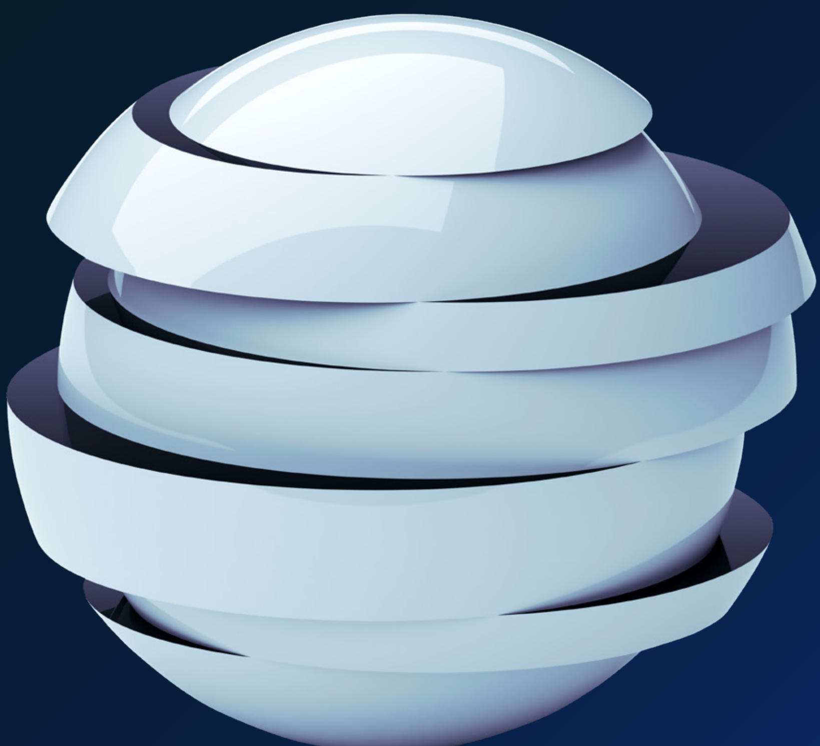
McKinsey & Company

McKinsey on Finance

Perspectives on corporate finance and strategy



Perspectives on portfolio management

Also inside: the CFO's central role in integrations, a prescription for healthy business partnerships, an overview of crisis-market dynamics, a reflection on Warren Buffett's impact on investing, and a look at how war games can help leaders make better business decisions.

Number 75,
November 2020

McKinsey on Finance is a quarterly publication written by corporate-finance experts and practitioners at McKinsey & Company. This publication offers readers insights into value-creating strategies and the translation of those strategies into company performance.

This and archived issues of *McKinsey on Finance* are available online at McKinsey.com, where selected articles are also available in audio format. A series of podcasts on corporate-finance and strategy topics is available for streaming or downloading on McKinsey.com, as well as on Apple Podcasts, Google Play, and Stitcher.

Editorial Contact:
McKinsey_on_Finance@McKinsey.com

To request permission to republish an article, send an email to Quarterly_Reprints@McKinsey.com.

McKinsey on Finance

Perspectives on corporate finance and strategy

Perspectives on portfolio management

Number 75,
November 2020

Table of contents

Interested in reading *McKinsey on Finance* online? Email your name, your title, and the name of your company to McKinsey_on_Finance@McKinsey.com, and we'll notify you as soon as new articles become available.

Why you've got to put your portfolio on the move

We analyzed hundreds of companies around the world across a decade-long business cycle. The conclusion? Winners change their business mix year after year. Laggards sit still.

by Sandra Andersen, Chris Bradley, Sri Swaminathan, and Andy West

Every CEO will ask, at least once, “Which business should this company be in?” But the best know it can’t be a one-time question; they know the answer will keep changing over time. These executives consistently put their companies’ portfolios of businesses on the move—and outperformance tends to follow. The reverse holds true as well: CEOs who rarely ask the question end up with static portfolios. The market moves on, and their company doesn’t.

For many companies, sitting still can be a bad option. We know because we have measured. We analyzed the detailed financial results of more than 1,000 global public companies between 2007 and 2017, through a long cycle of downturn, recovery, and growth. Our research makes the case for dynamic portfolio management and reveals five critical principles (based on the outperformers’ best practices) for actively reallocating assets:

1. *Be consistent.* The outperformers rotate their portfolios steadily, not wildly, and avoid keeping them fixed in place.

2. *Move with the market.* The outperformers identify how headwinds and tailwinds are shifting, and they deploy resources aggressively to seize potential value-creation opportunities.

3. *Use transactions to speed your way.* The outperformers in our research account for an outsize share of M&A-transaction value during the period studied, and they favor a programmatic approach to M&A.[1]

4. *Focus on acquisitions at the perimeter of your portfolio.* The outperformers use M&A to seize new opportunities in existing but secondary businesses—that is, outside, but not too far outside, of their core sectors.

5. *When the going gets tough, go harder.* Our research reveals that context matters: how you stack up against your competitors affects how hard you need to pull on all the levers we have outlined. We found that companies in the lowest quintile of performance did better when they pulled even harder.

Interestingly, these lessons proved sound in both good times and bad. They are also harder to apply than it seems: challenging economic conditions and cognitive biases that get in the way of good

The outperformers in our research use M&A to seize new opportunities in existing but secondary businesses—that is, outside, but not too far outside, of their core sectors.

[1] A company that takes a programmatic approach to M&A makes roughly two or more small or midsize deals in a year, with a meaningful target market capitalization acquired over a ten-year period (the median of the total market capitalization acquired across all deals is 15 percent). See Jeff Rudnicki, Kate Siegel, and Andy West, “How lots of small M&A deals add up to big value,” *McKinsey Quarterly*, July 12, 2019, McKinsey.com.

Exhibit 1

An optimal refresh rate keeps a portfolio moving at a steady clip.

Total returns to shareholders, average excess performance, in 2007–17 (n = 209), %

[1] Refresh rate calculated as sum of absolute differences in company's share of revenues by industry divided by 2.

decision making can conspire to keep executives (and their portfolios) in a state of inertia. The reality is, however, that far more CEOs and investors will complain that companies shifted portfolios too little or too late than will gripe about the opposite. The data are with you if you decide to put your portfolio on the move.

The business case for portfolio change

There's a lot of literature available on corporate portfolio management, but it almost never addresses the *business case* for why portfolio changes improve performance or how to go through the difficult task of actually shifting the business mix. With such business realities in mind, we analyzed reams of reported data. We sought out the links between changes in companies' portfolios and actual performance results. More important, we sought conclusions that held true across market cycles. Five core lessons emerged from this study.

1. Be consistent

Our research revealed a Goldilocks rate of portfolio rotation that is neither too low nor too high but just right to produce outperformance. When we drilled down on a controlled subset of our studied companies, we found that about half kept their portfolios mostly static, refreshing them by fewer than ten percentage points over our studied ten-year period. Their portfolio mixes at the end of the period were similar to what they had been at the start. This group barely moved the needle in average annual excess total returns to shareholders (TRS). Another group, comprising about a quarter of the companies, refreshed their portfolios by more than 30 percentage points over the decade; they actually produced slightly negative annual excess TRS (Exhibit 1).

The remaining 23 percent of the companies we studied registered a refresh rate between 10 and 30 percent. This last group delivered results that were *just right*—outperforming the others in excess TRS by, on average, 5.2 percent per annum. For a hypothetical company with $10 billion in revenues, a just-right rate of portfolio rotation would mean moving between $1 billion and $3 billion over ten years.

Of course, even within the range we identified, the right refresh rate will be different for companies, depending on industry and other factors. One high performer we studied, today a global logistics company, had operated substantial depository-credit and retail-banking businesses through the first decade of the 2000s. Those business units accounted for more than 15 percent of total company revenue in 2007. But between 2007 and 2017, the company exited banking and expanded its presence in supply-chain logistics and parcel and e-commerce delivery instead—areas that each grew to represent about 50 percent of its sales by

2017. This added up to a refresh rate of 16 percent, which put the company in the sweet spot that marks TRS high performers.

2. Move with the market

We created a baseline of industry momentum to consider how a company's portfolio would have evolved had each of its business units performed in line with its pure-play peers. This allowed us to measure whether changes within a portfolio either sped up or slowed down performance. The sum of a company's moves for each of its business units represents total portfolio momentum (Exhibit 2).

When we examined the impact of portfolio momentum on a portion of our broader data set, we found that the one-third of companies that had begun the ten-year study period with positive industry momentum did well, with annual excess TRS of 4.4 percent; they had started in the fast lane and remained there. The companies that had started in the slow lane and moved into the fast lane—for example, a life-sciences conglomerate that shifted capital to testing and treatment—reached the end of the ten years in reasonable shape, with excess TRS growth of 1.7 percent per year. But the companies that began in a slow-growing industry and stayed there delivered a negative average excess TRS over the measured period.

The best companies plumb market insights to forecast which industries and markets are likely to thrive, and they actively configure their portfolios to take advantage of those projected tailwinds. Consider the journey of one company, now a leading global provider of financial research and analytics. In 2007, 40 percent of its revenues came, collectively, from its publishing and education businesses; its financial-research arm contributed about one-third of the company's top line, and its data and analytics

Exhibit 2

Move with the market, and change lanes if you have to.

Illustrated example of portfolio momentum

	Industry momentum, 2007–17 Average change in economic profit, $ million		**Company's portfolio exposure** Proportion of revenue, % **2007**		**2017**		**Company's portfolio momentum** Expected change in economic profit, $ million
Business-unit A	1,000	×	27	+25	52	=	250
Business-unit B	100	×	33	+15	48	=	15
Business-unit C	–80	×	40	–40	0	=	32
Total							297

Pursuing a steady stream of deals can give a company access to the latest market intelligence and improve its transaction and integration capabilities.

businesses accounted for the rest. Seeing the challenges ahead for the publishing industry as a whole, the company sold its publishing and education businesses to private-equity investors and doubled down on financial research and analytics. By 2017, slightly more than half of the company's revenues were derived from financial research, and its financial-data-solutions business reached about 50 percent of the top line. These moves were ahead of the tide: between 2007 and 2017, the average economic profit of companies involved in information provision increased by $1.4 billion, while that of companies involved in publishing declined by $73 million. Veering out of the slow lane of publishing and into the fast lane of financial data helped contribute $400 million of the $850 million in economic-profit lift that the company realized over that period.

3. Use transactions to speed your way

M&A and divestitures are essential for positioning companies for value creation. But it's critical to understand that different approaches to M&A will produce different outcomes over a ten-year period. A company that takes the programmatic approach to M&A makes roughly two or more small or midsize deals in a year, acquiring a meaningful total market capitalization over a ten-year period (the median is 15 percent of total market capitalization acquired across all deals). In the large-deal approach, regardless of how many deals a company does, if an individual deal is larger than 30 percent of the acquiring company's market capitalization, most of its portfolio story is told by this one large bet. Selective M&A involves doing deals, but their value often doesn't add up to a meaningful proportion of a company's market capitalization at the end of a ten-year period. And in the organic approach, a company makes one deal or fewer every three years, and the cumulative value of the deals is less than 2 percent of the acquirer's market capitalization.

When we looked at the companies that were operating at the Goldilocks refresh rate of between 10 and 30 percent over ten years, programmatic M&A appeared to be the optimal path. Indeed, the companies in our sample that used programmatic M&A delivered average excess TRS of 6.2 percent per year. We found similar outperformance when it came to changing industry lanes: of the companies that used transactions to move into high-growth industries, those that relied on a programmatic approach averaged 3.7 percent in annual excess TRS, compared with –0.5 percent for companies that attempted this using selective M&A and 1.2 percent for companies using the large-deal approach.

A global industrial company, for example, divested numerous businesses in which it lacked a competitive advantage and made more than 50 transactions between 2008 and 2017, posting a refresh rate of 29 percent. Its discipline paid off. The company's excess TRS versus that of its peers over the same period was 9 percent.

Programmatic M&A may not be right for every company in every industry, but pursuing a steady stream of deals can give a company access to the latest market intelligence and improve its transaction and integration capabilities. Deals won't succeed all of the time, but doing them as part of a regular business cadence can enforce portfolio-management discipline, help teams get smarter about industry levers and trends, and engender confidence from investors.

4. Focus acquisitions at the perimeter of your portfolio

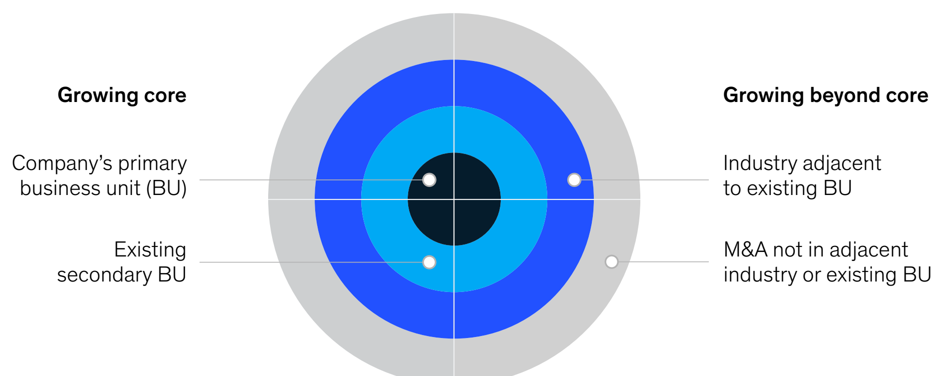
We categorized the acquisitions of the companies in our 2007–17 data set in one of four ways: adding to its primary industry segment; adding to an existing, secondary industry segment; buying into a segment adjacent to an existing business; or stepping out into an unrelated industry. We found that companies that made acquisitions to shore up existing but secondary businesses registered the best results, returning an average of 1.6 percent in annual excess TRS (Exhibit 3). That said, a company's existing industry context turned out to be critical. Those that started in well-performing industries did the best in pursuing M&A within their core industries—not surprising, since they had little reason to shift out of their fast lanes. Conversely, those that needed to change lanes got the biggest boost when they aimed further from their core businesses.

Value creation can be a multistep process, of course. Consider one multinational chemical company. At the start of our study period, it was primarily a basic-chemicals company, operating in a sector in which

Exhibit 3

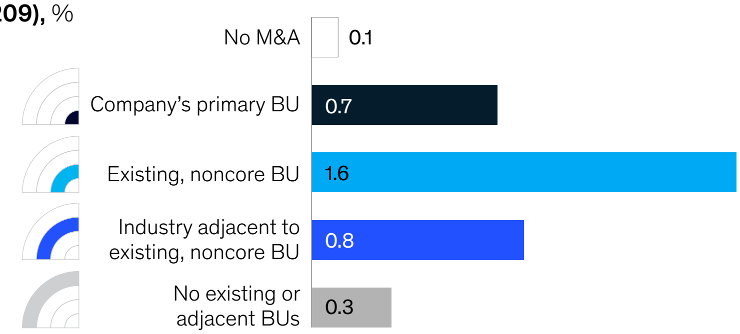
Top performers tend to aim their M&A outside the core—but not too far outside.

M&A radius



M&A activity

Total returns to shareholders, average excess performance, in 2007–17 (n = 209), %



larger US- and Middle East–based competitors had far greater scale. The company recognized that specialty chemicals—particularly nutritional ones, in which it already had a small footprint—could provide faster growth. Over a decade, it made multiple acquisitions to extend its presence in the nutrition business. In parallel, it exited businesses such as rubber, fertilizers, and energy, raising some $1.6 billion from its divestments. Those moves enabled the company to deliver more than 6 percent annual excess TRS.

5. When the going gets tough, go harder

According to our analysis, the worse your starting point is, the more urgent it becomes to shift to a faster track. Our research showed that bottom-quintile companies (by economic-profit performance) benefited the most from aggressive reallocation and higher-intensity M&A. The numbers revealed that step-out M&A, which is usually considered higher risk than acquisitions closer to the core, is often a better option than modest portfolio shifts are for companies that are at the back of the pack.

Going harder paid off in spades for a large global packaging company. In 2009, after several years of sluggish performance, the company, then much smaller, surprised industry observers by pulling off an ambitious acquisition of a multinational conglomerate's packaging unit. The conglomerate wanted to divest the noncore business unit after it had determined it was no longer the best owner. Through the deal, the packaging company boosted its growth and margin trajectory and realized a decade of outstanding shareholder returns. It was also a "bet the company" moment. Indeed, without the conviction to go hard on portfolio changes, the smaller company may well have become a takeover target itself.

A story of from–to

The metrics on portfolio change speak volumes. Yet too many organizations still incline toward inertia. As our research shows, around half of sampled companies continue to change their business portfolios barely, if at all.[2] There are several proven practices for getting portfolios moving:

— *Shift the default.* Whether we admit it or not, we fall in love with what we have. To break the spell, approach portfolio management as private-equity firms do, with the knowledge that most businesses must be sold or put on the block eventually. Having the conversation about "Why are we entitled to own this asset?" instead of "Should we sell it?" can help shift perspective in a way that generates a healthy and balanced debate.

— *Drive conviction.* When there's a difference of opinion about which strategic actions are required, leaders typically agree to wait a bit longer—surely a turnaround is right around the bend. Better to be clear about your strategy and pursue it with conviction: if a growth opportunity is emerging at the perimeter, your company should be programmed to go out and capture it. Recognize when one of your existing businesses is sputtering; admit that your company can't be a leader in every sector it's in. Follow the lead of one energy company, which established the rule that its corporate-planning team must identify 3 to 5 percent of the company's assets for potential divestiture every year.

— *Build a blueprint.* When companies make deals, they tend to be reactive. A better approach is to start with a quantified vision of how many deals you want to make and then hew to a program to make that happen. Companies that

[2] See Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, January 1, 2011, McKinsey.com; Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 1, 2010, McKinsey.com; and Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 13, 2018, McKinsey.com.

succeed in making portfolio change a part of their DNA spell out a vision for their optimal portfolios, and they create detailed M&A blueprints to establish baselines of their market positions, ambitions, and gaps, as well as boundary conditions (such as types or sizes of deals) that will focus the scope of their deal searches. Progress toward the target portfolio is reviewed by the planning committee regularly, ideally quarterly, to ensure that transactions are purposeful and not opportunistic.

— *Develop a machine.* Sophisticated deal makers manage their M&A programs as core parts of business operations. They consider corporate planning in a comprehensive way, and they view M&A as an enduring capability, not as an occasional event. For example, they conduct due diligence and integration planning at the same time—holding discussions early in the deal process about how to get "under the hood" of deal value and reimagine the opportunities that the acquired company could unleash once the deal is closed. They also have an integration plan, head count, and budget in place before the acquisition is closed, and they strive to fill in gaps in personnel or tools so that integration can begin immediately at closing.

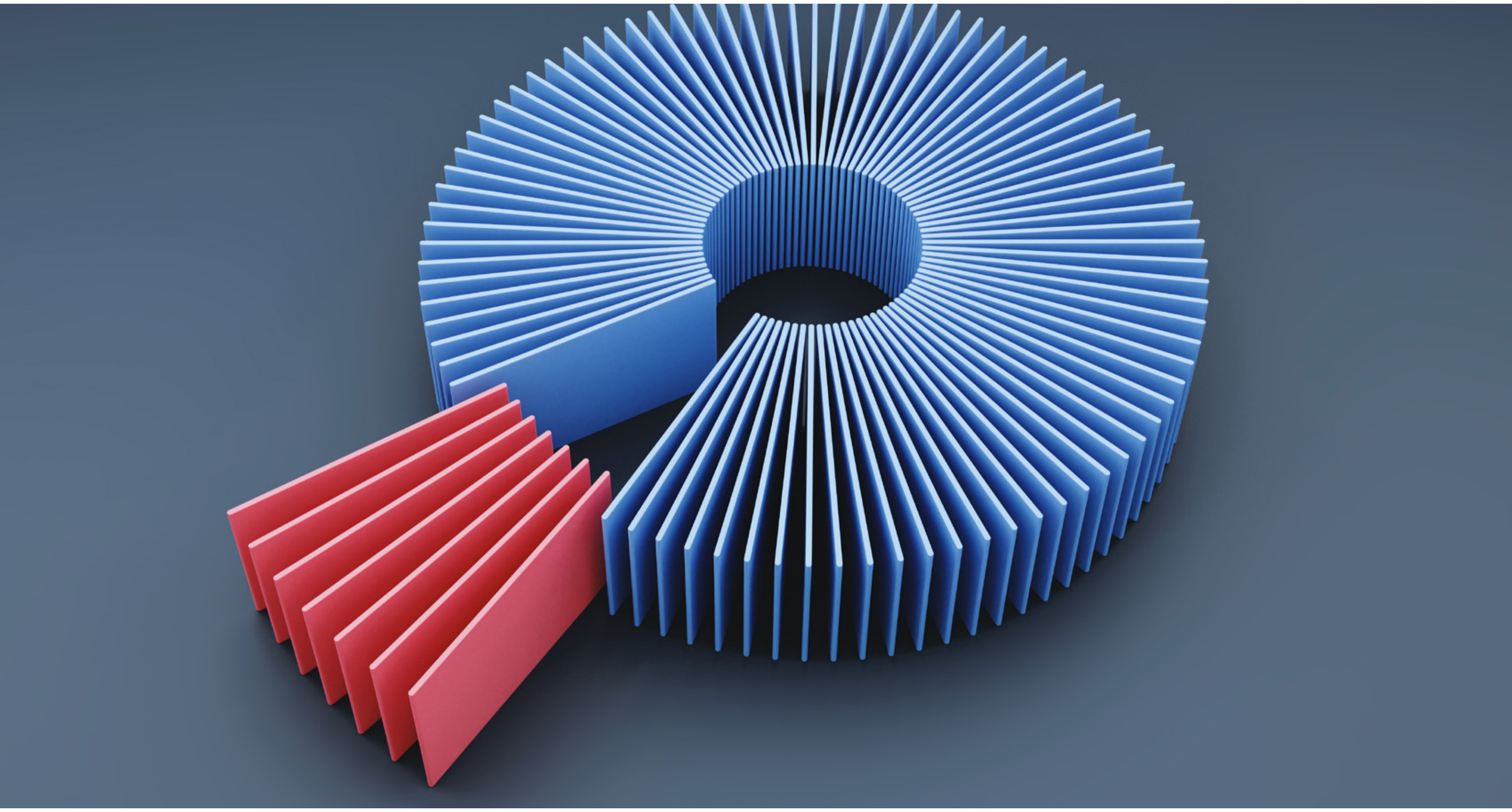
Distinctive companies manage their business portfolios relentlessly, continually pursuing new opportunities to create value and systematically divesting business units that underperform. While not every moment is one for disruption, nor every sector or company ripe for M&A, the dearth of portfolio activity highlighted by our research suggests that too many companies and leaders are keeping their heads too far down. Business leaders must regularly reappraise portfolios—and then commit to move.

Sandra Andersen (Sandra_Andersen@McKinsey.com) is an associate partner in McKinsey's New York office, **Chris Bradley** (Chris_Bradley@McKinsey.com) is a senior partner in the Sydney office, **Sri Swaminathan** (Sri_Swaminathan@McKinsey.com) is a partner in the Melbourne office, and **Andy West** (Andy_West@McKinsey.com) is a senior partner in the Boston office.

Three degrees of separation: How to successfully execute divestitures

The seller's focus on three key interrelated activities—defining, marketing, and disentangling—can help expedite the transfer of divested assets and increase total deal value.

by Jamie Koenig, Anthony Luu, and Steve Miller



The decision to divest a business unit or other asset can be painstaking and protracted. Leaders ruminate about sunk costs, the size and scope of their portfolios, and the status of their strategic objectives. But once all sides have been heard and the choice is finally made, leaders face an even more daunting challenge: executing the divestiture.

To part with an asset successfully, management teams must choreograph a range of critical tasks and consider the perspectives of dozens of internal and external resources and advisers—potential buyers, current employees, boards of directors, and so on. And they need to do these things quickly: McKinsey research reveals that, on average, separations completed within 12 months of announcement deliver higher excess total returns to shareholders (TRS) than do those that take longer.[1]

In most cases, however, business leaders allocate more time to the question of *whether* to divest rather than *how* to divest. So when they get the green light from the board, many find themselves stuck in neutral—unsure about where to put their energy, which decisions to make first, and which tasks to prioritize. Meanwhile, delays can diminish an asset's value or scuttle deals altogether. Our research and experience in the field suggest that, to get unstuck, business leaders need to break the divestiture process into three interdependent but distinct activities: defining, marketing, and disentangling the asset in question (see sidebar, "Parting words and deeds: Critical separation activities"). For instance, a company that wants to sell a business unit must identify key characteristics of the asset in question so it can consider how to disentangle it from others in the company's portfolio while simultaneously deciding on the valuation story to tell potential buyers.

Segmenting the separation process in this way can help business leaders better understand where to begin and where to focus their efforts—thereby increasing the odds of divestiture success.

Where to begin

Once business leaders get permission from the board to pursue a divestiture, they tend to go right to the marketing activity. They engage a deal team, retain an investment bank to support the sale process and evaluate the potential universe of buyers, and develop a ten- to 20-page document outlining investment highlights. Of course, this approach will work if the asset in question is a stand-alone entity with a strong track record—for instance, if it's a distinct business unit within a larger conglomerate that overlaps minimally with other businesses in the portfolio.

For most divestitures, though, there's a better way: start by fully defining the asset in question—particularly the financials involved—and considering potential disentanglement issues *before* launching

Separations completed within 12 months of announcement deliver higher excess TRS than do those that take longer.

[1] See Obi Ezekoye and Jannick Thomsen, "Going, going, gone: A quicker way to divest assets," August 6, 2018, McKinsey.com.

Parting words and deeds: Critical separation activities

Business leaders must manage the separation of assets through three interrelated but distinct activities:

— *Defining the asset.* The company must convene a cross-functional working group to define what is actually being divested—for instance, confirming deal boundaries, carve-out financials, and legal structures.

— *Marketing the asset.* The team needs to build a narrative that takes the buyer's point of view of the potential value it may gain from the asset being divested. McKinsey research shows that risk premiums decrease and valuations increase when sellers take this approach. The team should define the universe of potential buyers and prepare marketing materials that tell a consistent story.

— *Disentangling the asset.* The team needs to assess the risk from the separation for the various stakeholders, processes, and functions. It must consider the scope and timing of the transition while incorporating different financial and buyer scenarios.

any marketing efforts. In doing so, sellers are less likely to leave money on the table or to introduce skepticism among buyers about the information being provided about the asset, which could kill a deal.

The leaders of a complicated aerospace divestiture went straight to the marketing task before fully evaluating the upside potential and sources of value for an asset on the block. In the marketing materials, the seller provided an estimate for the cost of transitioning the asset to potential buyers. Days after the offering memorandum was released, a round of deeper financial analyses revealed that the corporate allocations used to generate that estimate were deeply understated. By then, it was too late. Sophisticated bidders quickly discovered the error, and the seller was left at a disadvantage during negotiations on the transition service agreement. The seller learned from this mistake, however. This was the first in a string of planned divestitures, so the corporate-development team made sure to validate and adjust historical allocations before bringing other assets to market.

By contrast, the executives at one software company developed an ambitious yet attainable value-creation plan for a business unit that the company intended to carve out. The plan included shedding lower-margin, slower-growth products associated with the carve-out, particularly those linked to other business units at the software company, and shifting sales and marketing resources toward newer products and services. Executives subsequently were able to focus their marketing efforts on the potential financial upside of the deal—an expected EBITDA[2] expansion of more than 25 percent—and on aggressive growth targets. This led to a substantially higher valuation of the asset at sale.

What to focus on

Even the most experienced business leaders and divestiture teams can have trouble determining when and how to deploy limited resources in high-pressure deal situations. Here, again, a focus on the three core activities—with recognition of how they inform one another—can help cut through much of the noise and external pressures. It will be

[2] Earnings before interest, taxes, depreciation, and amortization.

most critical to establish the deal perimeter (defining the asset), build upside into the valuation (as part of marketing the asset), and draw a "separation road map" (disentangling the asset).

Establish the deal perimeter
A common mistake among sellers is launching into due-diligence processes and negotiations with buyers without fully understanding what they are selling. Sellers should instead take the time to assess both the buyer landscape and the value-creating aspects of the asset in question. In this way, they can gain a better sense of the marketing messages that will attract potential buyers, as well as the effort that may be required to transition an asset.

The divestiture team must set a perimeter around the deal—drawing clear lines around the operations (such as manufacturing sites and equipment), products (such as SKU lists), intellectual properties (such as patent rights), and commercial capabilities (such as sales forces) associated with the asset in question. The team should explore critical questions, such as which products, geographies, and groups of personnel are in scope for the deal; which contracts will be reassigned; how shared intellectual property will be managed (transferred entirely or licensed); and which systems will remain with the divested asset (Exhibit 1).

Of course, the divestiture team should ensure that it's using complete and up-to-date information during this asset review. The deal team at one global pharmaceutical company realized too late that SKU records in the company's enterprise-resource-planning system were dated. The team had failed to validate the data with local market leads before sharing the information and agreeing to a transaction with a buyer. This led to some difficult conversations with the buyer during the sign-to-close phase, as some of the SKUs included in the deal were no longer being manufactured or marketed. The two sides entered into protracted negotiations that could have been easily avoided.

Build upside into the valuation
Corporate-development teams must ensure that all the technical requirements associated with the sale of the asset can be met. Just as important, they must ensure that the company is getting the best price for the asset. To do so, deal teams must take a fresh look at the performance of the business unit or asset to be divested. They must prepare a thorough assessment of the upside opportunities embedded in the valuation model and, ideally, push buyers toward a deal price that is based on a multiple of management's adjusted EBITDA.

In the case of the software company mentioned previously, for instance, the team identified and shared with all potential buyers the full range of value-creation opportunities from the deal, with typical levers such as growth and cost improvements. It went a step further, however, in highlighting for specific buyers how the deal could expand their profitability through, say, different market positioning, improved technological capabilities, and the compatibility of the asset in question with other businesses in their portfolios. The team also prepared detailed plans for how each buyer could seize those opportunities. With such a compelling valuation story, the team was able to help buyers understand how they could tap into new profit pools as a result of the deal—for

Exhibit 1

Divestiture teams must clarify the key requirements for any potential deal.

Critical	Necessary	Nice to have
• Products (eg, SKU list)	• Facilities	• Non-key assets
• Core operating assets (eg, manufacturing site, equipment)	• Key contracts	• G&A[2] personnel
• Commercial capabilities (eg, sales force)	• Key systems	• Non-key systems
• IP[1] (eg, patent right)		

[1] Intellectual property.
[2] General and administrative.

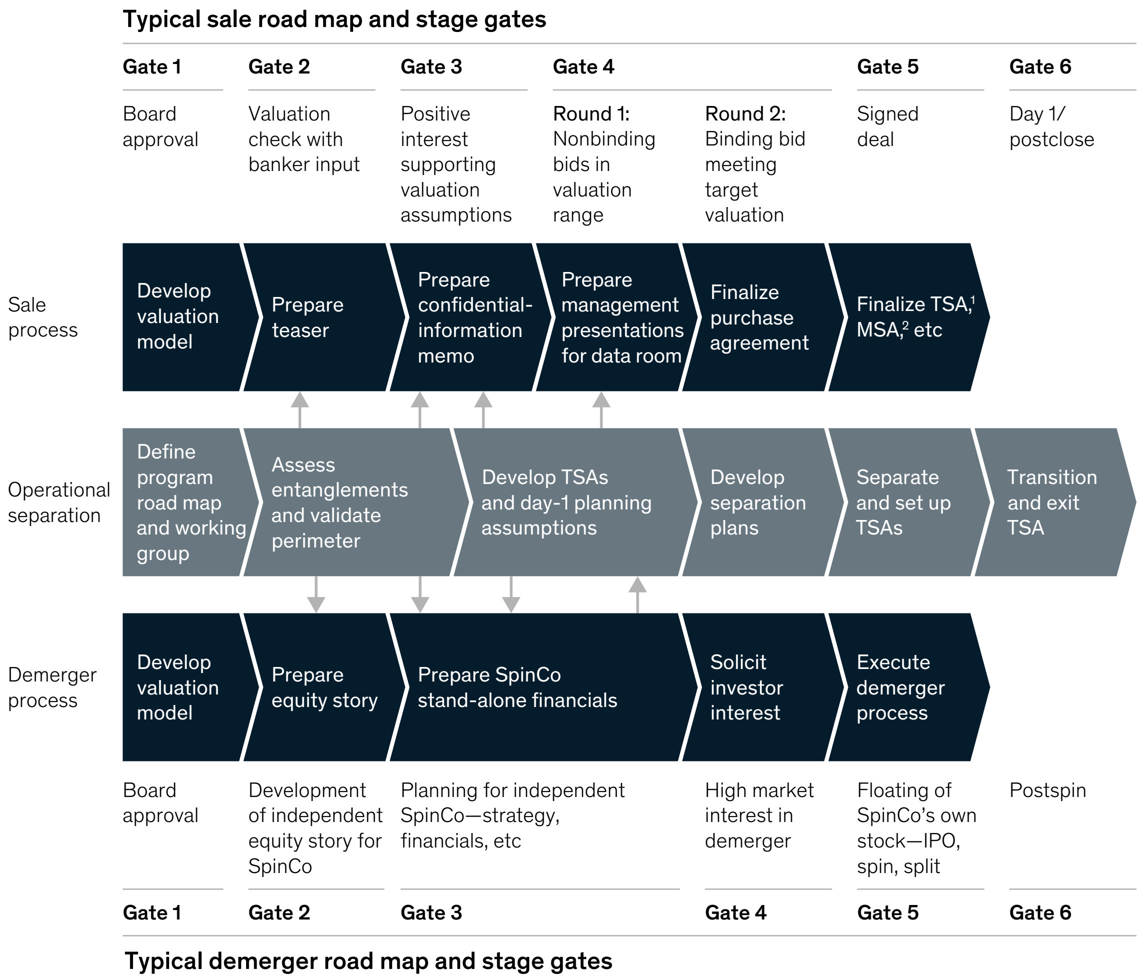
instance, gaining access to new innovations that could lead to new revenue streams or bringing on an experienced management team with a proven track record of execution.

Draw a separation road map

One of the biggest roadblocks to successful separations is executives' failure to anticipate all the dependencies and interdependencies associated with the assets in question. A comprehensive separation road map can help them address such disentanglement issues. The road map should capture all activities, as well as the sequencing of functional and cross-functional work streams associated with the divestiture. It should clearly link the intended goals and milestones for the separation with the related deal-process steps. For instance, the separation tasks of building a census of transferring employees and developing day-one planning assumptions should correspond with the deal-process step of preparing a confidential-information memo (Exhibit 2).

Exhibit 2

To disentangle divested assets properly, companies need to draw road maps.



[1] Transition service agreement.
[2] Master service agreement.

Divestiture teams will, of course, need to be aware of the time frames required to execute all the steps in their road maps. Some business entanglements, such as shared manufacturing, IT systems, and facilities, are more complicated than others and can take more time to resolve. To pace their investments better and minimize business disruption, deal teams may want to build stage gates—triggers that allow for companies to discontinue separation activities if designated thresholds aren't met—into their road maps.

An agricultural company was uncertain about whether it could attract enough interest in an asset it was putting up for sale. Senior management believed there would be a dearth of buyers able to support an acceptable valuation, given high consolidation in the market. Investment banks and some board members felt otherwise, however. There were also lingering questions about whether the costs and investments required to separate the asset's operations would outweigh the benefits of a potential sale. The divestiture team addressed these concerns by building into its separation road map a series of stage gates, one at each phase of the sale process. In this way, senior management and the board could conduct frequent cost–benefit analyses and formally consider whether to proceed with or halt any disentanglement activities. In fact, the separation was put on hold after the initial bids for the business failed to meet predefined valuation thresholds at a certain stage gate.

Divestitures can be challenging for the teams tasked with executing them. But by defining the assets in question, marketing them effectively, and anticipating the complexity of disentangling them from the existing businesses, executives can keep the focus on creating the most value for buyers and sellers alike.

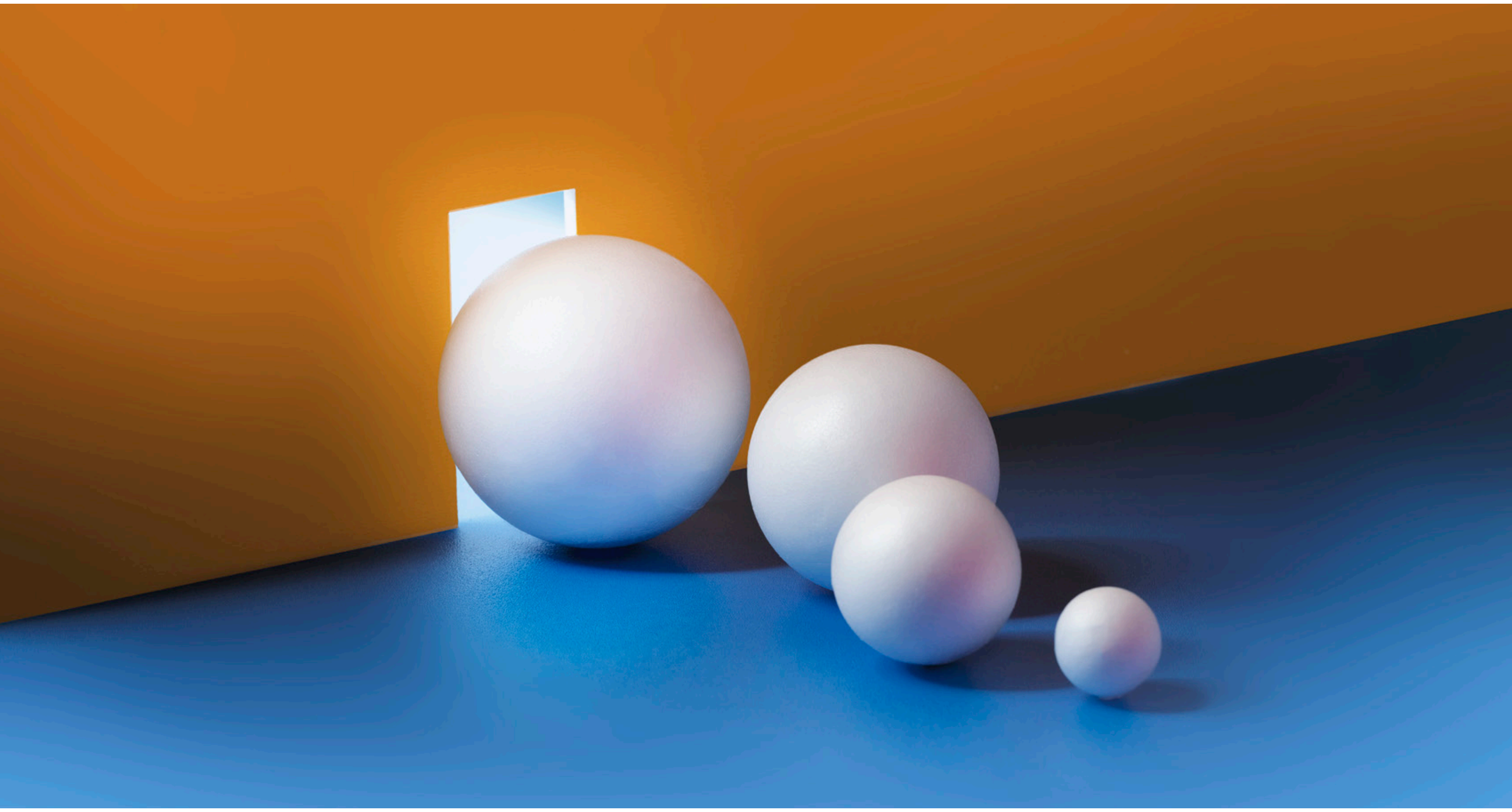
Jamie Koenig (Jamie_Koenig@McKinsey.com) is an associate partner in McKinsey's New York office, **Anthony Luu** (Anthony_Luu@McKinsey.com) is an associate partner in the Dallas office, and **Steve Miller** (Steve_Miller@McKinsey.com) is a partner in the Houston office.

The authors wish to thank Gerd Finck, John Henry Ronan, and Joe Waring for their contributions to this article.

What's keeping you from divesting?

Active portfolio management can create significant competitive advantages. Still, executives routinely shy away from separations. Here are six common roadblocks and some tips for breaking through.

by Gerd Finck, Jamie Koenig, Jan Krause, and Marc Silberstein



You've taken a close look at your portfolio and identified the assets that are no longer strategic priorities. Now what? Logic would dictate that you kick off a divestiture process—that is, you convene a deal team to define key process steps in the separation and then market the assets in question to potential buyers.

A recent survey of business leaders, however, confirms that this process gets abandoned more often than not, for a variety of reasons—among them, senior management's perception that disentangling the assets will be too complicated or that there will be few interested buyers. Executives and boards often fear that divestitures will reduce the size of a company in ways that will make it difficult to replace earnings.

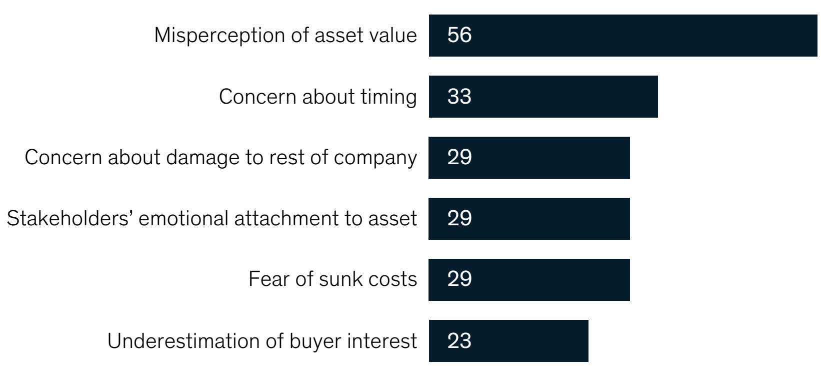
Such fears are often unfounded. In fact, research continues to mount in favor of active portfolio management, in which companies constantly redeploy their capital toward areas of the business where industry dynamics and their competitive advantages maximize ROIC. A recent McKinsey study shows that among companies in the sample, the 23 percent that regularly refresh 10 to 30 percent of their portfolios through acquisitions and divestitures outperform the others in total returns to shareholders (TRS) by an average of 5.2 percent a year.[1]

A recent survey of 128 senior business leaders helped us pinpoint the most common obstacles to divestitures. Respondents say one or more of the following six concerns had prevented them from pursuing a divestiture in the past ten years: misperception of asset value, underestimation of buyer interest, concerns about damage to the rest of the business, concerns about timing, fear of sunk costs, and stakeholders' emotional attachment to the asset (Exhibit 1). With 52 percent of the respondents also indicating that they

Exhibit 1

Executives cite six common obstacles to divestiture.

Roadblocks cited as 1st- or 2nd-most frequent divestiture inhibitor, % of respondents[1]



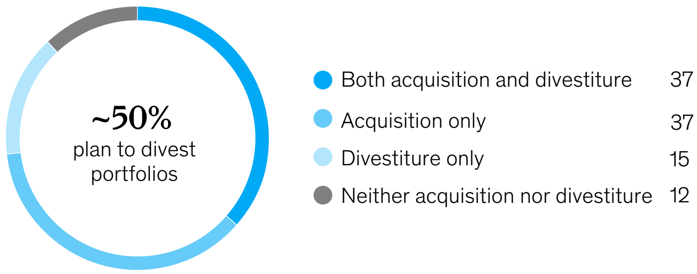
[1]Multiple answers allowed; n = 128.
Source: McKinsey survey of executives, board members, and corporate-development and -strategy leaders in June 2020

[1] This McKinsey analysis of 209 major international companies from a cross-section of industries measured average excess total returns to shareholders from 2007 to 2017. The refresh rate was defined by how much of a company's revenues came from business areas or service lines different from those ten years earlier.

Exhibit 2

A majority of surveyed executives expect their companies to shift their portfolios in the next 18 months.

Expect company to make acquisitions or divestitures in next 18 months, % of respondents[1]



[1]Figures may not sum to 100%, because of rounding; n = 128.
Source: McKinsey survey of executives, board members, and corporate-development and -strategy leaders in June 2020

expect to conduct divestitures in the next 18 months (Exhibit 2), now is the time to confront these challenges. In this article, we take a close look at each obstacle and suggest possible moves business leaders can take to overcome them.

Asset value

Business leaders often decline to part with an asset because they believe that its value is far greater than what anyone would be willing to pay for it. That belief is frequently rooted in unrealistic growth expectations for the asset—the traditional hockey-stick projection[2]—which fail to come to fruition year after year. So even when executives perform high-level valuation analyses and flank them with trading multiples, that fact base might not be sufficient to address biases in management's business plan or to consider realistically how valuable the asset might be to different types of buyers.

A better approach is to build a detailed, outside-in valuation model that factors in different business and market scenarios under current and other ownership. The executive team of a diversified utility company did just that. It established an outside-in perspective on the value of a business unit it had considered parting with, looking at the unit from the perspectives of different potential buyer groups (competitors, private-equity firms, infrastructure funds, and so on). In parallel, the team comprehensively reviewed the business unit's internal business plan and challenged the viability of its strategic initiatives.

Through this review, the executive team learned two things. First, there was a potentially strong market for the business unit among private-equity buyers and infrastructure funds, which could bring greater agility, focus, and flexibility to the asset. Second, the existing plan of the business unit didn't reflect the significant capital investments and other resources that would be necessary for its strategic initiatives to succeed. Once the executive team factored in the significant near-term cash needs, the picture looked very different. The team decided to divest now rather than await cash flows that would be unlikely to materialize—and it prepared its

[2] See Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," *McKinsey Quarterly*, April 19, 2018, McKinsey.com.

marketing materials in a way that would point out the value-creation opportunities for financial buyers, among others.

Buyer interest

In our experience, executives tend to limit the universe of potential buyers for an asset to the usual suspects or those already active in the industry. This, of course, leaves out a wide swath of potential suitors. One European utility sold its majority position in the operator of a electricity-transmission system to a consortium of more than a dozen infrastructure funds and life, pension, and health-insurance companies. The buyers had no previous exposure in the electricity sector but were attracted by the system operator's stable cash flows.

Business leaders seeking to divest should consider potential buyers within adjacent industries and geographies, new market entrants and disrupters, and financial sponsors, among others. These groups may be looking for new integration, cross-selling, or expansion opportunities. Executives may even want to consider alternative transaction structures—joint ventures and asset swaps, for instance—to entice parties that may not be in a position to acquire an asset outright.

An agricultural-equipment company seeking to exit production sites in several locations believed that antitrust authorities would block any sale of those sites to competitors. It abandoned its hopes of divestiture and began to assess shutdown costs. A further assessment of the situation, however, showed the executive team that the production sites held significant value for companies (even some financial sponsors) that didn't have operations in the region. Given the expanded range of potential buyers, the agricultural-equipment company decided to divest and took initial steps to determine how best to tailor its marketing messages to different types of buyers.

Damage to the rest of the company

Business leaders commonly believe that divestitures create too much upheaval for the rest of their companies—that it's too complicated to disentangle divested assets from the rest of a business and will take too much time, diminish economies of scale, and result in stranded costs. In our experience, however, the operations of a company can actually become more efficient as its portfolio is streamlined. As former Oppenheimer executive Laton Spahr put it, "Split the worm in half, and it grows two new heads. Now we've got two great companies."[3]

Rather than assume that the divestiture process may negatively affect the rest of the company, its leaders should review the possible effects systematically. First, they should formally document and assess the links or entanglements between the asset being divested and the rest of the business. Second, they should quantify the benefit of any links and entanglements and the value that could be lost by breaking them. Executives can use hard data on procurement, revenues, and margins to assess whether any losses in value could be offset or mitigated. Finally, they should evaluate the true effort required to disentangle the asset in question. A seemingly complicated divestiture process may actually be simplified by, for instance, redefining the scope of the separation or hammering out long-term commercial or manufacturing supply agreements.

It can also be helpful to draw a "separation road map" that captures all the activities associated with divesting an asset, the teams and functions affected, and the intended goals and milestones (see "Three degrees of separation: How to successfully execute divestitures" on page 12). One manufacturing company, for instance, wanted to sell off three assets. By conducting a detailed assessment of the potential effects on the company, its leadership discovered that some production lines associated with two of the assets would need to be shared 50-50 with any

[3] Jen Wieczner, "Activist investors love spin-offs. Here's why you should, too," *Fortune*, June 29, 2015, fortune.com.

buyer. Under these conditions, the manufacturing company would need to restructure its production footprint significantly, which could take years. The company decided not to divest these two assets. However, the process revealed that the third asset was operating on a stand-alone basis, with its own logistics network, procurement contracts, and IT systems. This made it a prime candidate for sale to a financial sponsor as a new platform company.

Timing

The reality is that the right time to begin the process of divesting an asset is the moment you recognize that it no longer supports your strategic objectives.[4] Business leaders who wait expectantly for market conditions to change often risk a continued decline in the asset's performance, accompanied by an increased need to divest, but now at potentially lower purchase prices.

In our experience, even significant changes in market conditions (for instance, the collapse of credit markets and COVID-19-related humanitarian and economic crises) rarely warrant abandoning divestiture plans. At worst, the sale process is put on hold for a few months until conditions stabilize. Under these conditions, sellers can make it easier to complete deals by looking at alternative structuring arrangements—for instance, purchase-price earn-outs, staple-on financing, staggered payments, and two-step acquisitions. Executives should remember that divestitures typically take 12 to 18 months from concept to deal close; today's challenges will look different by the time a deal is completed.

Sunk costs

After investing millions of dollars into a business or asset, executives often don't want to admit that they aren't the right owner to turn it around once performance declines. Rather than pull back when signs of significant financial or operational weakness appear, individuals and teams are inclined to escalate their commitment to losing courses of action.[5] By holding on, though, they are just delaying the inevitable.

To counteract this emotional bias, executives should change the way they evaluate their portfolios. For instance, during regular portfolio reviews, it can be helpful to have teams present conflicting opinions—the cases for and against divestiture—as a counterweight to arguments about sunk costs. The head of one industrial company convened red and blue teams to explore whether it was still the best owner of two lagging business units. One

The right time to begin the process of divesting an asset is the moment you recognize that it no longer supports your strategic objectives.

[4] Richard Dobbs, Bill Huyett, and Tim Koller, "Are you still the best owner of your assets?," November 1, 2009, McKinsey.com.
[5] Tim Koller, Dan Lovallo, and Zane Williams, "Bias busters: Pruning projects proactively," *McKinsey Quarterly*, February 6, 2019, McKinsey.com.

team explored the argument for divestiture, and the other explored options for retention. Both consulted with internal and external experts. Both made presentations to the executive-leadership team and the board. Through this process, executives discovered that it made good sense to divest one of the business units and to spin off the other as a joint venture. The latter deal ended up creating significant value for the company—value it would have foregone if it had continued to hold on to the unit because of sunk costs.

Attachment to asset

A range of stakeholders—boards, employees, shareholders, business partners, regulators, and policy makers—are affected by and can have adverse reactions to divesting assets. In our experience, business leaders seeking a divestiture will need to have a consistent message about it—for instance, “We are doing this because this business unit is exposed to different cycles, markets, and customers and would therefore fare better as a stand-alone company.” Once this rationale is established, business leaders can tailor the message for each stakeholder group.

For example, business leaders can remind *the executive team and the board* that, rather than damage the entire company, a divestiture will free up limited capital to reinvest in critical or new strategic priorities. The forms of analysis described previously can be used to gather the important data required to make this case. Any board discussions should focus on the creation of long-term value rather than possible reactions of short-term investors during the quarters immediately after divestiture.

Since the decision to divest will have outsize effects on *employees*, business leaders should be transparent about what it means for employees personally and what it means for the company’s future. Let them know, for instance, about the additional growth opportunities each stand-alone business will be able to pursue if it doesn’t have to compete for resources with other, disconnected businesses.

In addition, ensure that *shareholders* understand the value-creation opportunities from divestiture, the intended outcomes of the process, the potential resources required, and the planned timing. Ultimately, divestitures are intended to create incremental value for shareholders, so make sure you bring them along on the journey.

Most business leaders understand the need—now more than ever—for active portfolio management. Yet delivering on the promise of divestitures remains a challenge for many. By taking a pragmatic and structured approach to evaluating divestiture candidates and opportunities, executives can greatly improve their odds of success and shift their portfolios into a higher gear.

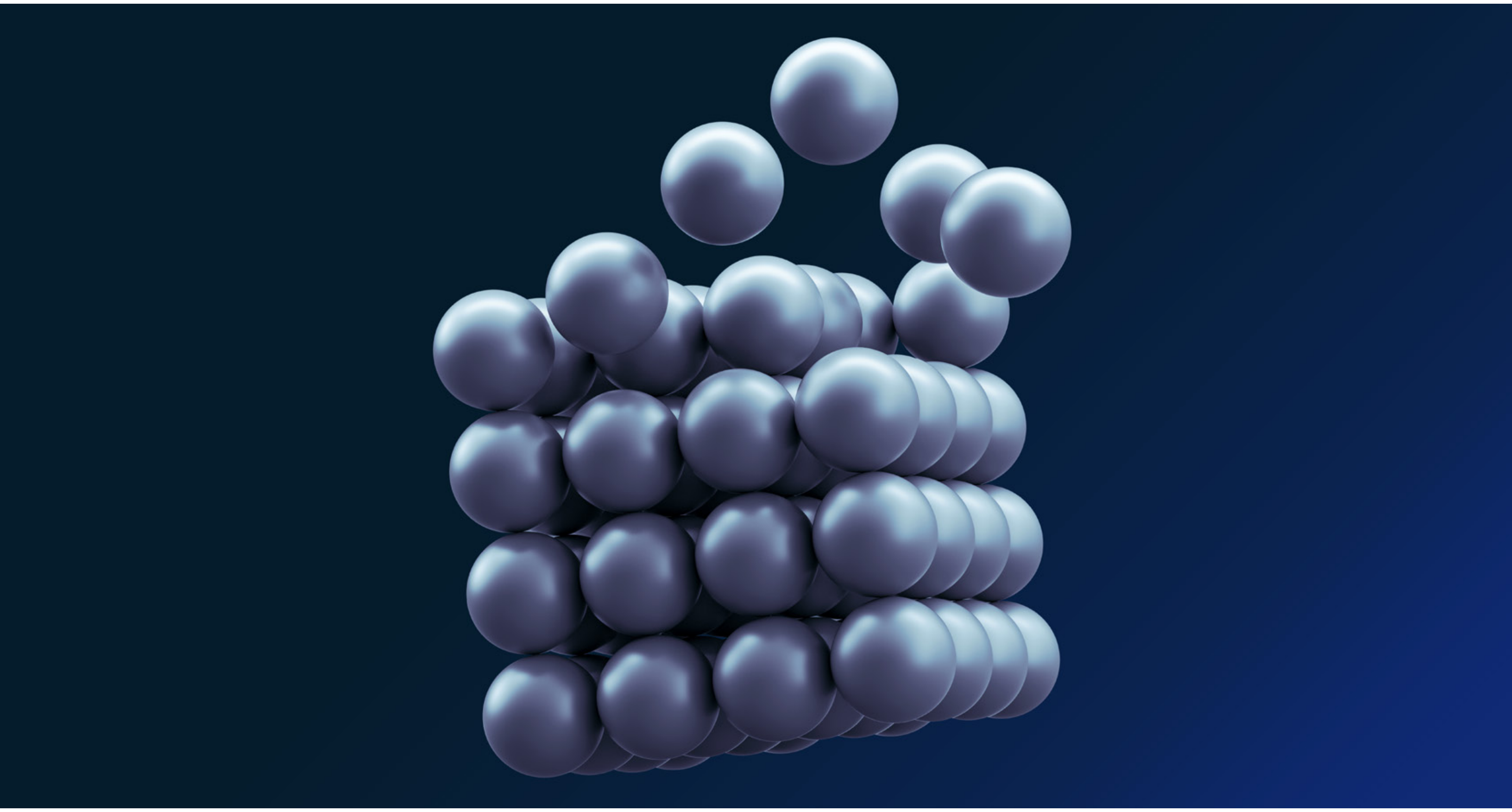
Gerd Finck (Gerd_Finck@McKinsey.com) is a senior expert in McKinsey’s Düsseldorf office, **Jamie Koenig** (Jamie_Koenig@McKinsey.com) is an associate partner in the New York office, **Jan Krause** (Jan_Krause@McKinsey.com) is a partner in the Cologne office, and **Marc Silberstein** (Marc_Silberstein@McKinsey.com) is an associate partner in the Berlin office.

The authors wish to thank Anthony Luu and Steve Miller for their contributions to this article.

Divesting with agility

Research shows that active, efficient reallocation of resources creates better returns for companies than simply standing pat does. Here's how to make portfolio decisions faster.

by Obi Ezekoye and Anthony Luu



Recent McKinsey research revealed that, over a ten-year period, companies that regularly refreshed between 10 and 30 percent of their portfolios through acquisitions and divestitures outperformed the market by about 5 percent[1] (see "Why you've got to put your portfolio on the move" on page 4).

There's value in a proactive approach to asset reallocation. Too often, however, companies hesitate to move critical resources to the more attractive business prospects, refusing to part with even under-performing assets. Why? Corporate-development executives tell us there are number of reasons, including fear of missing out on a business unit's resurgent performance, perceived inability to replace lost earnings, and concerns about shrinking the company too much.[2]

Companies' traditional portfolio-review processes—which, in most businesses, tend to happen only every few years—can further encourage companies to drag their feet when it comes to making divestiture decisions. Meanwhile, with markets moving faster than ever, speed and the commitment to act are both at a premium. Our research shows that, on average, separations completed within 12 months of their announcements delivered higher excess total returns to shareholders than did those that took longer.[3]

Given this backdrop, companies will need to adopt an agile model for managing their portfolios and making allocation decisions. Such a model should emphasize a tried-and-true approach to frequent portfolio reviews that gives corporate-development leaders the detailed insights they need to make divestiture decisions more quickly and confidently.

Agile portfolio reviews

Companies facing resource-allocation decisions must prioritize those business units or assets that can create the most value for the company and those for which the company is the best owner—that is, best able to extract more value than any other potential owner. To that end, regular portfolio reviews can reveal how each business fits within the company's overall strategy. Companies can use the

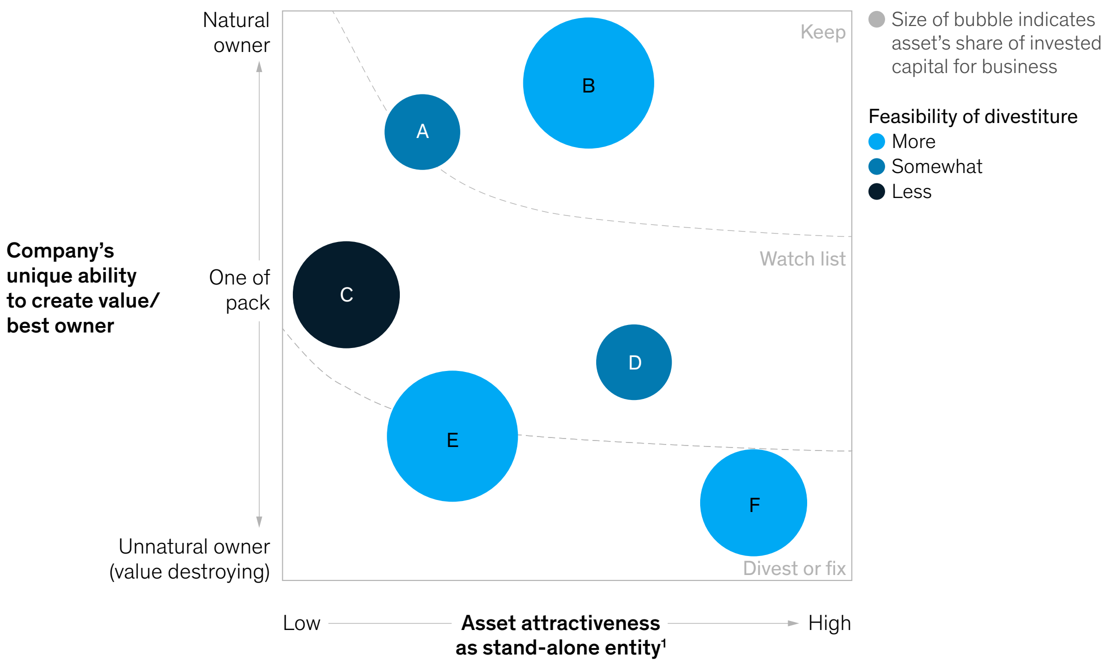
Companies' traditional portfolio-review processes—which, in most businesses, tend to happen only every few years—can further encourage companies to drag their feet when it comes to making divestiture decisions.

[1] See Obi Ezekoye and Jannick Thomsen, "Going, going, gone: A quicker way to divest assets," August 6, 2018, McKinsey.com.
[2] See Gerd Finck, Jamie Koenig, Jan Krause, and Marc Silberstein, "What's keeping you from divesting," September 18, 2020, McKinsey.com.
[3] See "Going, going gone," August 6, 2018.

Exhibit 1

A standardized framework for portfolio reviews can help companies determine which assets to divest and how quickly to do so.

Illustrative framework for asset assessment



[1]Regardless of relationship with parent company.

market-activated corporate-strategy framework,[4] which maps the company's unique ability to own or create value from an asset against the asset's attractiveness as a stand-alone entity (Exhibit 1).

But the typical three- to five-year time frame for portfolio reviews is no longer sufficient or practical to keep up with markets that are continually churning. Our research and experience in the field reveals the importance of revisiting portfolios and reconsidering ownership status much more frequently. The pace of reviews should match the pace of change in the industry—for instance, semiannually, or even more frequently, if new market entrants, disruptive technologies, or other competitive factors emerge.

To review portfolios more frequently, business leaders must adopt a reliable, repeatable process for doing so—one in which business leaders define the company's portfolio aspirations at the outset and then regularly monitor the company's performance toward those goals. They should assess the speed and frequency with which sources of revenue can be shifted and how resilient a portfolio is to market change. They should rely heavily on standardized metrics—for instance, assigning performance rankings and scores to elements of the portfolio and continually adjusting those metrics based on the latest information. Business leaders should routinely consider the portfolio's overall performance against peers, for instance, and against investors' expectations.

[4] Frederick W. Gluck, Stephen P. Kaufman, Ken McLeod, John Stuckey, and A. Steven Walleck, "Thinking strategically," *McKinsey Quarterly*, June 1, 2000, McKinsey.com.

The information generated by this analysis can reveal to business leaders whether they are truly still the best owner of an asset, as well as how feasible it is to disentangle an asset from the rest of the company. A global manufacturer of industrial goods, for instance, conducted a portfolio review as part of its annual strategic-planning process and identified opportunities to divest a business unit for which the company no longer seemed to be a natural owner. The review also showed that sales operations would be difficult to disentangle: in some countries, the business unit's sales operations would need to sell products that the manufacturer would be divesting along with products that the manufacturer would be keeping. Given this twist, senior management decided to keep the business unit but initiated a plan to stand up the business unit formally so that its performance could be tracked and reported separately. In this way, the manufacturer created clear lines of accountability and preserved the option to divest the business unit in the future.

Agile decision making

Even after a thorough portfolio review, executives need time—to consider short-term performance against long-term prospects, for instance, or to get additional buy-in from the board or other key leaders. The good news is that taking an iterative, or agile, approach to portfolio reviews can increase transparency among these business leaders, mitigate organizational inertia and internal biases, and make conversations more inclusive—all of which can help business leaders coalesce around value-creating divestiture decisions as opportunities arise, not after they have come and gone (Exhibit 2).

A global consumer conglomerate examined its portfolio during its strategic review of the business. The company wanted to shift its portfolio toward more profitable segments and to identify the optimal mix of assets, opportunities for divestiture, and potential investment themes. When senior management reviewed the company's goals and performance in prior M&A activity, it found that the company had generally delivered below-average returns compared with internal benchmarks. With these data in hand, and through a series of regular portfolio reviews that followed, senior managers were able to clarify the company's M&A strategy as well as its overarching strategy and how the two could complement one another. This analysis empowered the company to define several M&A themes and pursue investments that were more in

Exhibit 2

An agile approach to portfolio decision making can help companies address increasingly dynamic markets.

	Static decision making	Agile decision making
Assessment approach	• Inconsistent approach; situation specific • Addresses question, "Should we sell this?" • Subjectivity and organizational politics at play	• Consistent framework; applied to all assets • Addresses question, "Are we the best owner of this?" • Objective, transparent process and clear metrics help mitigate biases • Emphasizes feasibility and opportunity to divest rather than infeasible recommendations or "excuses" to defer decisions
Frequency	• Reviews done in response to crisis or infrequently	• Reviews conducted annually, at least; health checks conducted alongside industry or market events; continual refresh of analyses with relevant data (eg, M&A trends, new technologies, emerging markets)
Prevailing mindset	• Fear of making big moves to shed underperforming assets; decisions and execution stalled	• Open to taking action and using creativity to navigate roadblocks before market sentiment moves; incentives aligned both to grow revenues and to create value

line with its overarching strategic goals, thereby increasing the odds of delivering higher returns from its moves.

Having the infrastructure in place to monitor portfolio performance and speed up decisions about divestiture is particularly critical in industries prone to disruption from new technologies, activist investors, or geopolitical shocks. At one technology company, for instance, business-unit heads are asked to bring both suggested acquisition targets and suggested products to divest at every strategic review. They must make a case for keeping certain products and, at times, are asked to trade a current product in the portfolio for a target they think is worth acquiring. These sessions have forced business leaders to break from the status quo, and they have pushed the management team's thinking on portfolio moves.

Meanwhile, the incoming CEO at a software company initiated a portfolio review within their first weeks on the job. Growth had been stagnant, and the new CEO was anticipating action from an activist investor. Through the review, the CEO discovered several near- and long-term options to divest assets and improve the portfolio. The CEO and senior-management team used the information from the review to set a bold strategy for the company, as well as a road map for making it happen—which they shared with the activist investor on their own terms. The executive team won over the investor and gained broad support for transforming the company.

Agile portfolio management continues to be one of the biggest levers to improve company performance. It's vital to have a clear, unbiased view of how assets are performing and which ones are still creating value for the company. Agile portfolio managers can use the mechanisms described in this article and others to avoid emotional attachments to legacy assets. And once a decision is made to divest, managers must act—finding ways to navigate potential roadblocks creatively and maximizing value before the market shifts again.

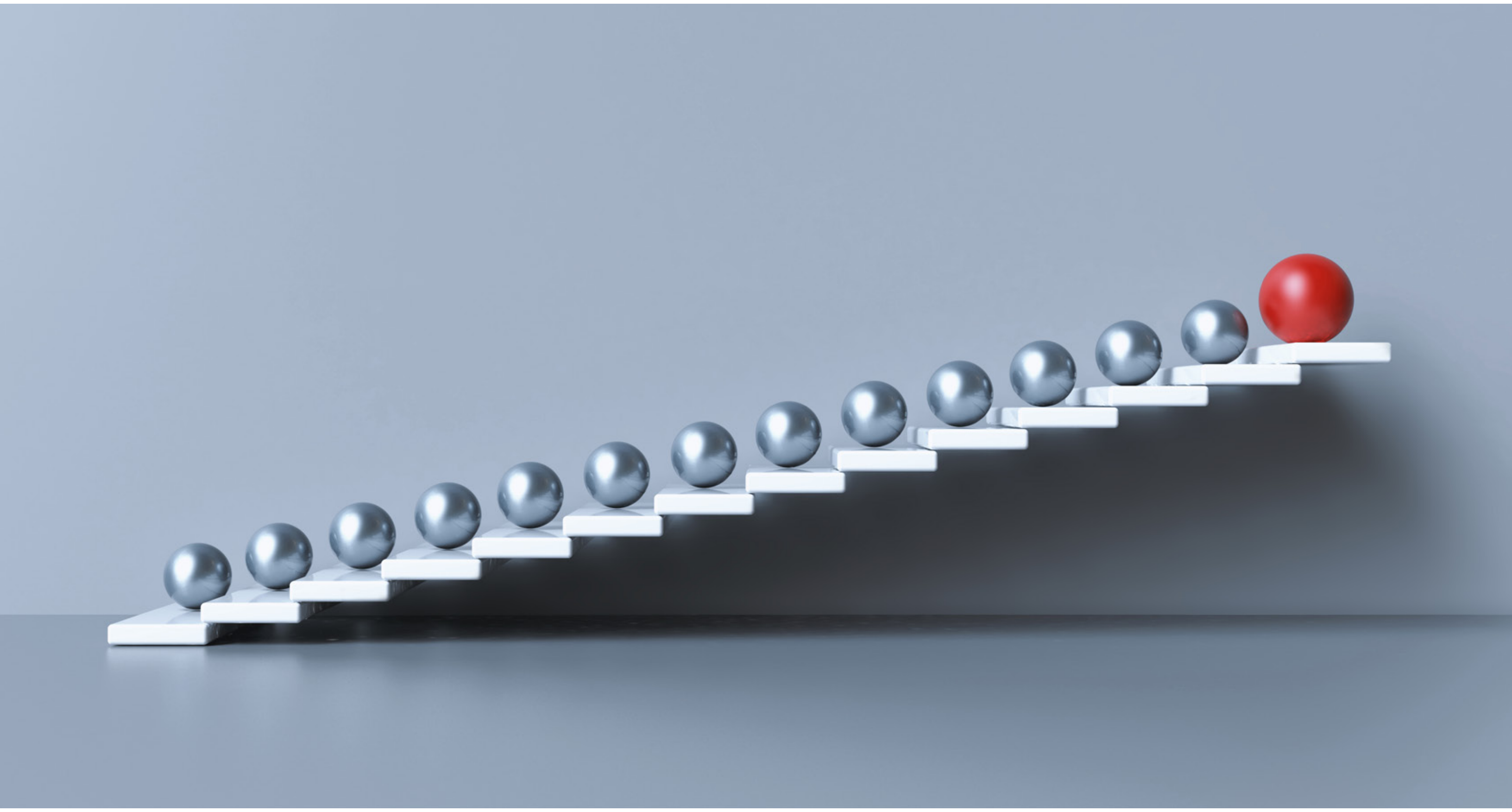
Obi Ezekoye (Obi_Ezekoye@McKinsey.com) is a partner in McKinsey's Minneapolis office, and **Anthony Luu** (Anthony_Luu@McKinsey.com) is an associate partner in the Dallas office.

The authors wish to thank Ajay Dhankhar, Jannick Thomsen, and Andy West for their contributions to this article.

Deciding to divest? Make your preparation time count

LiveRamp president and CFO Warren Jenson explains how the up-front work companies do on communications, planning, and analysis can boost the odds of success in separations.

by Anthony Luu and Paul Roche



All too often, business leaders lament the one that got away—the deal they didn't pursue or targeted too late. They back away from carve-outs and divestitures for any number of reasons, including concerns about timing, sunk costs, damage to the rest of the business, and misperceptions about asset value (see "What's keeping you from divesting?" on page 18). Senior leaders at LiveRamp (formerly a division of Acxiom) held some of those same fears. But they acted anyway, driven by the desire to transform a business and bolstered by a comprehensive divestiture-preparation process.

In 2014, Acxiom bought the technology start-up LiveRamp for $310 million in cash. Four years later, leadership sold most of Acxiom to a corporate buyer for $2.3 billion. The remaining company, LiveRamp, now provides customer-relationship-management software that companies use to build better end-user experiences. Having the courage to say "yes" paid off: the transformed LiveRamp was able to retire about $230 million in debt, return more than $750 million of capital to shareholders, pursue other strategic acquisitions, and fund further growth and innovation.

In a conversation with McKinsey's Anthony Luu and Paul Roche, LiveRamp president and CFO Warren Jenson shared some lessons for others struggling with divestiture decisions. Hint: it's all about courage and preparation. The following is an edited version of their conversation.

McKinsey: *How did you decide to divest?*

Warren Jenson: When our current leadership team joined Acxiom about nine years ago, we did so with a vision that the company could be the bridge between the on- and offline worlds of marketing and advertising. Three years into our tenure, we made a big strategic bet and bought LiveRamp. We paid a high price for this relatively small but fast-growing SaaS [software-as-a-service] business, and over the next several years, two strong but very different businesses emerged. Acxiom Marketing Solutions [AMS] was our slow-growth, high-touch service business that generated a lot of cash. LiveRamp was our high-growth SaaS platform, and while it had significantly fewer employees and lower capital requirements, it was also still very much in investment mode—in other words, losing money.

Each business had very different valuation characteristics and attracted opposite investor types. Through our portfolio analysis, we realized that a divestiture could unlock more value from both entities but only if we structured the deal in a way that resulted in two healthy businesses, each with the capability to flourish on its own, and each with the right investor set—value-oriented investors for AMS and software and growth-oriented investors for LiveRamp.

McKinsey: *What obstacles did you face at the outset of the process?*

Warren Jenson: There were all kinds of challenges. The biggest one was the fact that we were considering strategic options for a business that represented 75 percent of our revenue and employees, 100 percent of our cash flow, and approximately 90 percent of our assets. LiveRamp was a good young company but with a lot yet to prove. Ultimately, we were betting on our ability to reach a good outcome for AMS on our ability to run LiveRamp as a successful independent company, and that investors would support our strategy and react positively.

Defining the carve-outs was also a big deal, both strategically and operationally. We had to get the right assets and people in the right places to ensure ongoing support for our customers and the health of each business. We also had to get our management team to buy into the divestiture and convince our board that it was the right strategic decision and that it made financial sense. We had to consider the structure of the deal and evaluate the relative benefits of a sale, a tax-free spin, a nontaxable merger, and other financial alternatives. Finally, we needed to make a decision on timing and how to communicate our transformation story to key stakeholders, including employees, customers, and investors.

McKinsey: *How did you address those obstacles?*

Warren Jenson: Let me start with how we defined the carve-out. We actually started the process of separating our businesses into stand-alone structures more than two years ahead of announcing that we were exploring strategic options for AMS. As part of the separation, we knew each entity would need to have complete, independent, and auditable financial statements. We knew that having all these elements in place would give us true optionality. We also knew this would allow us to move quickly and be transparent with all constituents, including our investors.

To build investors' confidence in our valuation assumptions, we worked with financial advisers to come up with a carefully defined valuation range. We did a lot of complex modeling, running a scenario analysis to account for a variety of strategic, operational, and financial variables. Things like asset allocation and mix were often the subject of debate, so we went through a lot of iterations. We considered scenarios in which LiveRamp would emerge as only a moderate-growth company producing higher cash flow, for instance, as well as scenarios in which various parts of AMS went with LiveRamp. In the end, we chose to look at strategic alternatives for AMS and keep the high-growth

Warren Jenson

Education
Holds a bachelor's degree in accounting and a master of accountancy degree, both from Brigham Young University

Career highlights
LiveRamp
2018–present
President and CFO

Acxiom
2012–18
CFO, executive vice president, head of technical operations, and president of international

Silver Spring Networks
2008–11
COO

Electronic Arts
2002–08
CFO

Amazon.com
1999–2002
CFO

Delta Air Lines
1998–99
CFO

NBC
1992–98
CFO

Fast facts
Warren Jenson has been named twice to *Institutional Investor's* Best CFOs in America list. He was honored as Bay Area Venture CFO of the Year in 2010. He serves on the boards of Cardtronics, Tapjoy (a privately held company), the Brigham Young University Marriott School of Business, and the University of Southern California Marshall School of Business.

“When you’re defining a carve-out, remember that everyone has to win; both companies need to come out of the process strong and healthy.”

software business. By the end of 2017, we had a pretty powerful valuation story to tell, and our board was ready to move.

Our end-to-end communications about the divestiture were completely transparent. In February of 2018, we publicly announced that we were beginning a process to explore strategic alternatives for AMS. We explained to employees how we intended to map various roles across both entities and communicate with those affected by the divestiture of AMS. In such situations, no solution is perfect, but we tried to eliminate as much uncertainty as possible. With investors, we shared pro forma financials for a stand-alone LiveRamp, including our approach to reduce overhead and our expected transition costs. Even after the transaction, we continued to share information about these costs; we specifically called them out in our financial reporting until they were fully absorbed.

McKinsey: *What challenges did you face during the execution phase of the divestiture?*

Warren Jenson: When the time came to launch the divestiture, we were ready. We had mapped every asset and employee to one of the two entities. We had prepared and documented more than 125 separate transitional service agreements between LiveRamp and the eventual buyer, as well as eight major intercompany agreements. Having auditable financial statements in place for each entity saved us a ton of time. The biggest challenge was finding the right partner. At least 100 of our customers were customers of *both* LiveRamp and Acxiom, so it was critical to identify good strategic partners.

Initially, we considered a wide range of potential partners, but we took care to qualify all the participants and narrowed down the list significantly. In the end, IPG emerged as the best home for AMS—one that could unlock significant value for our shareholders. The timeline for the deal is evidence of our preparation. We announced our strategic exploration in early February 2018, then announced the transaction with IPG in July 2018, and we closed the deal in October 2018.

McKinsey: *Fear of shrinking has kept lots of companies from pursuing separations and divestitures. How did you overcome that bias?*

Warren Jenson: You need courage at the top and relatively fearless leadership in your pursuit of value creation. Scott Howe, our CEO, provided that. There are a thousand times in a process like this where you can easily stop; some people don’t ever start. The process worked for us because we believed in the vision, and we had confidence in our numbers and analysis. In addition, we maintained optionality. We knew we could continue to run the business as is; we hadn’t limited our ability to do so. When we announced that we were looking at strategic alternatives, we were open to anything that took us to our desired end state. It could have been a partnership or a tax-free merger. It ended up being a sale, but we never closed any doors. Through our preparation, we not only protected but also increased our optionality and value.

McKinsey: *What effect has the divestiture had on the business?*

Warren Jenson: While our company became much smaller, it also became more valuable—just as we had envisioned. Since early 2018, our share price has more than doubled, we have a strong balance sheet, and we have returned more than $750 million in value to shareholders. The capital influx resulting from the sale allowed us to execute an independent strategy for LiveRamp. And the best thing about the deal is that AMS is also flourishing under its new owners.

McKinsey: *What might you have done differently? What advice do you have for others pursuing such transactions?*

Warren Jenson: There were a few places in the original intercompany agreements where we wish there had been more clarity—nothing material but where we wish we had another turn of the crank. The lesson there is, the more buttoned up you are going in, the better. My advice to everyone exploring divestitures, separations, and carve-outs is to start with vision and strategy. Moves like this have to make strategic sense and show a clear path to value creation. When you're defining a carve-out, remember that everyone has to win; both companies need to come out of the process strong and healthy. To that end, you need a clear process for making hard calls—our CEO; our chief strategy officer, David Eisenberg; and I were the tiebreakers. We also learned that up-front planning is everything and that business leaders shouldn't skimp on resourcing. Transactions like this are a huge undertaking and can crush your team. They take real teamwork, the right set of advisers, and a willingness to change course constantly.

Comments and opinions expressed by interviewees are their own and do not represent or reflect the opinions, policies, or positions of McKinsey & Company or have its endorsement.

Anthony Luu (Anthony_Luu@McKinsey.com) is an associate partner in McKinsey's Dallas office, and **Paul Roche** (Paul_Roche@McKinsey.com) is a senior partner in the Silicon Valley office.

The one task the CFO should not delegate: Integrations

The numbers show that when the finance chief is directly involved in identifying potential synergies, transformation and value-creation opportunities, and cultural pitfalls, companies see greater deal success.

by Ankur Agrawal, Brian Dinneen, Edward Kim, and Robert Uhlaner

Today's CFO is busy in ways that previous generations of finance leaders couldn't have anticipated, with more responsibility for corporate strategy, board engagement, digital initiatives, and the like.[1] As the list of tasks grows, it's important for the CFO to identify and prioritize those business activities in which they can help create the most value for the organization. Our research shows that M&A has become one of those critical areas of focus.

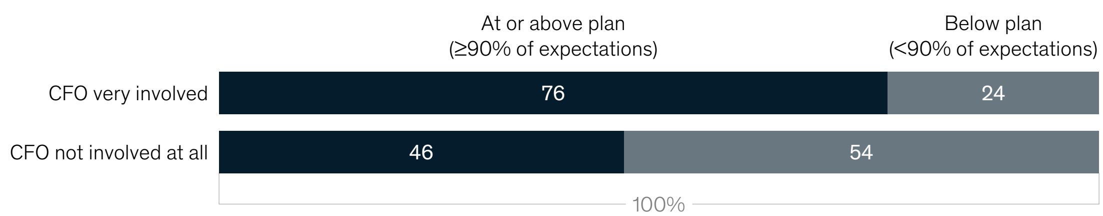
Of more than 200 global CFOs polled, 39 percent say they played major roles in initial merger strategy; 42 percent report involvement in deal execution; and 37 percent say they were involved in merger integrations. In all three categories, the numbers had increased since the previous years' findings. Even more revealing, when the CFO was "very involved" in merger integrations, companies were much more likely to capture cost and revenue synergies that were at or above plan (exhibit).

To integrate companies and cultures successfully, business leaders must have an informed perspective on the synergies to be captured, the transformation opportunities to be pursued, the value to be created, and the cultural pitfalls to steer clear of. The CFO operates at the nexus of all these concerns and has both the information and the expertise to provide that perspective and help lead the way.

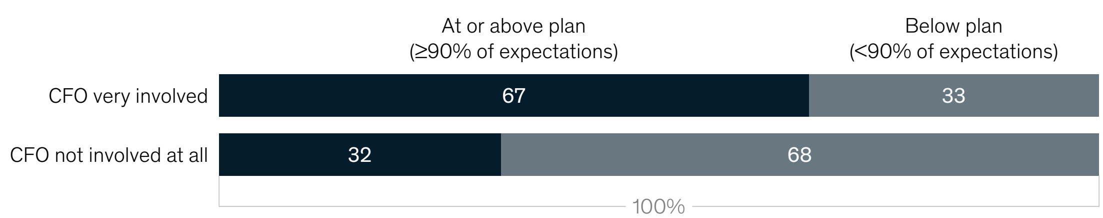
Exhibit

Cost and revenue synergies are more likely to be achieved when the CFO is involved in merger integrations.

Cost synergies achieved, % of respondents[1]



Revenue synergies achieved, % of respondents[1]



[1] Survey was conducted online April 18–30, 2018, garnering responses from 414 C-level executives and senior managers, and via phone interviews June 20–July 2, 2018, garnering responses from 34 CFOs. In total, 212 CFOs at company, functional, or business-unit level responded to the survey. To adjust for differences in response rates, data are weighted by contribution of each respondent's nation to global GDP.

[1] "The new CFO mandate: Prioritize, transform, repeat," December 3, 2018, McKinsey.com.

Whether and how the CFO chooses to do so can determine the success or failure of large integrations and corporate transformations. In our research, in the companies that outperformed peers, for instance, the CFO went above and beyond simply providing guidance on synergies: 49 percent of respondents in outperforming companies say the CFO had designed the company's "transformation road map" (versus only 34 percent of peers saying the same). They point to the CFO as a cultural role model: 47 percent say the finance chief took the lead in developing the capabilities required to support integration, and an additional 41 percent say the CFO was instrumental in encouraging new mindsets and ways of working in the wake of integration. Additionally, respondents in outperforming companies saw the CFO take on an important communication role—for instance, setting high-level goals for integration and transformation and communicating them effectively to both internal and external audiences.

In this article, we take a closer look at the varied roles the CFO can play in ensuring that companies capture the most value from critical deals.

Synergy leader

The synergy leader is perhaps the most obvious role for the CFO to play in integrations, given the impact of such transactions on company financials and valuations. The finance chief must establish an end-to-end process for capturing the most value from a deal. This process involves assessing potential synergies, building forecasts and scenarios, and involving top leaders in financial planning and analysis (FP&A) to ensure that financial and strategic objectives can be met once the deal is completed. It means proactively weaving synergy targets and metrics into current financial processes—for example, building one-time costs into budgets and creating incentive plans that support deal objectives.

Ideally, the CFO starts this process during pre-close planning by developing a baseline that maps the costs for similar activities and business processes across the companies being merged. A detailed baseline can often be more effective than standard benchmarks; it becomes a "treasure map" that the CFO can use to identify duplicate costs quickly and rationalize the people, processes, and systems. As any finance chief will admit, it can be onerous to incorporate every single detail into the baseline, but it's worth the effort to give business leaders the fullest possible picture of the combined company's financials and potential synergy opportunities.

The CFO can also help ensure that the company is targeting the full range of opportunities from the deal, not just those synergies required to justify it. The most successful CFOs put aside the deal model and "cleansheet" the design of the new organization—or reimagine the way work is done today.

On day one, the CFO can embed synergy targets and metrics into normal finance processes. For example, variance analyses and forecasting processes for the newly combined company should break out the direct effects of the deal. In our experience, the most successful integrations involve companies that are able to merge synergies into the budget within the first quarter, even for large, complex deals.

Through these actions, the CFO and top FP&A leaders can see and help remove roadblocks that are preventing a company from capturing value from an integration. For instance, the CFO at one software company continually monitored the progress of its integration with the target company, comparing objectives with outcomes and establishing a monthly review process to update forecasts associated with the initiative.

The software company aimed to combine its products with those of the target company, thereby reducing costs. The risk was that some customers might switch if their favorite products were discontinued. During one review, the CFO and finance team discovered that, in their attempts to rationalize products from both companies, they had overestimated the savings coming from slimmed-down product lines. Given the reduced savings, the CFO realized that certain products shouldn't be discarded. By forgoing some synergies, the company more than met its target customer-retention rate, which created even more value for the company than promised cost savings. The CFO's willingness to consider value, not just costs, helped make this deal successful.

Transformation sponsor

As most finance leaders know, a focus solely on traditional postmerger synergies, such as greater efficiencies and lower costs, will go only so far in creating the value most companies are targeting with M&A. With guidance from the CFO, business leaders can open the aperture and view integrations as opportunities for broader organizational and process change.

As a transformation sponsor, the CFO can facilitate discussions about the financial and strategic trade-offs that are inevitable in any merger—for instance, how to set up shared services, how to rationalize IT systems, or how to upgrade talent and capabilities.

In one recent integration, for example, the CFO reimagined what the combination of two large technology companies could look like. One had a strong brand and had increased market share by aggressively spending on marketing. The other had a lean operating model and was keen on cutting costs to invest in adjacent areas that promised growth. Rather than taking sides and saying one approach was right and the other wrong, the CFO took a market-back view of the companies' strategies and, with help from the finance team and business-unit leaders, conducted a zero-based-budgeting exercise to align the companies' cost structures.

The CFO also created a monthly review process that brought the combined leadership team together to debate openly the financial and operational choices and gain agreement on important issues. In this way, the CFO was able to guide the conversation by what was possible for the newly formed company instead of just looking for postmerger synergies. The CFO was also realistic about the costs required to achieve the merged company's potential. Teams were allowed to reinvest any synergies captured after the merger in transformational initiatives. For instance, senior leaders in both companies reduced

As a transformation sponsor, the CFO can facilitate discussions about the financial and strategic trade-offs that are inevitable in any merger.

More than other C-suite leaders, a finance chief has the information and expertise required to present a complete financial picture while tailoring a value story to each set of key stakeholders.

their marketing activities for certain products and reallocated some of those marketing dollars toward the launch of new offerings from the combined company.

Communication leader

Given proximity to the deal rationale and value-creation goals, the CFO is in a strong position to help senior management build and communicate a compelling story (from announcement through post-close execution) about how the acquisition has progressed and the potential outcomes from integration. More than the CEO and other C-suite leaders, the finance chief has the information and expertise required to present a complete financial picture while tailoring the value story to each set of key stakeholders—customers, suppliers, investors, employees, and board directors.

This capability is particularly important during integrations, in which the company will have new sets of investors with limited understanding of the combined entity or groups of employees being asked to work in the new entity without a clear sense of what the long-term organizational structure will look like. The wrong message to investors can make it appear as though an integration is off track. An overly simplistic message to employees may sound deceptive. An ambiguous update to the board may create anxiety about the true progress of the transaction.

The CFO can help senior management address key concerns from individual groups of stakeholders. In the case of one large healthcare-player merger, for instance, the CFO spoke frequently and consistently about merger priorities, time frames for capturing various synergies, and how the company was tracking synergies. The message was tailored for various stakeholders. For investors, the finance leader referenced the same metrics each quarter, with detailed supporting discussions on the progress made and opportunities that remained. For employees, the CFO continually referred back to the deal's priorities and their connection to changes made in performance management, financial metrics, and incentive rewards. For board members, the CFO emphasized transparency on milestones achieved, as well as on any challenges and risks (anticipated and unanticipated). The CFO also convened a special session in which the board and senior leadership conducted a full postmortem on the merger and identified things to do differently in future deals.

Cultural role model

Integrations inevitably pose cultural challenges for business leaders. This is particularly true for the finance function, as employees come together and realize that, given the many duplicative roles and processes, there might not be room for everyone in the new organization. As a highly visible member of the top team and the leader most closely associated with strategies and decisions relating to resource management and reallocation, the CFO is in a good position to ease such concerns and model the culture of accountability required in such situations.

Consider the following example. The CEO of AcquireCo selected the CFO from TargetCo to lead the finance function of the newly merged entity. Members of the finance function within TargetCo welcomed the news happily, of course, while their counterparts in AcquireCo were unsettled. Their anxiety increased further when, weeks later, the CFO who had been selected decided to leave the organization.

The new CFO leading the merger between AcquireCo and TargetCo had her work cut out for her. Her first task was to work with the new top team to outline a clear vision for the future of the finance function, factoring in the structural and cultural changes that would be required. She translated that vision into specific goals for members of the finance team. The CFO shared the merging companies' aspirations to automate specific tasks, thereby freeing up finance-team members to work on higher-order assignments. She also shared plans to move the finance organization to a shared-services model to take full advantage of scale and expertise across both companies. The CFO also publicly committed to retaining top talent because the merged businesses still needed support from different kinds of subject-matter experts.

The CFO's actions sent a message to the whole organization: that the transformation was central to the merged company's strategy and purpose, that top talent from both companies would be valued, and that she and other leaders would be accountable for successes or failures resulting from the changes. The finance leadership, inspired by the CFO, mirrored this culture of accountability.

CFOs already play a leading role in M&A execution. The number of hats they wear is multiplying, however, with an expanding focus on the end-to-end management and integration of such deals. The reward for taking on this added responsibility? Improved operating models and investor confidence, new capabilities, and value capture that goes beyond traditional synergies and veers toward meaningful transformation.

Ankur Agrawal (Ankur_Agrawal@McKinsey.com) is a partner in McKinsey's New York office, where **Edward Kim** (Edward_Kim@McKinsey.com) is an associate partner; **Brian Dinneen** (Brian_Dinneen@McKinsey.com) is a senior expert in the Boston office; and **Robert Uhlaner** (Robert_Uhlaner@McKinsey.com) is a senior partner in the San Francisco office.

Checking the health of your business partnerships

Frequent, systematic assessments of joint ventures and alliances can reveal hidden problems and opportunities to create more value.

by Ankur Agrawal, Kenneth Bonheure, and Eileen Kelly Rinaudo

Formal business partnerships—whether structured as joint ventures (JVs) or a series of alliances—can help companies enter new markets, manage risk, and optimize costs. But as many executives know, even well-designed partnerships can be challenging to establish and maintain, given inevitable changes in partners' priorities, market dynamics, or ongoing operations.

The partners in one healthcare-company alliance, for instance, were dutifully fulfilling the operational commitments they had agreed to, yet their joint initiatives were constantly falling behind schedule. In another JV, senior leaders of the chemical companies involved put lots of time and attention toward improving the JV's governance processes and operations, yet managers on both sides had to stave off employees' declining morale and increased attrition. In both cases, the success factors associated with strong partnerships were in place, but the outcomes didn't materialize as expected, which was confusing and frustrating for all involved (see sidebar, "The six building blocks of successful partnerships").

Like others in their shoes, the executives in these companies likely neglected a critical task: regularly monitoring the health and performance of their business relationships. Their actions mirror those of an individual who wants to get in shape and commits to following certain dietary restrictions and exercise routines but never schedules a visit with a doctor to assess how effective the changes have been.

By contrast, leaders in high-performing JVs and alliances routinely perform a "partnership health check." They review the goals and guiding frameworks for the partnership, conduct interviews with leaders, and measure performance against jointly defined health metrics. And they put all their business relationships through these paces, no matter how old, how new, or how geographically dispersed.

In this article, we describe what such a health check looks like and how business leaders can use it to track the trajectory of critical business relationships, adjust them as necessary, and create more value from them.

Health checks and balances

It may seem obvious to partner companies that they should regularly monitor the progress of their JVs and alliances. But knowing and doing are two separate things, and often it takes time and intentional effort for partner companies to get on the same page.

When a high-tech company and a consumer company were negotiating the terms of their partnership, for example, leaders in both companies realized they were using similar language but in different ways. The high-tech company's definition of a "priority decision" was focused on speed, or the ability to make a key decision within a certain time frame. Conversely, the consumer company's definition was focused on process, or the ability to get senior partners to agree on a course of action. This mismatch in terminology accounted for several misunderstandings within the partnership early on.

It's important to establish a clear set of health-check protocols from the outset of the relationship—during negotiations if possible. Specifically, the partner companies should outline the processes and tools (and, yes, even the language) they will use to assess the business relationship. The earlier this occurs, the more likely it is the partners will adhere to consistent, periodic reevaluations.

Ideally, the health check should be conducted at predetermined times—typically annually. The review process is often coordinated by the manager of the alliance or JV, with support from important stakeholders within each partner organization. The results are typically shared with the partnership's steering committee or JV board as well. Some partnerships

The six building blocks of successful partnerships

In our experience, executives need to focus on the following six building blocks to succeed with business partnerships:

- *Strategy*—gaining agreement on the partnership's objectives
- *Culture and communication*—encouraging open and trust-based communication among all parties
- *Operations*—establishing a new operating model and performance metrics (for instance, sales or quality-assurance metrics)
- *Governance and decision making*—adhering to key decision processes, metrics regarding speed of decision making, stage gates, and timelines
- *Economics*—defining how value will be created from the partnership
- *Adaptability*—proactively planning how to tend the relationship over time in the wake of industry and organizational shifts

In general, executives understand the need to be diligent in all these areas; however, based on our observations and experiences in the field, the areas most likely to be underemphasized are those of culture and communication and of adaptability.

will even tap a trusted adviser or former board member to lead the health-check process to gain an outside perspective; this approach can be particularly effective when the partner companies have tried and failed multiple times to identify root causes of poor performance or missed milestones.

Early is better, but it's never too late to establish a health-check process. Some partnerships won't even realize they need a health-check process until well into the tenure of the relationship—typically when the partnership hits a speed bump. The partner companies in one established automotive venture, for instance, were stymied by the partnership's inability to reach its targets. What the partner companies couldn't see was that teams were becoming frustrated by the venture's project-approval process: they would get the green light on an initiative only to discover a few days later that requirements had changed, so it was back to the drawing board. It seemed to these managers that the partnership's priorities were constantly shifting. All the delays and rework on projects prompted many to leave the venture.

It was only after launching a partnership health check that the partner companies discovered the issues with the approval process and took steps to address them, ensuring that everyone knew the timing of go and no-go decisions. Once the health-check process was established, senior leaders on both sides of the business relationship were able to use it to ensure that the approval refinements were working. Indeed, regular partnership checkups can have lasting cultural benefits. They can help reduce fear of change among employees and encourage them to consider and experiment with frequent, small adjustments to the partnership as needed.

The elements of a good health check

There are two important elements of a good partnership health check. First, teams need access to the most relevant information about the partnership (both historical and current

Early is better, but it's never too late to establish a health-check process.

perspectives). Second, they need access to deep-dive performance assessments.

Information about the partnership

The health check should start with an articulation and confirmation of the core tenets of the partnership. To achieve this, the team will need to gather all the basic information about the business relationship—how it started and how it has evolved (noting any team or leadership changes, for instance). A partnership among consumer companies, for example, was hitting many of its targets but much slower than expected. A health-check team comprising leaders from both companies was prepared to restate the purpose of the partnership and then proceed quickly to a more detailed discussion about operations, which all considered to be at the crux of the partnership's performance issues. The team was startled to see how difficult it was to agree on a high-level description of the partnership's strategy and objectives. There was a fundamental disagreement, for instance, about which market segments were a priority. The team realized that it needed to identify and gain agreement on the fundamentals of the partnership before it could address any operational shortcomings.

Deep-dive performance assessments

In the second phase of the health check, the team should conduct a series of leadership interviews to get a sense of how senior executives perceive the status of the partnership. These perspectives should be combined with the information gathered during the first phase of the health check to provide both qualitative and quantitative insights on how the partnership is performing along key measures of success. The initial discussions may reveal strong hypotheses from executives about why the partnership is underperforming, but the deep-dive assessment often shows that the root cause of a problem is something quite different.

At the healthcare-company alliance mentioned previously, for instance, a health-check team conducted partner interviews to help determine why they thought milestones were not being met as quickly as expected. The health-check team paired those responses with a holistic evaluation of the business partnership along several success factors: strategy, culture and communication, operations, governance and decision making, economics, and adaptability.

Through this deep-dive assessment, the team recognized three trends. First, each partner organization was contributing resources as agreed; having clear evidence of this helped soothe tensions and restored executives' faith in the business relationship. Second, operations were not failing to meet expectations; they were just doing so more slowly than expected. This prompted a separate discussion about how individual tasks and decisions were being handled and how they could be managed differently. Finally, the deep-dive assessment revealed that, in some joint initiatives, partners were contributing overlapping resources, which had created overly complex processes. This insight prompted the partner organizations to simplify them, thereby improving the speed of execution.

Implementing the health check

There is no one-size-fits-all approach to establishing a health-check program for a partnership. It will be necessary, though, to build a dashboard that partners can use as a catalyst for considering potential interventions and then continually revisiting the health of the partnership.

The team designing and overseeing the health-check process should build a dashboard that leaders on both sides of the relationship can access easily. It can be created manually and distributed as a PowerPoint presentation or shared in a digital format—either way, it should reflect the metrics most relevant to evaluating the partnership's ability to fulfill its objectives.

Ideally, the dashboard should be standard for all; there should be no option for specialized reports for individual executives or teams within partner companies. The health-check team should instead try to incorporate as many of the standards and preferences of each partner company into the dashboard as possible. Team members at one high-tech JV were creating three different reports—one for each of the two parent companies and a third to cover the joint-partner request. This created a lot of tension and confusion among the partners. When it discovered the issue, the health-check team consolidated the reports into one, slightly larger overview that included all the required information.

With such information in hand, partner companies can identify issues and consider potential interventions. Depending on the partners' objectives and the specific challenges in play, the interventions can be as simple as identifying a new set of key performance indicators and reporting processes for the partnership, or they can be as complicated as restructuring the partnership's operating model. On occasion, health checks can also trigger a mutually agreed-upon exit for partnerships that have met their objectives or that are no longer in line with market needs.

As with good personal health, good organizational health requires frequent checkups. By consistently assessing a partnership's performance on the critical components for success (strategy, culture and communication, operations, governance and decision making, economics, and adaptability), partners can improve their partnerships and increase their likelihood of long-term success.

Ankur Agrawal (Ankur_Agrawal@McKinsey.com) is a partner in McKinsey's New York office, where **Eileen Kelly Rinaudo** (Eileen_Kelly_Rinaudo@McKinsey.com) is a senior expert; **Kenneth Bonheure** (Kenneth_Bonheure@McKinsey.com) is a senior partner in the Singapore office.

The authors wish to thank Ruth De Backer for her contributions to this article.

Wall Street versus Main Street: Why the disconnect?

Despite turmoil in the real economy, the US stock market remains resilient because of three critical factors: the basis of valuations, the market's composition, and investors' expectations.

by Marc Goedhart, Tim Koller, and Peter Stumpner

On September 2, 2020, in the midst of the worst economic crisis since before World War II, the S&P 500 reached a record level of 3,580, representing a year-to-date increase of about 9 percent in value. Since then, the US stock market has been resilient in the face of continuing concerns about the global COVID-19 pandemic and the lingering recession. Some economists and investors claim that the stock market is no longer guided by economic fundamentals but is instead leading a life of its own—one detached from reality.

We disagree.

The US stock market has remained resilient during the COVID-19 crisis because of three critical factors that reflect certain truisms about valuations, the market's composition, and investors' expectations. These factors are very much grounded in reality.

The stock market takes a long-term perspective

Today's investors realize that even if it takes two or three years to restore a normal level of GDP and profits, the COVID-19 pandemic's long-term effect on share prices won't be that high. The math explains why. No one knows the extent or length of this economic recession. But let's assume that for the next two years, corporate profits will be 50 percent lower than they otherwise would have been and will then return to their precrisis levels and growth rates. If we discount the impact of lower short-term profits and cash flows, the present value of the stock market declines by less than 10 percent (Exhibit 1).

Exhibit 1

The stock market during the COVID-19 crisis is still focused on the long term.

Illustrative impact of COVID-19 crisis on stock-market value, index (100 = 2020)

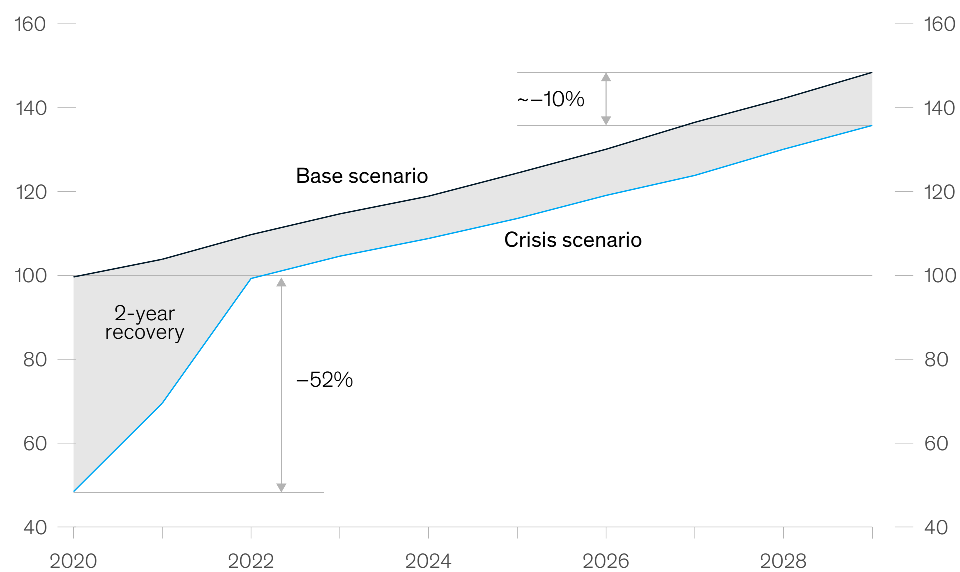
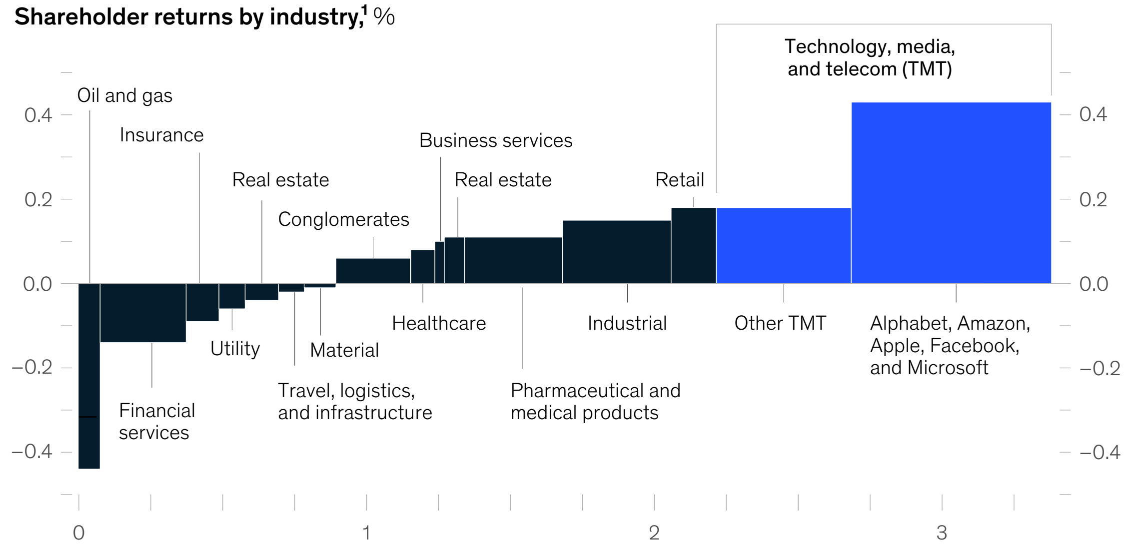


Exhibit 2

Technology companies are driving up the market's aggregate total shareholder returns.

Shareholder returns by industry,[1] %



[1]Largest 1,000 US companies. Year-to-date (September 15, 2020) weighted average; local currency.
Source: S&P Global; Corporate Performance Analytics by McKinsey; McKinsey analysis

The stock market doesn't set a value for the market as a whole

The market values individual companies from many different sectors, and these companies add up to the whole. Especially now, performance differs vastly within and across sectors.[1] Companies in oil and gas, banking, and travel, for instance, have been significantly challenged during the COVID-19 pandemic, and their performance is down. Within the retail sector, grocery stores have generally fared well, but department stores have not. Some companies in pharmaceuticals and in technology, media, and telecommunications (TMT) are actually doing better now than they were at the beginning of the year—in part because the introduction of new products and services affects them more than the health of the broader economy does. As a result, the stock market's aggregate value remains resilient.

This dynamic is even more pronounced now that the TMT sector carries greater weight than ever before: its share of the top 1,000 companies has increased from about 14 percent at the end of 1995 to about 35 percent in September 2020. Alphabet, Amazon, Apple, Facebook, and Microsoft collectively account for 21 percent of the market's value—up from 2 percent in 1995 and 16 percent at the beginning of 2020 (Exhibit 2). Without these five megacap companies, the value of the 2020 market would have increased by only 3 percent (versus 9 percent). And without the TMT sector as a whole, there would have been zero growth.

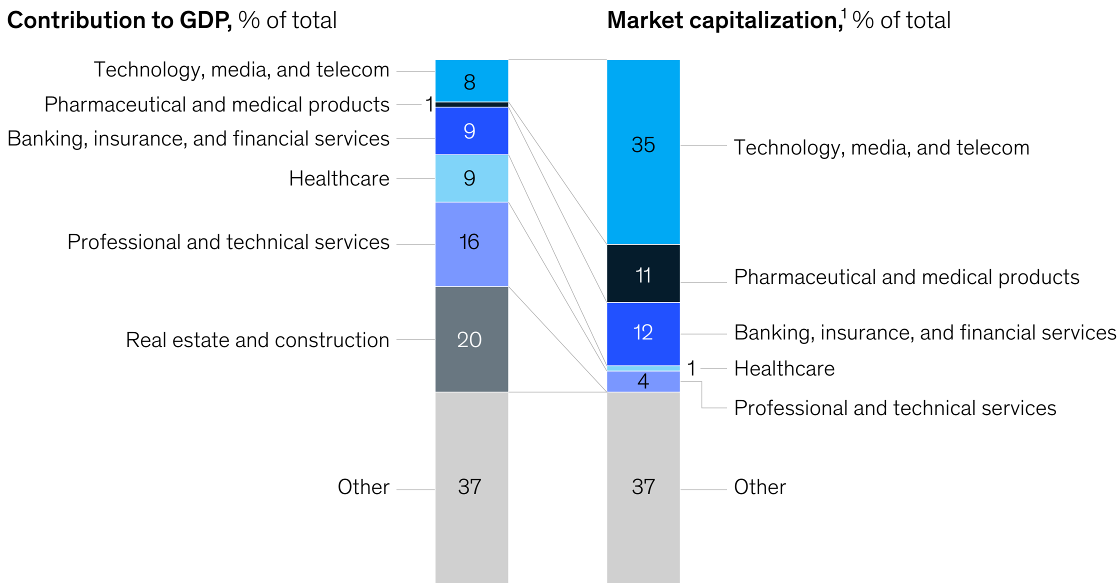
The market value of listed US companies doesn't reflect employment or GDP levels in the real economy

As we have said, companies from high-growth sectors that have done relatively well during the COVID-19 crisis now heavily weight the US stock market. By contrast, many sectors that have done worse account for a smaller share of the market and often have few listed companies. Many apparel retailers and department stores, for example, were

[1] See "Market valuation of sectors in 2020" interactive, COVID Response Center, McKinsey.com.

Exhibit 3

The market value of listed US companies doesn't reflect the dynamics of the US real economy.



[1]Largest 1,000 US companies as of September 15, 2020.
Source: S&P Global; Corporate Performance Analytics by McKinsey

already under pressure before the pandemic, and their market values were low. The current collapse of these companies' share prices doesn't have much impact on market aggregates. Many of the construction and professional-services companies, gyms, hairdressers, hospitals, restaurants, and other service businesses that generate lots of jobs and contribute materially to GDP aren't even listed. The overall stock market can do relatively well even when employment and GDP are severely depressed (Exhibit 3).

Similar dynamics are at play in Asia and Europe. The European market, for instance, is only 6 percent below precrisis levels. Variations in performance across sectors resemble those we find in the United States, and as in the United States, the composition of the European index doesn't reflect real-world GDP and employment contributions. One important difference is that there are no European megacap companies and fewer technology companies overall. In Europe, for instance, TMT companies account for only 10 percent of the market, versus 35 percent in the United States.

The disproportionate weight that the TMT sector and a handful of companies in that sector carry in the US market could turn into a risk if investors decide to drop their growth expectations for even a few TMT companies. But the numbers show that the US stock market is neither irrational nor erratic; the specific mix of industries in it has played a big role in making it more resilient than the economy as a whole.

Marc Goedhart (Marc_Goedhart@McKinsey.com) is a senior expert in McKinsey's Amsterdam office, **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Stamford office, and **Peter Stumpner** (Peter_Stumpner@McKinsey.com) is an associate partner in the New York office.

The authors wish to thank Vartika Gupta for her contributions to this article.

Warren Buffett: An appreciation

As Warren Buffett turns 90, the story of one of America's most influential and wealthy business leaders is a study in the logic and discipline of understanding future value.

by Tim Koller

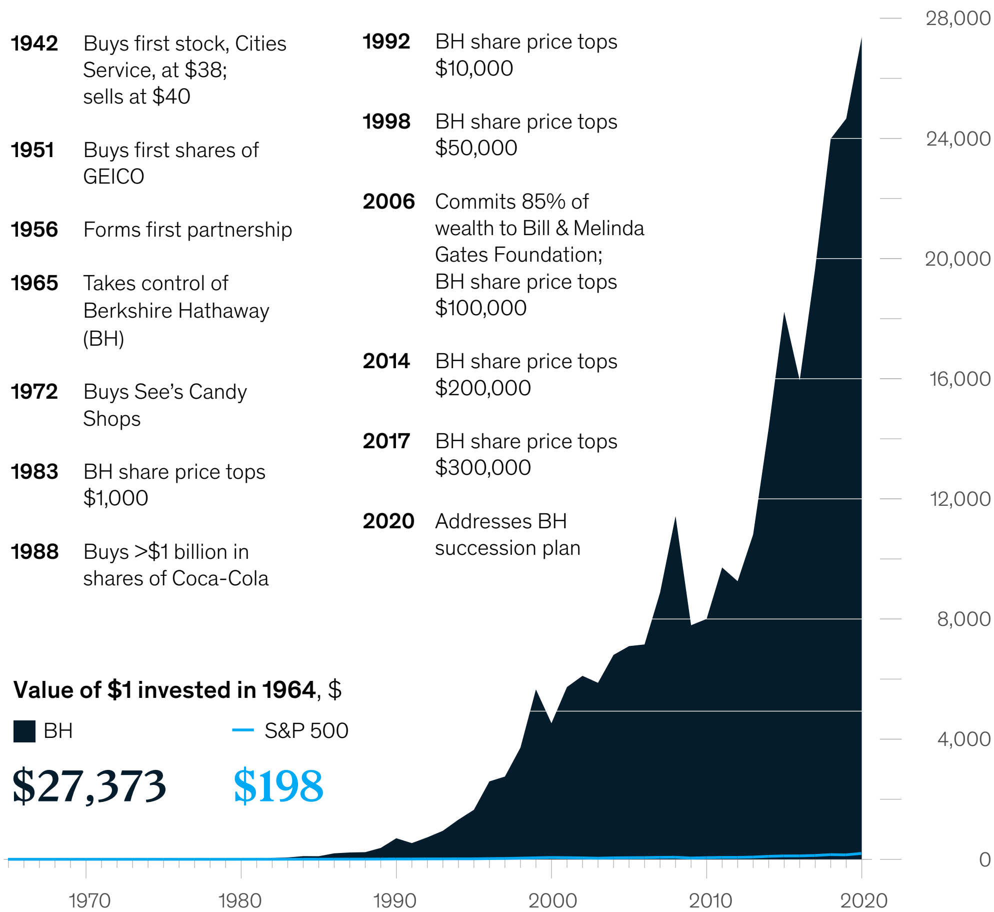
Patience, caution, and consistency. In volatile times such as these, it may be difficult for executives to keep those attributes in mind when making decisions. But there are immense advantages to doing so. For proof, just look at the steady genius of now-nonagenarian Warren Buffett. The legendary investor and Berkshire Hathaway founder and CEO has earned millions of dollars for investors over several decades (exhibit). But very few of Buffett's investment decisions have been reactionary; instead, his choices and communications have been—and remain—grounded in logic and value.

Buffett learned his craft from "the father of value investing," Columbia University professor and British economist Benjamin Graham. Perhaps as a result, Buffett typically doesn't invest in opportunities in which he can't reasonably estimate future value—there are no social-media companies, for instance, or cryptocurrency ventures in his

Exhibit

Warren Buffett's decisions, grounded in logic and value, have earned millions of dollars for investors.

Timeline of Warren Buffett's career



Source: CNBC

Buffett banks on businesses that have steady cash flows and will generate high returns and low risk. And he lets those businesses "stick to their knitting."

portfolio. Instead, he banks on businesses that have steady cash flows and will generate high returns and low risk. And he lets those businesses "stick to their knitting." Ever since Buffett bought See's Candy Shops in 1972, for instance, the company has generated an ROI of more than 160 percent per year[1]—and not because of significant changes to operations, target customer base, or product mix. The company didn't stop doing what it did well just so it could grow faster. Instead, it sends excess cash flows back to the parent company for reinvestment, pointing to a lesson for many listed companies: it's OK to grow in line with your product markets if you aren't confident that you can redeploy the cash flows you're generating any better than your investor can.

As Peter Kunhardt, director of the HBO documentary *Becoming Warren Buffett*, said in a 2017 interview, Buffett understands that "you don't have to trade things all the time; you can sit on things, too. You don't have to make many decisions in life to make a lot of money."[2] And Buffett's theory (roughly paraphrased) that the quality of a company's senior leadership can signal whether the business would be a good investment or not has been proved time and time again. "See how [managers] treat themselves versus how they treat the shareholders . . . .The poor managers also turn out to be the ones that really don't think that much about the shareholders. The two often go hand in hand," Buffett explains.[3]

Every few years or so, critics will poke holes in Buffett's approach to investing. It's outdated, they say, not proactive enough in a world in which digital business and economic uncertainty reign. For instance, during the 2008 credit crisis, pundits suggested that his portfolio moves were mistimed, he held on to some assets for far too long, and he released others too early, not getting enough in return. And it's true that Buffett has made some mistakes; his decision making isn't infallible. His approach to technology investments works for him, but that doesn't mean other investors shouldn't seize opportunities to back digital tools, platforms, and start-ups—particularly now that the COVID-19 pandemic has accelerated global companies' digital transformations.[4]

Still, many of Buffett's theories continue to win the day. A good number of the so-called inadvisable deals he pursued in the wake of the 2008 downturn ended paying off in the longer term. And press reports suggest that Berkshire Hathaway's profits are rebounding in the midst of the current economic downturn prompted by the global pandemic.[5]

[1] Theron Mohamed, "Warren Buffett's favorite business is a little chocolate maker with an 8000% return. Here are 5 reasons why he loves See's Candies," Business Insider, July 12, 2019, markets.businessinsider.com.
[2] "Peter Kunhardt," *Charlie Rose*, January 31, 2017, charlierose.com.
[3] Tae Kim, "Warren Buffett on judging management: 'See how they treat themselves versus how they treat the shareholders'," CNBC, May 9, 2018, cnbc.com.
[4] Esther Shein, "COVID-19 is 'the digital accelerant of the decade,' forcing businesses to adapt quickly," TechRepublic, July 15, 2020, techrepublic.com.
[5] Geoffrey Rogow, "Berkshire Hathaway's profit jumps as market rebound boosts results," *Wall Street Journal*, August 8, 2020, wsj.com.

At age 90, Buffett is still waging campaigns—for instance, speaking out against eliminating the estate tax and against the release of quarterly earnings guidance. Of the latter, he has said it promotes an unhealthy focus on short-term profits at the expense of long-term performance. "Clear communication of a company's strategic goals—along with metrics that can be evaluated over time—will always be critical to shareholders. But this information … should be provided on a timeline deemed appropriate for the needs of each specific company and its investors, whether annual or otherwise," he and Jamie Dimon wrote in the *Wall Street Journal*.[6]

Yes, volatile times call for quick responses and fast action. But as Buffett has shown, there are also significant advantages to keeping the long term in mind as well. Specifically, there's value in consistency, caution, and patience and in simply trusting the math—in good times and bad.

Tim Koller (Tim_Koller@McKinsey.com) is a partner in McKinsey's Stamford office.

[6] Warren E. Buffett and Jamie Dimon, "Short-termism is harming the economy," *Wall Street Journal*, June 6, 2018, wsj.com.

Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

War games? Here's what they're good for

by Hugh Courtney, Tim Koller, and Dan Lovallo

The dilemma

There's usually a steep price to pay when you fail to anticipate competitors' actions and reactions—or who the competitors even are. France, for instance, spent ten years and billions of francs in the 1930s to erect a collection of concrete forts, obstacles, and weapons installations (called the Maginot Line) to stop German forces from invading with tanks. But French military leaders didn't anticipate that, in the period between World War I and World War II, Germany would change course and adopt a blitzkrieg strategy, increasing its use of air strikes and invading through neutral countries, such as Belgium. French outposts and citizens were left open to attack (exhibit).

The fate of a nation was not at stake, but a maker of medical equipment similarly faltered because of competitive blind spots. It was first to market in the 1970s with groundbreaking technology for computed-tomography (CT) scanning, but it didn't anticipate how many other innovators would enter the market, find new uses for its technology, and build high-level sales and product-marketing capabilities around the applications. The medical-equipment manufacturer eventually ended up exiting the business because it couldn't keep up with the specialized competitors.[1]

Exhibit

The French military was so focused on building terrestrial obstacles that it didn't anticipate Germany's invasion by air.

The research

Whether in the military or in business, strategy decisions are interdependent decisions most of the time. So why do executives so often fail to anticipate competitors' moves when making their own? Competitor neglect is a manifestation of the inside view, in which decision makers lend more weight to their own data and perceptions than to relevant external factors. Because they're focusing so much on their own plans and ambitions, they end up blind to how competitive dynamics are shifting around them—the big changes as well as the incremental ones.[2] This bias is particularly common among leaders in new and rapidly changing markets, such as those for streaming content, electric vehicles, and artificial-intelligence software. The data about competitors' strategies may be incomplete, inconsistent, and difficult to interpret.[3] It can also be hard for companies to identify a meaningful group of peers with which to compare themselves.

The remedy

War games[4] can be an effective hedge against competitor neglect. Not just for the military, these exercises can also help senior business leaders assess potential strategies and determine how well they are likely to perform given potential competitor responses.

---

1 Will Mitchell and Jennifer Smith, "Playing leap-frog with elephants: EMI, Ltd. and CT scanner competition in the 1970s," case study, August 1994, www-personal.umich.edu.
2 Colin Camerer and Dan Lovallo, "Overconfidence and excess entry: An experimental approach," *American Economic Review*, March 1999, Volume 89, Number 1, pp. 306–18, aeaweb.org.
3 Hugh Courtney, *20/20 Foresight: Crafting Strategy in an Uncertain World*, Boston, MA: Harvard Business School Press, 2001.
4 Competitive simulation exercises are often referred to as "war games," likely because the US Army War College uses such exercises extensively and developed many of the protocols that other organizations use when designing, playing, and debriefing these exercises.

One consumer-electronics company used war games to optimize the launch of the next version of its flagship product. The company convened a team of senior leaders and industry experts to build deeply researched profiles of two primary competitors. The information in the dossiers informed a multiround war game that projected likely actions and reactions among the three companies in response to the product launch. In each round, a team was assigned to represent a competitor, and each team independently chose pricing and promotion strategies for its company. Industry experts weighed in about whether their respective strategy choices were likely to succeed or not, and the company developed a simple simulation model to crunch the numbers. After several rounds of analysis and discussion, the company's launch plans were adjusted accordingly, enabling it to achieve a first-mover advantage in the market.

War games can take many forms and encompass many technologies—from simple to sophisticated—but the one constant should be a debriefing session, conducted within and across teams to capture lessons and reformulate strategies and processes as necessary.

Particularly today, no company is an island. Those that most accurately perceive the competitive landscape as it is—and is likely to be—will have a distinct advantage.

Tim Koller (Tim_Koller@McKinsey.com) is a partner in McKinsey's Stamford office; **Hugh Courtney** is a professor of international business and strategy at Northeastern University and an alumnus of the Washington, DC, office; and **Dan Lovallo** is a professor of business strategy at the University of Sydney and a senior adviser to McKinsey.

Podcasts

Learn more about these and other topics on our corporate-finance and strategy podcasts, available for streaming or downloading on McKinsey.com, as well as on Apple Podcasts, Google Play, and Stitcher.

BOARDS AND GOVERNANCE

The pros and cons of activist investors
Management teams that engage positively with attackers may find activist campaigns bring ideas that create value and improve shareholder performance.
Joe Cyriac and Sandra Oberhollenzer, with Sean Brown

How activist investors are changing public-company boards
Rotman professor and experienced board director David Beatty considers several profound changes.
David Beatty, with Tim Koller

What's changing in board governance
How has board governance changed—and how can CEOs and CFOs work together to improve a company's performance?
Bill Huyett, with Werner Rehm

CORPORATE FINANCE

The evolution of the CFO
CFOs are playing an increasingly pivotal role in creating change within their companies. How should they balance their traditional responsibilities with the new CFO mandate?
Ankur Agrawal and Priyanka Prakash, with Sean Brown

Starting from zero
Zero-based budgeting (ZBB) is experiencing a resurgence. But why this—and why now? An expert in the field helps us understand how digitization has given new life to ZBB, the benefits it offers, and how to implement it in both large and small organizations.
Wigbert Böhm, with Roberta Fusaro

When should companies sell off their accounts receivable?
It's a form of borrowing known as factoring, but it isn't always necessary or even possible.
Tim Koller and Emily Yueh, with Werner Rehm

Getting better at resource reallocation
Although managers understand the value of shifting resources into more productive investments, obstacles stand in the way. These can be overcome.
Yuval Atsmon, with Werner Rehm

How do share buybacks affect investment in growth?
What's driving the recent increase in share buybacks and dividends, and does that affect investment in growth?
Marc Goedhart and Tim Koller, with Werner Rehm

Getting a better handle on currency risk
When exchange rates are volatile, companies rush to stem potential losses. What risks should they hedge—and how?
Marc Goedhart, Tim Koller, and Werner Rehm

DECISION MAKING

Bias Busters: How to take the 'outside view'
It may be easier than you think to debias your decisions and make better forecasts by building the "outside view."
Tim Koller and Dan Lovallo, with Sean Brown

Bias Busters: Four ways to assess projects and keep them on track
Our experts suggest ways to avoid snap judgments, how to elicit strong arguments for and against proposals, the benefits of project premortems, and using contingency plans to avoid the sunk-cost fallacy.
Tim Koller and Dan Lovallo, with Sean Brown

M&A

Why you need to keep changing your company's business mix
Because the market is always moving, a static portfolio of businesses tends to underperform.
Sandra Andersen and Andy West, with Sean Brown

Toward faster separations
Successful divestors "move slow to move fast": they carefully think through all the strategic and operational considerations before making a public announcement. Then they systematically assess what and when to divest, as well as how to manage the task most efficiently.
Obi Ezekoye and Andy West, with Roberta Fusaro

Reflections on digital M&A
What exactly is digital M&A, and how does it compare with garden-variety deal making?
Robert Uhlaner, with Werner Rehm

November 2020
Designed by McKinsey Global Publishing

Printed in the United States of America.