the largest-ever venture-invested tech start-up we could find evidence of barely exceeded a \$6 billion valuation

at IPO—a small number by today's standards. Moreover, a considerable part of the run-up in valuation came not from Internet companies but from old-school telecom companies, which saw the sector's total value grow by more than 250 percent between 1997 and 2000.

Equity markets seem to have learned from that episode. In aggregate, publicly held tech companies in 2015 showed little if any sign of excess valuations, despite the steadily escalating ticket size of the IPOs. Valuations of public tech companies in 2015 averaged 20 times earnings, only 10 percent above the general market, and they have been relatively stable at those levels since 2010.

By historical standards, that's relatively low: over the past two decades, tech companies on average commanded a 25 percent valuation premium, often

Exhibit

Today's public tech valuations are roughly in line with the general market globally.

Price-to-earnings multiple



¹ Index of 392 publicly listed technology companies.

² Index of 7,115 publicly listed companies.

Source: Datastream

It wasn't until 2009 that a pre-IPO company reached a \$1 billion valuation. The majority of today's unicorn companies reached that valuation level in just the past 18 months.

much more. During the technology and telecommunications bubble of 2000, the global tech-sector valuation peaked at just under 80 times earnings, more than 3 times the valuation of nontech equities. And over the five years after the bubble burst in 2001, the tech sector enjoyed a valuation premium of, on average, 50 percent over the rest of the equity market (exhibit). Even with a focus limited to Internet companies—the sector most often suspected of runaway valuations—there is no obvious bubble among public companies at present.

Nor do these companies' valuation premiums appear excessive to the general market when viewed in light of their growth expectations. Higher multiples are in most cases explained by higher consensus forecasts for earnings growth and margins. The market could be wrong in these expectations, but at least it is consistent.

China is a notable exception, though equity valuations in China always need to be viewed with caution. Before 2008, Chinese tech companies were valued on average at a 50 to 60 percent premium over the general market. Since then, that premium has grown to around 190 percent. Why? In part because the Chinese online market is both larger and faster growing than the United States, and the government has ambitious plans to localize the higher-value parts of the hardware value chain over the next few years.³ The growth in China's nonstate-owned sector is another part of the story. Many of the new technology companies coming to the market in the past five years have been

nonstate-owned, and nonstate-owned companies are consistently valued 50 to 100 percent higher than their state-owned peers in the same segments.

This time, it's different?

Where the picture today is most different from 2000 is in the private capital markets and in how companies approach going public.

It wasn't until 2009 that a pre-IPO company reached a \$1 billion valuation. The majority of today's unicorn companies reached that valuation level in just the past 18 months. They move in a few distinct herds: roughly 35 percent of them are in the San Francisco Bay Area, 20 percent are in China, and another 15 percent are on the US East Coast.

Notable shifts in funding and valuations have accompanied the rising number of these companies. The number of rounds of pre-IPO funding has increased, and the average size of venture investments more than doubled between 2013 and 2015, which saw both the highest average deal size and highest number of deals ever recorded. Increases in valuation between rounds of funding have also been dramatic: it's not unusual to see funding rounds for Chinese companies involving valuation increases of up to five times over a period of less than a year.

Whatever the quality of new business models emerging in the technology sector, what's unmistakable is that the venture-capital industry

has built up an unprecedented supply of cash. The amount of uninvested but committed funds in the industry globally rose from just over \$100 billion in 2012 to nearly \$150 billion in 2015, the highest level ever. And where buyout, real-estate, and special-situations funds all have the luxury of looking across a range of deal sizes, industries, or even asset classes, venture capitalists have less flexibility. Many venture funds fish in the same pool of potential deals, and some only within their geographic backyard.

The liquidity in the venture-capital industry has been augmented by the entry of a new set of investors, with limited partners in some funds looking for direct investment opportunities into venture-funded companies as they approach IPO. This allows companies to do much larger pre-IPO funding rounds, marketed directly to institutional investors and high-net-worth individuals. These investors dwarf the venture-capital industry in scale and can therefore extend the runway before IPO, though not indefinitely: their participation is contingent on the promise of an eventual exit via IPO or sale.

Thus valuations of individual pre-IPO start-ups need to be viewed cautiously, as the actual returns their venture-capital investors earn flow as much from protections built into the deal terms as by the valuation number itself. In a down round (when later-stage investors come in at a lower valuation than the previous round), these terms become critical in determining how the pie is divided among the different investors.

The IPO hurdle

Private-equity markets do not exist in isolation from public markets: with few exceptions, the companies venture capitalists invest in must eventually list on public exchanges or be sold to a listed company. The current disconnect between valuations in these two markets will somehow

be resolved, either gradually, through a long series of lower-priced IPOs, or suddenly, in a massive slump in pre-IPO valuations.

Several factors incline toward the former. Some late-stage investors, such as Fidelity and T. Rowe Price, have already marked down their investments in multiple unicorns, and it's increasingly common for start-up IPOs to raise less capital than their pre-IPO valuations. Given the still-lofty level of those valuations, this no longer attracts the extreme stigma that it did in 2000. Regardless of how the profits divide up, the company is still independent and now listed.

Tech companies also are staying private for, on average, three times longer.⁴ A much greater share of companies wait until they are making accounting profits before coming to market. From 2001 to 2008, fewer than 10 percent of tech IPOs were launched after the company had reached profitability: since 2010, almost 50 percent had reached at least the break-even point. The number of companies coming to market has remained relatively flat since the 1990s technology bubble. But the average capitalization at IPO time has more than doubled in the past five years, reflecting the fact that the companies making public offerings are larger and more mature.

What happens post-IPO? Over the past three years, 61 tech companies have gone public with a market cap of more than \$1 billion. The median company in this group is now trading just 3 percent above its listing price. The valuations of a number of former unicorns are lower still, including well-known companies like Twitter in the United States and Alibaba in China.

History paints a challenging picture for many of these recently listed companies. Between 1997 and 2000, there were 898 IPOs of technology com-

panies in the United States, valued collectively at around \$171 billion. The attrition among this group was brutal. By 2005, only 303 of them remained public. By 2010, that number had declined to 128. In the decade from 2000 to 2010, the survivors among these millennials had an average share-price return of -3.7 percent a year. In the subsequent five years, they returned only -0.8 percent per annum—despite soaring equity markets.

The geographic dimension

The current crop of pre-IPO companies is far more diverse than in 2000. It will be particularly interesting to see which of the two largest geographic groups—the US and the Chinese unicorns—weathers the shakeout best. Consider just Internet companies. The total market value of listed Internet companies today is around \$1.5 trillion. Of this, US companies represent nearly two-thirds, and Chinese companies—mostly listed in the United States—almost all of the remainder. The rest of the world put together amounts to less than 5 percent.

The differences between the unicorns in these regions are revealing. Of the more than 100 unicorns operating in the United States and China, only 14 have overlapping investors, and just 2—the electronics company Xiaomi and the transportation-network company Didi Chuxing (formerly Didi Kuaidi)—account for two-thirds of the combined valuation of all of them. Three-quarters of the Chinese unicorns are

primarily in the online space, compared with less than half of the US unicorns, and these serve separate user bases as a result of regulatory separation of the two countries' Internet markets.

It is not obvious which group holds the advantage. The local market to which Chinese Internet companies have access is substantial, with well over twice as many users as in the United States; the e-commerce market is significantly larger and growing almost three times as fast. Moreover, the three Chinese Internet giants, Baidu, Alibaba, and Tencent, have invested in many of the Chinese unicorns, giving them easier access to a platform of hundreds of millions of users on which to operate.

The Chinese unicorns also have a much higher proportion of “intermediary” companies—start-ups that act primarily as channels or resellers of other companies' services and take a cut of earnings. Around a third of the Chinese unicorns have business models of this kind, compared with only one in eight of their US counterparts. Finally, the US start-ups tend to adapt faster to a global audience. Although there are several established Chinese technology companies that have successfully made the leap to the global stage, such as Huawei, Lenovo, and ZTE, very few of the companies founded in the past five years have reached that point.



For all the differences between the tech start-up markets of today and those of 2000, both periods are marked by excitement at the potential for new technologies and businesses to stimulate meaningful economic change. To the extent that valuations are excessive, the private markets would appear to be more vulnerable. But perspective is important. The market capitalization of the US and Chinese equity markets declined by \$2.5 trillion in January alone. Any correction to the roughly half a trillion dollars in combined value of all the unicorns as of their last funding round is likely to seem milder than the correction of the last technology bubble. ■

¹ Scott Martin, "Startup investors hit the brakes," *Wall Street Journal*, April 14, 2016, wsj.com.

² The lion's share of the more than 160 pre-IPO unicorns is in the United States and China. See, for example, "The unicorn list: Current private companies valued at \$1B and above," CB Insights, updated in real time, cbinsights.com.

³ "China said to plan sweeping shift from foreign technology to own," *Bloomberg*, December 18, 2014, bloomberg.com.

⁴ Jeremy Abelson and Ben Narasin, "Why are companies staying private longer?," *Barron's*, October 9, 2015, barrons.com.

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How a tech unicorn creates value

Delivery Hero CEO Niklas Östberg describes how his company disrupts the way we eat.

Thomas Schumacher and Dennis Swinford

Niklas Östberg, an energetic 35-year-old Swede, is the CEO and cofounder of Delivery Hero. Based in Berlin and financed with venture-capital money, the company is built around an online platform that matches restaurants with hungry customers. Delivery Hero has grown to operate today in 33 markets across five continents, processing 14 million takeout orders each month and offering customers recommendations, as well as peer reviews of restaurants.

With a valuation of \$3 billion, Delivery Hero is also one of about 170 “unicorns”: start-ups with valuations above \$1 billion. Given the number of new companies that crashed when the turn-of-the-century tech bubble burst, many executives

and investors have cast a skeptical eye on the unicorn phenomenon. Östberg recently discussed with McKinsey’s Thomas Schumacher and Dennis Swinford the start-up landscape, the importance of innovation grounded in data, and his company’s role as a “disruptor of an inefficient restaurant industry.”

McKinsey on Finance: *Valuations of pre-IPO tech companies have come under scrutiny lately, particularly the emergence of so-called unicorns. What’s going on, in your perception?*

Niklas Östberg: I’m sure a number of those unicorns shouldn’t be unicorns. As always, earlier-stage businesses come at a higher risk. But I am

also sure that the next Google or Apple is among them—and if only one or two of the current pool of unicorns get to that level, it justifies their valuations, collectively, from an investor point of view.

But a lot has changed in the 15 years since the tech bubble of 2000. At that time, many valuations were based on what the future might look like, particularly in the Internet space, rather than on the returns a business could demonstrate. The supposition was that the world was changing and would probably change for the better as people went online. And although people did eventually go online, that happened much more slowly than predicted.

Today, there's no doubt that online and Internet businesses are taking over. Some of the biggest businesses in the world, including Facebook, Amazon, Google, and Apple, are solidly grounded in the new world of technology. A lot of other companies also have large, tangible revenue growth and earnings. They don't buy users or customers with the hope of making money when, maybe, those users eventually change their behavior. Delivery Hero, too, generates a lot of revenue—and earns a lot of profit in many markets. So valuations don't depend on imaginary future earnings but on actual returns and EBITDA.¹

McKinsey on Finance: *How does your business model work?*

Niklas Östberg: We're a place where users and restaurants meet. The core of our business is an online platform that allows us to map users to the restaurants around them. Users are attracted to the platform and become very loyal to it because it helps them identify which restaurants are available and which ones are good. It's also convenient because they can pay online, review past orders, and chart their savings.

It's a good model for restaurants, too. We channel more business to them and they increase their orders. And because the variable cost of food is pretty low, adding incremental customers is pretty lucrative. A restaurant that serves 100 orders a day might not make a lot of profit, for example, but if it boosts that to 110 orders a day, it would make good profits. Boost that to 200 orders a day, and it will make loads of money. So restaurants want to be on our platform, and we charge them a fee for transmitting orders. If they decide they no longer want to be on the platform, customers can order from other restaurants.

Everything is automated and online, so our gross profitability per order is around 90 percent. That also comes back to why we want to grow—because if you have 90 percent gross profitability and low variable costs, the closer you get, in theory, to 90 percent net profit. This compels us to build scale to add those incremental users and get closer to that 90 percent EBITDA margin. In some markets, we have already reached over 60 percent.

McKinsey on Finance: *Who are your competitors?*

Niklas Östberg: The usual way of ordering food is to pick up the phone and call, so our biggest competitor is still the phone. And most people also still cook, though only some of them actually like doing it. So why shouldn't we get the many who don't like cooking? At a societal level, is it efficient for every little household to do its own cooking? For everyone to go to the supermarket and shop for groceries individually, versus buying groceries and preparing meals for 100 people at once? More and more, people don't cook as long as they can get the healthy food they want when they want it. That's our challenge, then—to improve the inefficiency of that industry, to make it more accessible and available.

McKinsey on Finance: *You're talking about disrupting the entire social network of how people eat?*

Niklas Östberg: I think we should, over the long term. Of course, you can't do that all at once, but if you look over ten years, why not? Our focus is first to attract those customers who order by phone and then to keep attracting new customers by making the service better. Every small, incremental improvement takes us one step closer. And at some point, maybe we'll have a service that's so good, why would anyone cook?

McKinsey on Finance: *So if home cookers and the telephone are your major competitors, who really worries you?*

Niklas Östberg: We do also have competitors in our own space. Uber, for example, and Amazon and Yelp have similar efforts under way. It's a big space, so why wouldn't they try? Even Facebook could enable online food ordering via chat bots, which could completely change the industry yet again. And, indirectly, guys like Facebook could

become our competitors because they could connect to someone else who provides restaurant info to their chat bots. And Google, continuously offering better access to information, is already offering restaurant data, including restaurant menus. So if we don't stay innovative, and don't stay the best, and don't offer access to the best and fastest food, then in the long term we are in trouble. That's why we can never relax.

McKinsey on Finance: *Do the restaurants get more value out of this than just reaching more customers?*

Niklas Östberg: We try to give them as much value as we can, and it's part of our vision to do so. Besides attracting more customers, we reduce their operational costs, since they don't need to have someone answering the phone, for example. We also provide them with a point-of-sale system replacing the cash register and we compile useful statistics. That will not only save some thousands of euros per year but also help them provide better food and service to their customers.

Niklas Östberg



Education

MSc in industrial engineering and management, KTH Royal Institute of Technology and ETH Zurich

Career highlights

Delivery Hero

Cofounder and CEO
(May 2011–present)

OnlinePizza

Cofounder and chairman
(November 2007–May 2011)

Fast facts

Provided capital and advice to several European start-ups as an angel investor, including Beekeeper, GetYourGuide, and Peakon

And while we expect to do more in the next year or so, we're already able to tell restaurants which menu items are likely to work. We can say, for example, "It looks like there's no one in your area providing a bacon burger. Why don't you add a bacon burger to your menu?" We can say which dishes always bring customers back. Conversely, we can also tell which menu items draw customer complaints or have very low reorder rates. Customers order, but never return. Every time someone buys that dish, the restaurant loses a customer.

McKinsey on Finance: *Innovation is most successful when it disrupts what already exists. Who are you disrupting?*

Niklas Östberg: I would say that we are a disruptor of an inefficient restaurant industry. We're disrupting bad service, inefficient manual processes. We're disrupting inefficiencies in how restaurants connect with customers—not every restaurant can build its own online food-ordering platform. We're disrupting inefficiencies in delivery. It makes no sense for every small restaurant to try to have its own delivery fleet with its own drivers, given the cost of maintaining a fleet and coordinating deliveries. After all, if a restaurant five kilometers away delivers to someone in one place and then goes five kilometers in another direction to deliver to someone else, it's expensive. It's bad for the environment. And it's bad for customers because it takes so long.

We're also disrupting the inefficiency of a system that doesn't serve the food customers want. If you were to ask people on the street, a lot of them would say, "I don't like delivery because I don't eat pizza" or "It's just bad quality and bad food." Combined, those inefficiencies raise costs and reduce quality.

McKinsey on Finance: *How are you using all the data you generate to improve your business?*

Niklas Östberg: Big data should actually be big, meaning it should be available to the entire organization—especially at the front line of the business. That's where companies make tens of thousands of decisions every day, some of which can be handled automatically. These can be very small things: "Shall we do this kind of promotion for our users?" "Is that a good channel for our advertising?" "How do we improve our relationship with a specific customer?" If a restaurant has very bad delivery on Sunday evenings, we can downgrade it on Sunday evenings. If the system detects fraud, we can trigger people to stop ordering.

We also monitor our restaurants to maintain relationships. We know, for example, that a restaurant is likely to cancel its contract if it starts contacting us more frequently or gets negative feedback from customers. The data automatically trigger a pop-up to one of our sales agents—"call this restaurant, see what's wrong, and do what you can to help." This involves decisions that are made both automatically and independently by sales agents, as long as they have the right information, and saves a lot of money.

McKinsey on Finance: *Do data also help inform investment decisions?*

Niklas Östberg: Data help us to be a little faster at managing our investments. Say you make an investment with a 1-to-10 probability that you'll be right—but if you're right, you'll make a 100-to-1 return. That's a very good investment to try. The problem is that if you're wrong in nine out of ten cases, you need to have a very fast way of figuring that out. Then, when you do find the one investment with high returns, you can put a lot of money on it.

For example, while the main part of our offering is the online platform, we've also invested in separate businesses to handle delivery for independent

“Big data should actually be big, meaning it should be available to the entire organization — especially at the front line of the business.”

restaurants. That is part of building up our logistics to enable a better service. Restaurants still do the cooking, naturally, but we track their orders. We offer quality assurance through metrics like user ratings and reorder rates. And we tell restaurants which dishes on their menus are good for delivery. We also make much more money on that—around €10 per order, less the cost of delivery.

For investments like that, we track the data and optimize performance, shutting them down quickly if it becomes clear they can't meet our expectations. We spent nine months on an earlier delivery-space investment, based on a different concept and setup, for example. We did as much as we could to improve its performance and invested close to €10 million in the project. But it wasn't meeting our expectations, so we shut it down and took the loss. Now, maybe we could have realized that sooner and lost just €6 million, but other companies might have dragged out the investment and spent €100 million on it. The point is, if you're going to fail, you want to fail fast. You invest to validate or invalidate the concept and then shut it down if necessary.

McKinsey on Finance: *You appear to have a highly federated business model with a number of CEOs of individual delivery businesses. How does that work?*

Niklas Östberg: Centralization is always more efficient in a way because you can do one

thing and multiply it across units. On the other hand, giving people autonomy and authority and responsibility also has an amazing value. What rarely works is to be 100 percent one approach or the other. The trick is finding the right balance.

We give local CEOs autonomy and authority to encourage entrepreneurship—and they fight with blood and sweat to win in the market. But you have to set the rules of the game. And you have to set the culture of your company. That balance can be fragile. For example, if you set the wrong incentive scheme and you place autonomy at the local level, people are more likely to optimize for their incentive schemes rather than for their businesses. And, suddenly, you're sitting there on a conference call wondering, “Is this the right decision that he's suggesting, or is this the right decision for him?” And you don't really know. That's why, first of all, it's important to find people with an owner mentality rather than managers whose careers and financial interests are the top priority. Then give them an incentive scheme that reflects ownership as closely as possible.

Finally, we're a data-driven culture. Decisions based on data are the glue that holds us together. And if data are your starting point, then a CEO in Argentina, for example, can't just argue that something should be done a certain way because every Argentinian's doing it that way. We might not agree, but we can do the A/B testing and see what the data tell us. CEOs get the final decision, but if they

can't prove that their way is better and still do things their way, it's a question of judgment. You can be wrong many times as long as you address the issue.

McKinsey on Finance: *If we look back in our imaginations five years from now—say, after an IPO or acquisition—what would have to happen for Delivery Hero to fail? And what must happen for it to justify its considerable valuation today?*

Niklas Östberg: We're in an economy that moves fast. It would be terribly dangerous to think that something can't go wrong or that we can't be disrupted. That could happen, especially if someone comes along with an innovation and we're not already there. So we are always—and I think you have to be—on the edge of innovating and on the edge of moving fast. That's what's required of companies at our stage.

In terms of revenue, we're in a good position. This is true even if I don't argue that we can grow over 50 percent five years in a row, though I think we could; even if I don't assume that we can improve our unit economics, though I think we will;

and even if I don't assert that we can increase our pricing, though I think we can. Today's valuation is not built on some utopian assumption that the world will change and people will suddenly start ordering food in a certain way. People already order food online—and we have the data. We are the market leader in at least 25 markets. We have a business model that people like. And every second of every hour, we deliver 16 meals globally, hundreds of millions of orders a year. I think we've proved we can make a profit out of that. ■

¹ Earnings before interest, taxes, depreciation, and amortization.

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Mergers in the oil patch: Lessons from past downturns

Past collapses in oil prices have prompted a deluge of deals. As activity looks set to pick up again, companies that acquire in order to cut costs are likely to be the most successful.

Bob Evans, Scott Nyquist, and Kassia Yanosek

Mergers and acquisitions in the oil and gas sector may be coming into fashion again. In the current era of low prices, a confluence of events makes acquiring more attractive. Pricing hedges that had locked buyers into higher prices are rolling off. Debt levels are high, particularly among independent exploration and production companies with exposure to US shale production—at nearly ten times earnings before interest, taxes, depreciation, and amortization. And like most commodities industries, the oil and gas sector is prone to consolidation during the downside of its business cycle (Exhibit 1). This raises the likelihood that some companies will be available at distressed prices. Healthy companies may have been slow to start deals, but they'll clearly want to be on the look-

out to strengthen their competitive positions as new opportunities emerge.

They may find that the strategies that worked when prices were rising won't work as well when prices are low. Our analysis of the value-creation performance of deals during a previous period of low prices, from 1986 to 1998, and the period from 1998 to 2015, which was characterized mostly by a rising-oil-price trend,¹ bears this out (Exhibit 2). Of all these deals when prices were low, only mega-deals,² on average, outperformed their market index five years after announcement. Periods of flat prices appear to call for a focus on cost synergies and scale. In contrast, in the 1998 to 2015 period, when prices were generally rising, more than 60 percent

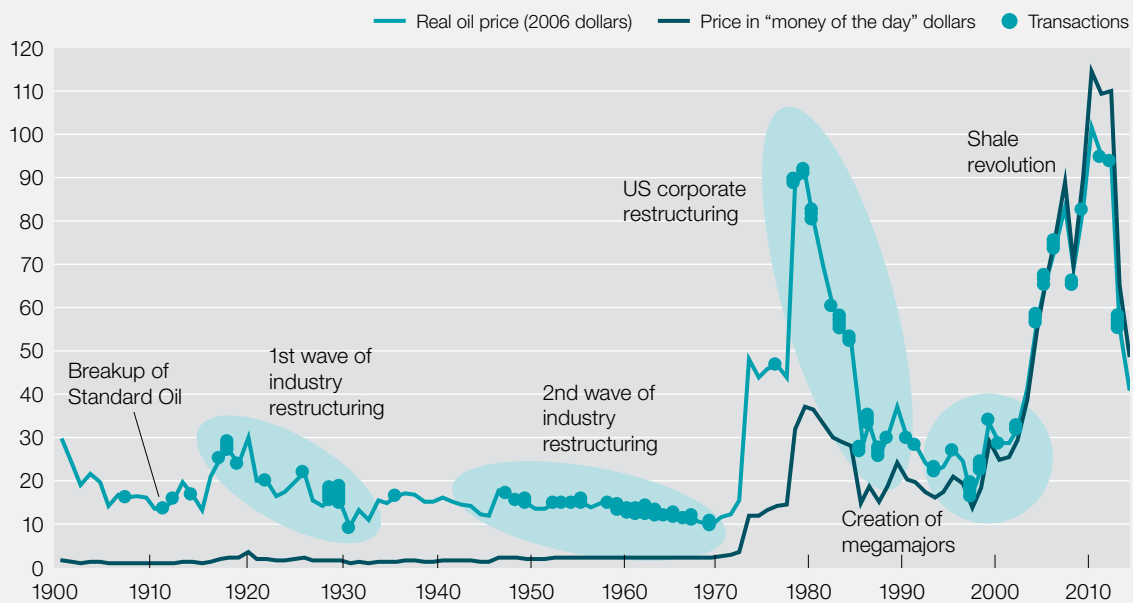
of all deal types outperformed their market index five years after announcement. Not surprisingly, this kind of rising-price environment rewarded deals that were more focused on growth through acquisitions of overlapping or new assets.

To understand how different approaches to deal making would work in an era when oil prices could languish for some time, we looked at the performance record of the most common M&A strategies over the last cycle. These include megamergers, increasing basin or regional density, entering new geographies, and entering new resource types. The data do not automatically prescribe or exclude any particular deal, regardless of strategy. But they do suggest which types of deals have been more successful in past eras of low oil prices.

Megadeals

Large mergers in the oil and gas sector have historically created value through cost reduction at the corporate, region or country, and basin levels. Acquirers captured synergies, such as overhead reductions, and optimized the combined portfolios to favor the most competitive and capital-efficient projects. This resulted in significant improvements in returns on invested capital that in turn translated into shareholder returns in excess of the market index. Further, the expanded breadth of the combined company's portfolio—both geographically and in resource types—helped extend reach. That facilitated growth and diversified the risk of megaprojects. And as oil prices rebounded and growth took off, this was rewarded in equity markets.

Exhibit 1 Historically, oil-price down cycles have led to an increase in M&A activity.

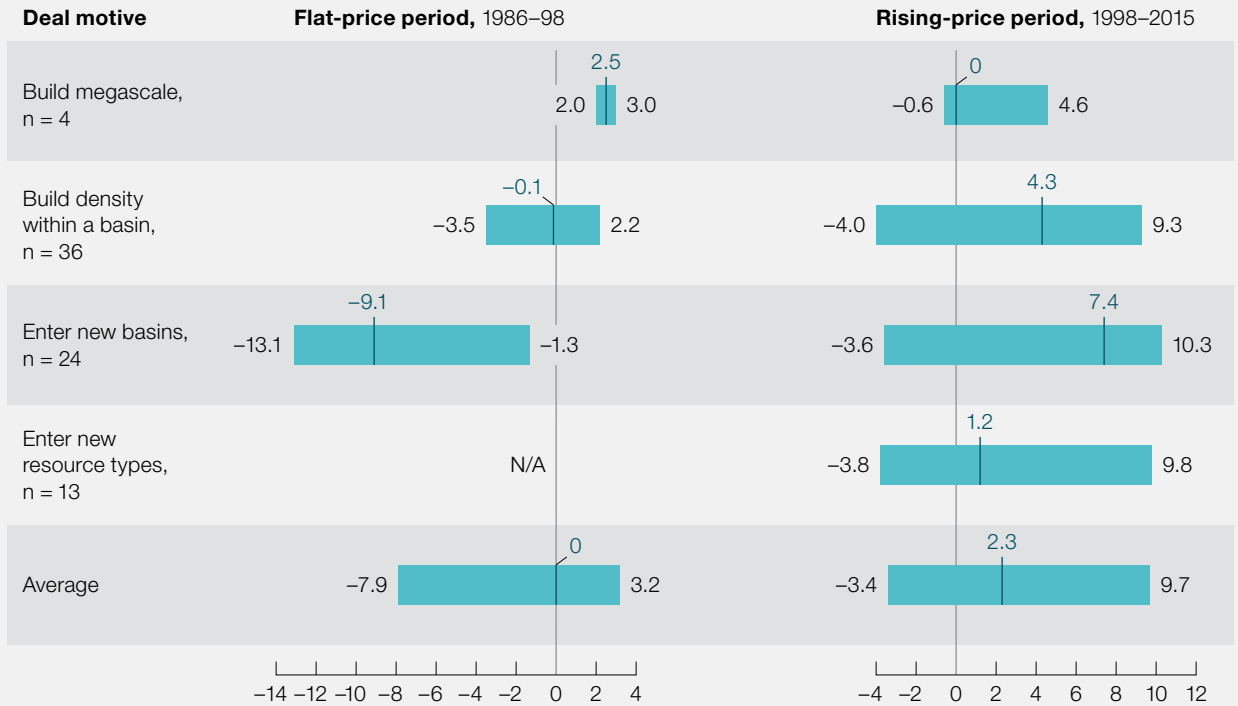


Source: BP Statistical Review of World Energy 2003; S&P Global Platts; Eric V. Thompson, *A brief history of major oil companies in the Gulf region*, Petroleum Archives Project, Arabian Peninsula and Gulf Studies Program, University of Virginia; Thomson Reuters; Daniel Yergin, *The Prize: The Epic Quest for Oil, Money & Power*, New York: Free Press, 2008; analysis of data provided by McKinsey Corporate Performance Analytics, a McKinsey Solution

Exhibit 2 Flat-price periods call for deals that differ from those in rising-price periods.

Range of TRS outperformance relative to MSCI Oil, Gas & Consumable Fuels Index, 5 years after deal,¹ compound annual growth rate, %

Median



¹ Deals prior to 1995 are measured against MSCI World Index, while deals announced after Jan 1995 are measured against MSCI Oil, Gas & Consumable Fuels Index.

Source: IHS Herold; analysis of data provided by McKinsey Corporate Performance Analytics, a McKinsey Solution

Take the merger of Exxon and Mobil. Announced in 1998, the deal had a strong focus on executing postmerger integration, which enabled the company to capture \$10 billion in synergies and efficiencies within five years. That exceeded the \$2.8 billion savings estimated when the deal was announced. The savings resulted from job cuts and stricter, centralized controls on capital spending and allocation across the postmerger company—upstream, downstream, and technology. Over the following decade the deal opened

the path for significant growth, especially in the liquefied-natural-gas business.

In the rising-price period, there were no megadeals to be included in our data sample. But a number of major acquisitions in the period used value-creation levers similar to those of the earlier period. For example, Anadarko Petroleum’s 2006 acquisitions of Kerr-McGee and Western Gas Partners for \$23 billion created large-scale positions in the deep-water Gulf of Mexico and US Rocky Mountains.

Both deals provided cost-savings opportunities and growth potential. Postmerger, Anadarko made substantial divestments to strengthen its finances and improve the quality of its resulting portfolio, setting the company up for a decade of organic growth. In today's environment, any large-scale acquisitions that do occur are likely to create the opportunity for significant cost reductions using these same levers.

Basin- and regional-density deals

Our analysis found that when oil prices were low, deals that increased basin or regional density created value more or less in line with the benchmark index. In contrast, when prices were rising, these regional transactions outperformed the benchmark. In principle, these deals facilitate cost-reduction opportunities because the acquirers are already established operators in the area. They know the geography and geology, the practices, and the people (internal and external) necessary to get the most production possible from these assets. In addition, they can capture synergies by cutting regional overhead costs, consolidating vendor contracts within basins (where many onshore providers are regional rather than national), and optimizing overlapping operations (for example, increasing the efficiency of pumpers and other parts of the supply chain).

Chevron's \$18 billion acquisition of Unocal in 2005 highlights characteristics of a successful deal that

increased regional density. In Thailand, Chevron consolidated acreage under the Unocal manufacturing model for drilling, which enabled it to increase volumes and reduce costs significantly. In the Gulf of Mexico, acquiring Unocal put Chevron in a position to move from exploiting individual wells to developing an integrated hub. This enabled Chevron to make much more efficient use of its capital, reducing costs. While the acquisition was regarded in the industry as having a high deal premium, other factors that boosted value creation included Chevron's insights on the acquired resource's potential (based on the acreage it already controlled), strong merger-management execution, and the benefit of a rising-oil-price environment.

Entering new basins

For companies entering new basins within their existing resource type—such as a shale producer entering new regions or a deepwater operator expanding to foreign offshore basins—our data show a clear contrast in performance between the two pricing environments. Such deals tend to create value during periods of rising prices and destroy value when prices are flat or depressed. By nature, such deals offer few cost-reduction opportunities, as there are limited synergies in operations for the acquirer to tap. In a rising-price environment, however, a lack of cost synergies may be offset by the overall value created by higher and expanding margins coming from top-line

As leading players in the sector plan their moves, they should recognize that deals offering cost-reduction opportunities are likely to create the most value in a lower-for-longer oil-price environment.

growth. Other value-creation levers may be at play, as well—for instance, if the acquirer sees greater potential in a resource than its current owner does.

Examples of successful deals abound from the past 15 years. For example, consider Encana's \$2.7 billion acquisition of Tom Brown in 2004. The deal established the company's gas-production position in a number of new basins in the Rocky Mountains and Texas. On the other hand, Burlington's \$3 billion acquisition of Louisiana Land & Exploration in 1997 suggests what can go wrong when prices are flat. The acquirer expanded in areas including Louisiana, the Gulf of Mexico, Wyoming, and overseas but overpaid for mature assets, with no opportunities for synergy capture to help returns. Burlington lagged behind its index by 7 percent over the next five years and was itself acquired in 2006.

Entering new resource types

This theme is typically a portfolio-expansion strategy, such as an onshore producer seeking to add offshore operations or a company with conventional operations entering unconventional gas and shale-oil basins. Our data set does not have examples of such deals during the period of depressed oil prices. There have been a number of value-creating deals in the rising-price period, but there are also a number of examples of companies encountering difficulties even in this environment.

Foreign companies that have entered North America to build exposure to unconventional shale assets provide mostly cautionary tales. Some of these companies lacked the expertise for local land acquisition (a competitive advantage for most high-performing shale producers) and needed to travel the learning curve to gain the capabilities necessary to be efficient producers. As a result, these transactions were value destroying.

By nature, deals defined by this theme do not offer the kind of cost-reduction opportunities that can help ROIC performance in a period of low oil prices.



Another big wave of M&A activity in the oil and gas industry could soon break. As leading players in the sector plan their moves, they should recognize that deals offering cost-reduction opportunities are likely to create the most value in a lower-for-longer oil-price environment. At the same time, excellence in M&A practices throughout the deal process—from the identification of opportunities to post-merger integration—will remain an important contributor to value creation. ■

¹ With the exception of 2008 to 2009, because of a short-lived down cycle resulting from the financial crisis, and mid-2014 to 2015, when oil prices fell again.

² Defined as deals worth more than \$60 billion.

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‘We’ve realized a ten-year strategy goal in one year’

Gerard Paulides, who led Shell’s \$66 billion acquisition of BG, describes the thinking, the process, and the intensity behind the deal.

Ivo Bozon and Dumitru Dediu

When Royal Dutch Shell announced plans last year to acquire BG Group,¹ the Britain-based oil and gas producer, the deal represented both Shell’s largest M&A deal ever and one of the first energy mergers in an era of low oil prices. Although the acquisition came as oil prices continued to fall, investors roundly approved of it.

Gerard Paulides, who led the team that planned the acquisition and worked on its completion, says the strategic discontinuity in the energy sector is more fundamental than finding new resources or taking out costs as oil and gas remain volatile and the mix of energy sources changes. He recently sat down with Ivo Bozon and Dumitru Dediu to discuss deal making in the oil and gas sector, the BG trans-

action, and the challenges of implementing large mergers and acquisitions. What follows is a transcript of that conversation, edited for publication.

McKinsey on Finance: *The oil and gas sector would seem to be ripe for deal making. What’s the historical view of the role of M&A in oil and gas?*

Gerard Paulides: Historically, the sector has done big M&A deals (rather than just regular asset transactions) when there have been big discontinuities. In the late 1990s, the discontinuity was oil at \$10 a barrel, and the focus was on managing costs. In the early 2000s, the discontinuity was the perception that the world was going to run out of oil and gas at some stage. The focus at that point was

on finding more oil and gas reserves—both through M&A and organically finding and developing resources to produce. The discontinuity in the current environment is more fundamental than finding new resources or taking out costs. It's about the ability to move in a changing world with highly volatile oil and gas prices—and, possibly, a different mix of future energy sources.

Companies in the oil and gas sector typically develop assets, resources, and relationships with governments organically and over the long term. We like to hold onto assets, developing and producing them over three or four decades. Arguably, the industry's integrated model between production upstream, trading, downstream, gas, and chemicals makes it a bit more dynamic than, say, a pure upstream model would. But at the same time, being integrated also makes the industry even more fixed.

McKinsey on Finance: *How does Shell's recent acquisition of BG fit into that?*

Gerard Paulides: The purpose of acquiring at this moment in time on such a fundamental scale is that it allows us to recycle a meaningful part of our company. It's a purposeful, deliberate move to emphasize the company's strategic goals in certain segments, such as integrated gas and deepwater. We always have a coveted, or target, portfolio, but it's something of a ten-year outlook. With the BG acquisition, we've realized a ten-year strategy goal in one year.

Having done that, the implications of the move for our portfolio are here and now, and not in ten years' time. And we also have to take out the bits that no longer fit, which are a magnitude bigger than normal. We regularly divest assets from our capital employed. If you make a big move like this one, you have to measure that proportionately—so we now need to divest significantly more,

probably double the normal level and maintained over a number of years. We'll take our time, but we do need to do it to rebalance the company.

McKinsey on Finance: *You mentioned the volatility in oil prices, but you also talk about an industry that operates over three to four decades. How closely do you watch volatility given that long-term focus?*

Gerard Paulides: As a deal maker, I watch volatility closely, in specific segments, over the shorter term, and also in the financial markets in general. Because if volatility is high—over a month, three months, six months—risk capital becomes more scarce and your ability to move is affected. If you're committed and you can fill that vacuum, then you can realize a first-mover advantage relative to your competition. And once you complete a deal, you can focus on running your business while your competition is still trying to deal with that volatility—retrenching in terms of cutting back spending, cutting back capex, laying off people, and making defensive moves.

Now, that also means that once you've done a deal, you do need to get on with it. You can't continue to behave as if you hadn't placed your money yet. You've been given a license to spend so many billions of dollars, but people are watching you, and they have high expectations. And the bigger the deal, the more fundamentally it will impact the company.

McKinsey on Finance: *How do you put together the best core M&A team?*

Gerard Paulides: A company doing sizable, world-scale M&A should have a core deal team of about ten people—and you need to be deliberate about who you include. It's not a seniority game; it's a game about having the best people available for an intense activity over a prolonged period. If

Gerard Paulides



Vital statistics

Married, with 3 children

Education

Earned a master's degree in business economics from Tilburg University

Holds a certificate for governance and international directors from INSEAD

Education

Royal Dutch Shell

Executive vice president for deal completion (June 2015–present)

Nonexecutive director, Shell Midstream Partners (October 2014–present)

Global vice president of M&A and structured finance (October 2012–June 2015)

CFO and vice president of finance and strategy, Upstream Europe (September 2007–October 2012)

CFO, senior vice president, and director, Shell Canada (March 2007–September 2007)

Vice president for investor relations (January 2003–March 2007)

Fast facts

Nonexecutive director on the boards of Shell Midstream Partners, Radboud University, and the Radboud University Nijmegen Medical Center, where he also sits on the audit committee

Enjoys riding a motorcycle

you have five external team members available, principals from the bankers, the lawyers, the strategic advisers, then you have a good team—but you need to handpick them. The more you can allow them to do their job and mobilize as their point of view drives them, the better off you are.

Reporting lines are also important. An M&A team leader should have a direct reporting line to the CEO and CFO and also establish a relationship with the board. The head of strategy, if there is one, should be a part of any dialogue around deals but shouldn't be a conduit for that M&A dialogue between the team and the CEO. If you're talking about big deals on a global scale, you can only work with one decision maker.

McKinsey on Finance: *How does the long-term nature of the oil and gas industry correlate with how you think about short-term market reactions? Does the market often get it right at the start, or does it need to see a deal play out over time?*

Gerard Paulides: Obviously, financial-market requirements need to be followed during the entire process, ensuring timely and complete disclosure of information. If the market reacts differently than you expect, then either you didn't explain the deal very well or you didn't see an issue that the market does. You need to respond to that. I also think that in oil and gas it's much too easy to say, "We're a long-term industry, it's a short-term blip. Let's ignore it." The financial markets are

based on ultimate transparency of information and immediate pricing, and the feedback is immediate, brutal, transparent—and free.

So you need to know why the markets react the way they do. The financial markets have the luxury of not having all the detail, so they don't come up with all sorts of rationales to explain why a result is not what you think it should be. They step back and look at the big trends, and compare and contrast, and say, based on all this information, "I get it," or "I don't get it." On the other hand, the company has the luxury of having all the detail, so it knows how to explain the market's reaction. That can be a good thing or a bad thing, and you have to be honest enough with yourself to tell the difference.

McKinsey on Finance: *How would you compare the level of effort before announcing a deal of this size with the level of effort after?*

Gerard Paulides: If you manage a company like Shell, 99 percent of the company doesn't know what's happening prior to the announcement, or why—even though you're using your entire day and your entire week to deal with the intensity of the planning.

After the deal is announced, the intensity changes, because then 99 percent of the company and the market know what you're doing. They expect you to allocate time to it. In the beginning,

that's relatively predictable, because you've programmed it in, you've prepared yourself, and you've allocated half your calendar and agenda to manage the deal and half to running the company. And that's OK. But then you get to the end of the process—in our case, the last 3 months of a 12-month period—and the heat goes up. The scrutiny gets even more intense, as people have to place their bets, the shareholders have to vote, the debt providers have to calibrate their positions, and the other company has to make up its mind considering its own best interests and the latest developments in the market.

For a world-class transaction at the scale of our acquisition of BG—if you think you're going to be busy in those last three months, double what you expect, and you'll probably get close to where it will turn out. That's why it's important not to underestimate how grueling these things can be. It's well worth paying extra attention to your own mental and physical fitness—as well as that of your team.

McKinsey on Finance: *Is there a difference between the intensity of a deal and just the amount of time going into it?*

Gerard Paulides: You can spend a lot of time without being intense. We had about 20 subject-matter-expert work streams in the BG deal. At any moment, any of those work streams might be

“For a world-class transaction at the scale of our acquisition of BG — if you think you're going to be busy in those last three months, double what you expect, and you'll probably get close to where it will turn out.”

the most important, whether it's a treasury topic that requires immediate attention, some regulatory discussion for antitrust purposes, or a valuation of an asset in Brazil. So by intensity, I mean the demands of dealing with all those matters at once—when your judgment is consequential at a level you normally don't have.

There were certain points in 2015 and 2016 when I couldn't open a newspaper without reading some write-up or some subject-matter-expert review—and everyone knows what you're doing, including your entire family and all your friends. You probably cram three years into one. And you almost think, "What happened in the last 18 months? We were at Easter, and then it was Christmas, and then it was Easter again." That's intensity.

McKinsey on Finance: *On the BG deal, what was the market's initial reaction?*

Gerard Paulides: The BG acquisition was a unique fit for Shell, and the timing and opportunity were there. The market's reaction to the deal was complete and wholesome, and investors have embraced it as a good match. The debate was not about strategy or the rationale for the deal or the portfolio opportunity that the deal would create with divestments. All that was quickly understood. That was why we started the whole exercise, because it all makes sense.

The debate was about price. With oil prices dropping from above \$100 a barrel in early 2015 to below \$50 a barrel in early 2016, it's difficult to price the opportunity. You need to work your way through that. So you have your base valuation, you have your financial metrics, you have your synergy on top of that, and then you have your reset opportunity for the company. And most of the debate was around the reset opportunity and the pricing.

In fact, that's a pretty luxurious position, because it meant we weren't debating strategy. We weren't debating portfolio. Our fundamentals were spot-on. That's where you want to be for any deal. If you don't get over that hurdle, you don't have a hope of discussing financials, and value, and execution, and management quality, and trust, and all of that.

McKinsey on Finance: *What are the biggest risks to the success of a deal like this?*

Gerard Paulides: Failing to recognize the intensity of the integration needed. Or, if we go back to what used to be business as usual, spending as if we hadn't done this transaction. Market conditions can make it easier or harder. If oil prices go directionally more up than down, life will be easier—but that carries its own risk. An improving market can bail you out too easily, without the intensity of the reset and the portfolio rebalancing. You may forget your original intentions. ■

¹ Valued at \$86 billion at the time it was announced, according to Dealogic, the transaction was ultimately worth more than \$60 billion when it was completed on February 15, 2016, and represented some 40 percent of Shell's \$140 billion market capitalization on that date. The change reflected variability in currency prices, oil prices, and Shell's share price.

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