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Perspectives on corporate finance and strategy

Valuing digital assets? Don’t forget cash flows

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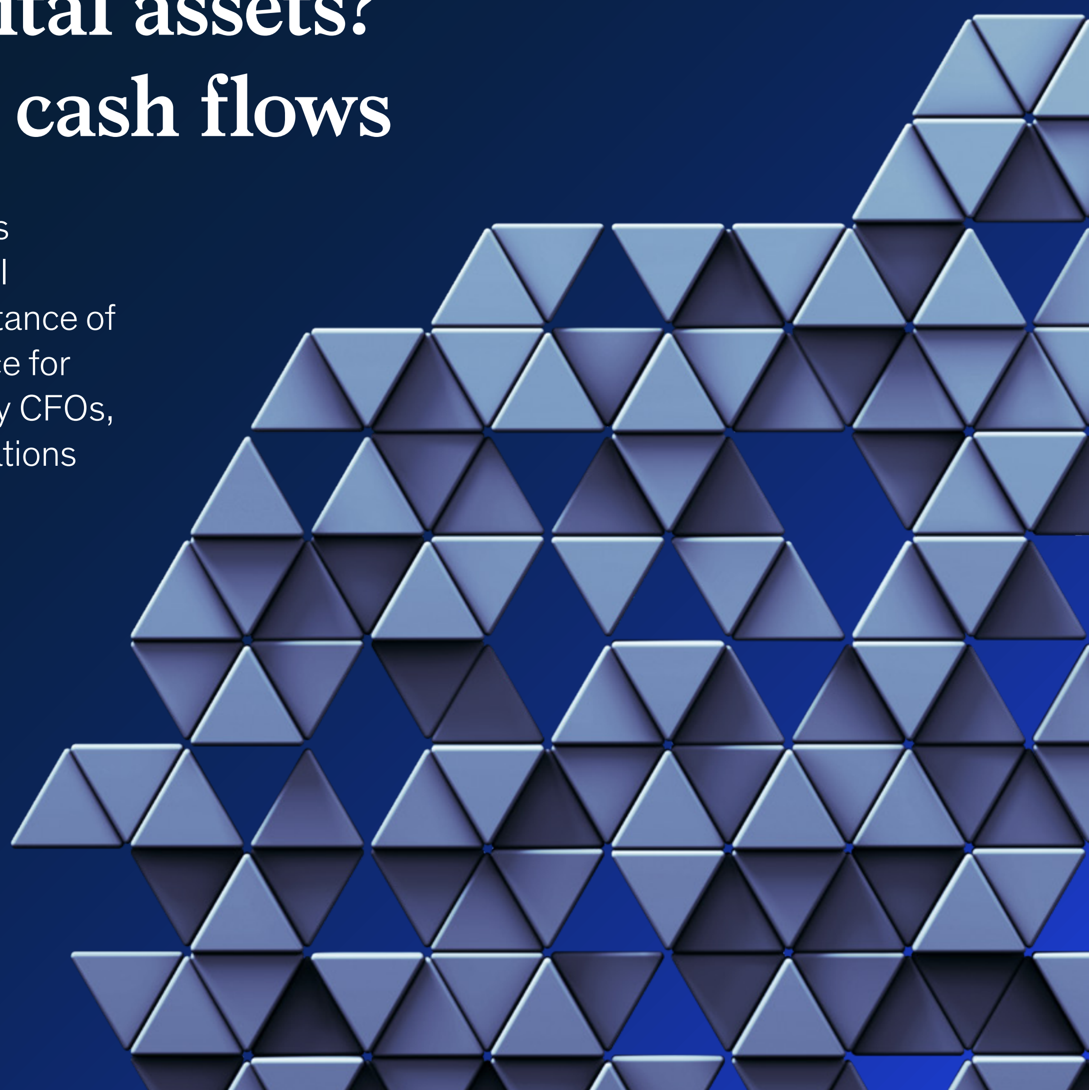

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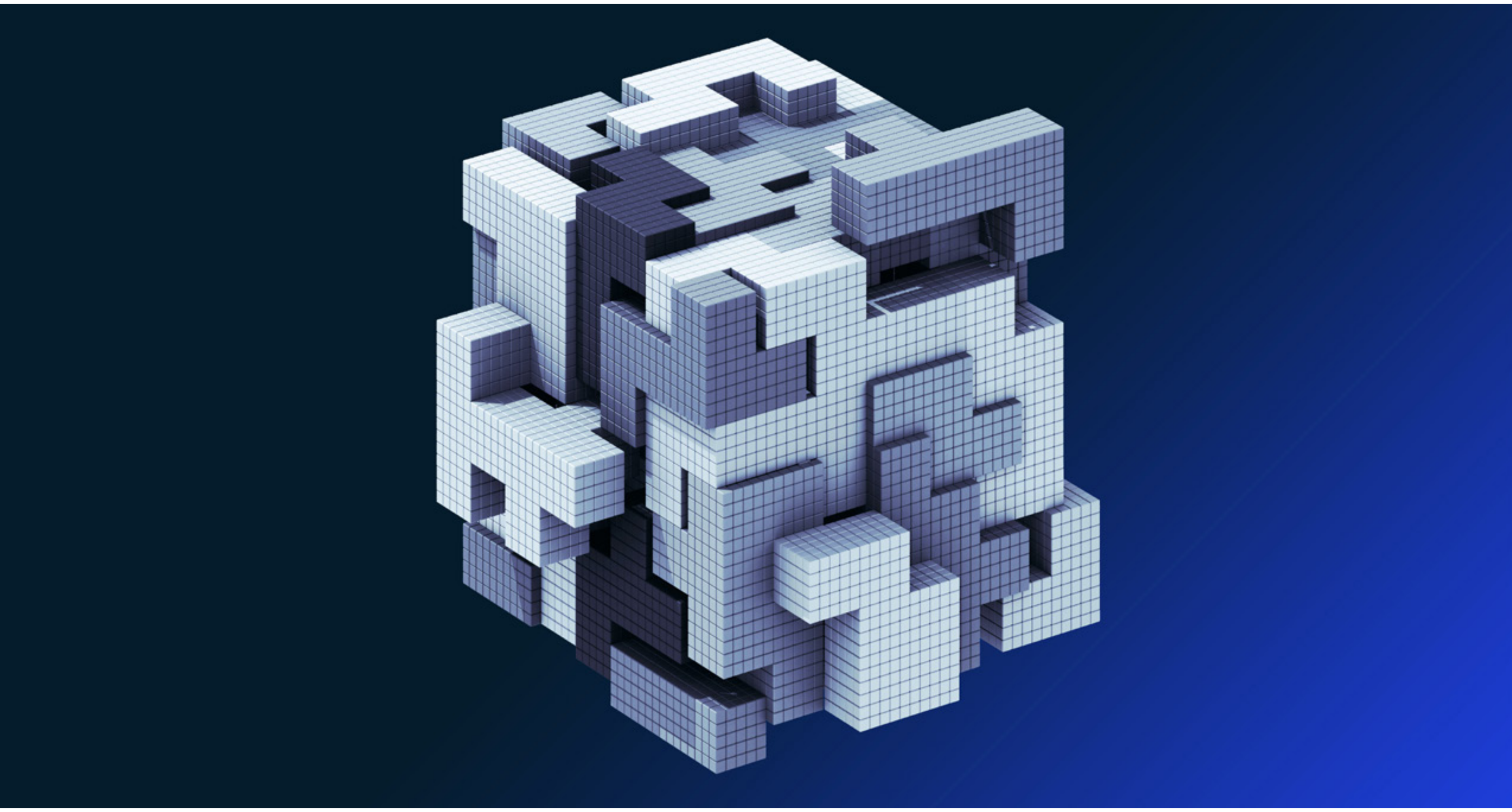
Why digital is no different when it comes to valuation

Whether tech enabled or old school, proposed projects and initiatives need to be assessed according to the cash flows they generate. The trick is getting the base case right.

by Liz Ericson and Tim Koller



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Ask any dozen business leaders how they define “digital,” and you will probably get just as many different answers. For some, “digital” is just an upgraded term for what their IT functions do. For others, it refers to the use of online tools and technologies to make process changes, to enable performance improvements, or to pursue organizational transformation. For still others, it’s an excuse to question the hows and the whys in their core businesses.

Our colleagues examined how a typical consumer-packaged-goods company defined the term and identified at least 33 types of digital initiatives—digital marketing, optimization of sales-force coverage, predictive maintenance, supply-chain planning, and robotic process automation in the back office, to name a few.

Given the prevailing fuzzy definition of “digital,” it isn’t surprising that business leaders are often unsure how to evaluate the myriad technology-enabled initiatives being proposed to them and how much value those initiatives may create. In a 2018 survey of 1,733 managers, about eight in ten said their organizations were pursuing digital initiatives. But only 14 percent of the managers said they had realized significant performance improvements from these efforts, and only 3 percent said they had successfully sustained any changes.[1]

A suggestion for these business leaders: don’t get tripped up by digital labels; follow the same principles that apply to *all* investment decisions. That is, evaluate digital projects and strategies based on the cash flows they are expected to generate, making sure to factor in “do nothing” scenarios (or base cases) and the overarching objectives of the digital project or strategy being proposed.

While that approach sounds simple, getting it right requires some thoughtful strategic analysis.

Don’t skip the base case

Which of the following (if either) would be more valuable to the organization: investing in a new e-commerce site or investing in some automation software that could improve the company’s procurement processes? Executives often argue that such digital-investment decisions can be difficult to make for a range of reasons, including the following:

— The benefits from digital initiatives often don’t materialize right away, and the projects can have front-loaded or “shadow” costs—as a result of, say, building a new digital business while maintaining the core business.

— Proposed digital initiatives can’t be meaningfully compared against traditional ones.

— The value of a specific feature (interest-free credit, for example) can be difficult to disentangle from its context.

— The link back to the core business decision underpinning the digital strategy or initiative can be obfuscated.

— Executives are wary of experiencing “death by 1,000 pilots that don’t scale.”

The decision-making default, then, has been to lean in on digital opportunities not because they are the best options but for other reasons—for instance, the potential improvements seem to be the most visible or the project owners are shouting the loudest. As the impact metrics shared previously reveal, this approach creates uneven results.

Ideally, all investment decisions should be analyzed against an alternative course of action. For digital projects, the alternative may be to do nothing. But especially in the case of digital projects, the

[1] “Five moves to make during a digital transformation,” April 24, 2019, McKinsey.com.

By developing an honest base case and a full range of cash-flow scenarios, business leaders can more meaningfully compare digital initiatives and strategies against other investments.

do-nothing case may not mean net-zero change; it may actually mean a steady (or accelerating) erosion of value. Consider the decision that many banks have faced over the years about whether to invest in mobile-banking apps: if all of a bank's competitors have mobile apps and the bank doesn't invest in one, its market share will likely fall over time as it loses customers or fails to attract new ones. Therefore, the base case isn't stable profits and cash flows; instead, it's a decline in profits and cash flows—along with a reputation for being a stale brand.

For reasons of comfort and even self-preservation, business leaders are often reluctant to build and share business-as-usual projections that show declines in profits and cash flows. Yet such declines are what most often happen when companies avoid change. Companies must be realistic about the potential for declining base cases. By developing an honest base case and a full range of cash-flow scenarios, business leaders can more meaningfully compare digital initiatives and strategies against other investments that may be competing for scarce resources. This approach may also prompt companies to think more strategically about how, when, and how much to invest in digital projects, given how quickly customers' expectations are changing.

Examine potential impact from digital

Building a realistic base case can provide the data needed to vet the potential impact of a digital strategy or initiative. It's also important, however, to identify the *type* of impact that digital strategies and initiatives may have and frame investment discussions accordingly. There can be some overlap, but companies' digital initiatives typically fall into one of two categories.

The first category is the application of digital tools and technologies to disrupt an industry fundamentally, requiring a major revamp of a company's business model or a spooling up of new businesses, some of which may even cannibalize the company's core strengths. The second (less dramatic but still critical) category is when companies use digital simply to do the things they already do, only better—in service to, for instance, cost reduction, improved customer experience, new sources of revenue, and better decision making.

New business models

In some cases, the use of digital tools and technologies can upend entire business models or create entirely new businesses. Look no further than the way the internet has changed the ways that consumers research and purchase airline tickets and hotel rooms, disintermediating many traditional travel agents—one of the original cases of industry reinvention. The introduction of video-streaming services has disrupted the economics of traditional broadcast and cable TV channels. And the rise of cloud computing not only has reshaped how companies are transforming themselves but also has entirely disrupted two other industries: manufacturers of mainframe and server computers and businesses that run companies' data centers. Cloud computing itself has become an enormous business: $150 billion was spent on cloud services and infrastructure over the first half of 2019.

To value these new opportunities, business leaders should use the standard discounted-cash-flow approach. The fact that these businesses often grow fast and don't earn profits early on shouldn't affect the valuation approach. Investors can certainly be patient at times, as Amazon saw for decades with its retail business, but digital initiatives will eventually need to generate profits and cash flow and earn an attractive ROIC.

With high-growth companies, business leaders must start from the future rather than the present—markets may not exist yet, so scenario planning is critical.[2] A look at the fundamental economics of the business can help managers build a realistic estimate of returns, but another important consideration is whether the new digital business will engender network effects. That is, as companies grow, they can earn higher margins and ROIC because their products become more valuable with each new customer. In most industries, competition forces returns back to reasonable levels. But in industries with network effects, competition is kept at bay by the low and decreasing unit costs of the market leader (hence the industry tag "winner takes all") and the inconvenience to customers of switching to new suppliers (the "lock-in effect").

Companies like Amazon, Apple, and Google have leveraged their payment, single-sign-on, and connectivity products to create incremental value from each new user. Microsoft's Office software provides another good, if tried-and-true, example of network effects. It has long been the workplace standard for word processing, creating spreadsheets, and generating graphics. As the installed base of Office users expanded, it became ever-more attractive for new customers to use Office for these tasks because they could share documents, calculations, and images with so many others. As the customer base grew, margins were very high because the incremental cost of providing software through DVDs or downloads was so low.

Cost reduction

Many digital initiatives help companies reduce operating costs. One mining company saved more than $360 million per year from process-automation software that gave managers more insight into what exactly was happening in the field, enabling managers to make adjustments on the fly. Meanwhile, several fossil-fuel-based power generators learned that they could improve their plants' heat rates (how efficiently the plants use fuel) by up to 3 percent by using sensors and actuators for remote monitoring and automated operations and by employing smart valves that self-report and repair leakages.[3]

Understanding the economics of cost reduction isn't as straightforward as it may seem. Business leaders might be tempted to estimate present value by simply discounting the expected savings and subtracting the investments required. But business leaders must also examine the second-order effects.

In a competitive industry—chemicals, for instance—cost reductions might simply be passed through to customers as price reductions. The present value of such a chemical company's cost-reduction efforts would seem to be zero. But a look at the alternative case reveals something different: if competitors are pursuing digital initiatives to reduce costs and your company isn't, you will still have to reduce your prices in line with those of your competitors. The alternative to the digital initiative would be a decline in cash flows because of lower prices without reduced costs. The present value of the initiative may turn positive again once the business leader compares the initiative with the right base case.

Improved customer experience

Consumers have benefited tremendously from companies' digital innovations, particularly regarding the purchasing experience. A customer

[2] "High-growth companies," in Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, June 2020, pp. 709–24.
[3] Gerardo Guzman, Abhay Prasanna, Peter Safarik, and Pankaj Tanwar, "Unlocking the value of digital operations in electric-power generation," October 11, 2019, McKinsey.com.

can buy an item of clothing in a physical store or online and have it shipped to the buyer's home, to a local store, or to any one of thousands of pickup points. If a local store doesn't have the right size for an in-store shopper, the customer can order it on the spot and have it delivered to their home. A customer who decides to return an item can return it to any of the company's physical stores or mail it back, regardless of how it was purchased. Consumers can also track in real time the progress of the shipments heading their way.

Using digitization to improve the customer experience can add value to the business in a variety of ways. In some cases, it can lead to reduced costs. An electricity-distribution company fully redesigned its customer interfaces in a "digital first" way that made a priority of customers' online interactions. As a result, its customer satisfaction rose 25 percentage points, employee satisfaction increased by ten percentage points, and customer-service costs fell 40 percent.

As is the case with applying digital solutions to reduce costs, it's critical to think through the competitive effects of investing in digital to gain a superior customer experience. In many situations, customers have come to expect an improved experience and are unwilling to pay extra for it. Meanwhile, providing omnichannel services can be expensive for retailers: the cost to ship online orders often makes these sales unprofitable, especially as shipping is expected to be free and fast (same day, in some cases). Meanwhile, in-store sales may be declining as a result of the omnichannel services, leading to lower margins, as some costs are fixed.

Even so, retailers have little choice but to provide omnichannel services despite lower profitability. If they don't, they stand to lose even more revenues and profits. When vetting digital initiatives in this category, business leaders should ask themselves some questions. Does the improved customer service lead to higher market share because the company's customer service is better than that of competitors? Or does it maintain the company's market share or avoid losing market share because competitors are doing the same thing?

New sources of revenue

Some companies have been able to create new revenue sources through digital initiatives. In these cases, the economic analysis versus the base case is more straightforward because, at least for a while, the company (and maybe its competitors) are making the pie bigger for the whole industry.

For instance, an ice-cream manufacturer set up centralized freezers in the United Kingdom. A delivery company picks up the ice cream and

In many situations, customers have come to expect an improved experience and are unwilling to pay extra for it.

delivers it to customers within a short time period. This service has generated more than ten times the volume of convenience-store freezers—and mostly in additional sales because without the convenient delivery, customers might simply skip the ice cream. In another case, an industrial-equipment manufacturer created a data-driven service business that collects soil samples and analyzes weather patterns to help farmers optimize crop yields. Sensors in tractors and other machinery provide data for predictive maintenance, automated sprinkler systems synchronize with weather data, and an open-software platform lets third parties build new service apps.[4]

Such new sources of revenue can create value because they don't involve just keeping up with the competition. In both examples, digital innovations created an overall increase in the revenue pool for the industry—even for the same old product—whether in overall consumption of ice cream or overall demand for precision-farming services.

Better decision making

Some executives are using advanced analytics to make better decisions about a broad range of business activities. Doing so can generate additional revenues, reduce costs, or both. For instance, a consumer-products company used advanced analytics to improve the design of its planograms (models of how it will allocate its limited space on retail shelves, describing which products to include and how to display them). The analytics program revealed to the company's decision makers that they could dramatically improve the effectiveness of their product placements. They were able to gain these insights by continually comparing and contrasting alternative product mixes, without waiting for weeks of physical-store receipts to hint at performance. At the same time, the company was able to reduce the number of people required to design the planograms from ten to just two, driving down costs.

In this case, the investment in advanced analytics helped the company increase total customer spending by getting customers to upgrade to more profitable products. And because the change involved only choices within the company's product mix, the improvement created value without necessarily inviting a competitive response. In other cases, the benefits may be diluted because competitors take similar actions, but the investment in analytics still may create value by maintaining competitive parity.

In our experience, it's easy for executives to get caught up in discussions about how technologies work and then try become fluent in them—for instance, by asking what knowledge graphs are, how exactly machines learn, and so on. More important, though, is to focus on identifying which decisions create (or destroy) the most value in their organizations and then consider the application of advanced analytics toward those discussions. The ultimate goal is to gain better insights and even prescriptive answers on how to operate.

As executives and investors seek to understand the competitive implications of digital technologies, it bears remembering that these topics and the management responses to them will likely be fluid for some time to come. It's also worth remembering that even when definitions seem fuzzy, the principles of valuation are not. They are steadfast and reliable, and they can help business leaders drown out the noise and distinguish value-creating opportunities from value-destroying ones.

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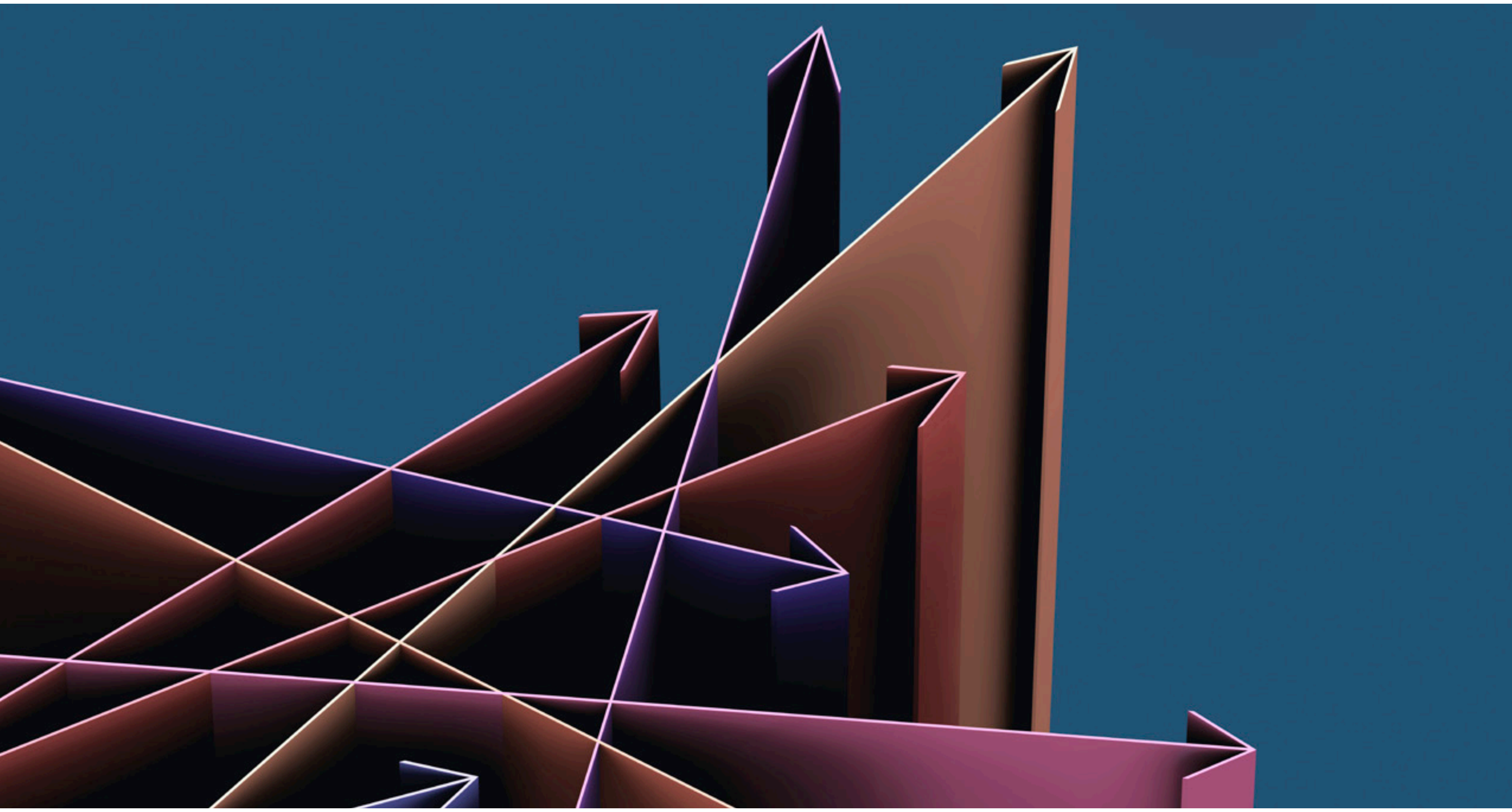
[4] Jacques Bughin, Tanguy Catlin, Martin Hirt, and Paul Willmott, "Why digital strategies fail," *McKinsey Quarterly*, January 25, 2018, McKinsey.com.

Predictive sales forecasting: Is your finance function up to code?

Some companies are using automation, machine learning, and advanced analytics to make the crystal ball clearer—and your company can do the same.

by Holger Hürtgen, Frank Plaschke, Karolina Sauer-Sidor, and Nils Wittmann



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Most executives will tell you that when shaping business plans and strategies, forecasts can serve as great counterweights to gut feelings and biases. Most will also admit, however, that their forecasts are still notoriously inaccurate.

There are signs, however, that some finance teams' early experiments with automation, machine learning, and advanced analytics are changing the game, particularly for demand planning and sales-and-revenue forecasts. A chemical distributor, for instance, increased its sales by 6 percent because of its ability to conduct more accurate and frequent forecasts that informed its allocation of resources. A retailer and a global engineering-consulting firm both reported similar benefits from advanced analytics, as measured by user responses to new products and by changes in profit on income, respectively.

In the wake of the current economic uncertainty and market volatility, it will become even more important for finance functions to explore advanced analytics and automation. Finance teams will need these techniques to turbocharge their forecasting capabilities. They will need efficient ways to generate and disseminate real-time forecasts that reflect rapidly changing circumstances. Likewise, it will be imperative for financial-planning and -analysis teams to embrace automated dashboards and other digital tools so that data can be refreshed frequently and encompass multiple perspectives (see sidebar, "Planning during a pandemic").[1]

In this article, we clarify the opportunities arising from advanced analytics and describe the organizational, operational, and leadership capabilities required to use new technologies to generate better, more accurate forecasts. Some leading-edge companies are already well on their way in the journey from fully analog to mostly digital. Their stories and remedies may be particularly illuminating for companies and finance organizations that are still trying to find a path forward.[2]

Opportunity: Better forecasts

Not all forecasts will be 100 percent correct 100 percent of the time. No statistical formula can predict the surge, outcome, or exact length of black-swan events, for instance—there will be no data for that. Nor will analytics generate optimal forecasts every time; even companies that currently use data analytics in forecasting acknowledge that context matters. In the wake of the COVID-19 pandemic, for example, streaming-media companies have had to reset their algorithms and data sets to take into account the unpredictable effect of quarantines on content consumption. Companies in many other industries are doing the same.

In general, however, a company that has a proven record of accuracy in forecasts can create trust among business leaders about the numbers it generates and the trends they may reveal. This is where the use of models based on automation, advanced analytics, and machine learning make the most sense, particularly as finance teams build forecasts for short-term operations (between three and 18 months) and midterm market demand (one to three years).

The short term

A global manufacturer's demand forecasts were regularly off by 30 percent or more. As a result, planning teams within each of the company's business lines didn't trust the numbers and instead chose to follow their gut instincts. By ignoring the centrally calculated predictions, however, they further limited the amount of good outside data they could use to develop market strategies.

The manufacturer's finance function had traditionally relied only on small historical sets of sales data and largely manual reporting processes to establish production baselines and make-to-stock requirements. Over a six-month period, it replaced this approach with a machine-learning-based model that incorporated a much richer data set—for instance, details about product life cycles and

[1] Mark Maurer, "Finance teams adapt to closing the books remotely amid coronavirus," *Wall Street Journal*, March 31, 2020, wsj.com.
[2] Frank Plaschke, Ishaan Seth, and Rob Whiteman, "Bots, algorithms, and the future of the finance function," January 9, 2018, McKinsey.com.

performance, historical growth and sales figures, survey results, and information about external events from various markets.

This change improved the accuracy of the manufacturer's short-term forecasts. The finance organization could quickly generate updated sales profiles based on "calendarized" orders and information about the macroeconomics of specific geographies. With this information in hand, the company was able to reduce inventories and product obsolescence by 20 to 40 percent, depending on the SKU. It was no longer simply reacting to market fluctuations; it was proactively managing them. It was also able to capture an additional 5 percent in sales because it was constantly meeting demand across most markets.

Planning during a pandemic

The COVID-19 pandemic has disrupted the usual forecasting and planning approaches. Demand patterns for different products and services—consumer goods, especially—have been abnormal, given the uneven spread of the novel coronavirus (SARS-CoV-2) and continuing economic and health uncertainties. Models that rely heavily on historical data therefore can't entirely capture the effects of the crisis both on current operations and into the next normal.

However, some finance teams are using advanced analytics to stress-test their forecasts and scenarios. The technology has allowed them to drill down on the impact of the crisis on specific product categories under different parameters. For instance, a consumer-packaged-goods company is using a combination of precrisis data, postcrisis assumptions about business drivers, and consumer-behavior research to model demand for its product categories under various recession scenarios. One early finding showed that the one-year CAGR in the canned-goods category changed from –2.7 percent in a business-as-usual setting to 4.2 percent under a deep-recession scenario. The behavior was linked to changes in GDP, disposable income, unemployment, consumer-confidence indicators, and other macroeconomic factors. By contrast, other products, such as laundry detergent, weren't influenced as much by the current situation; demand for them remained similar across all scenarios and assumptions.

The midterm

A category-leading consumer-goods company that sold nine categories of products in more than a dozen countries didn't have a unified view of its current sales. The company typically based its financial planning for the next one or two years on the previous year's numbers, so it couldn't gain meaningful insights beyond its initial predictions. The company's finance function therefore sought to automate the data-collection process and to combine all data into a single "source of truth" to be mined for insights.

Using cross-correlation analyses, a team worked with the company's business-unit leaders to identify the potential factors affecting demand for each market and category. It found that many of the business-unit heads based their forecasting models on hypotheses rather than evidence. One business unit, for instance, had been examining how rainy weather affected the sales of its products, but this variable couldn't be modeled accurately. A look at weather patterns could explain past performance, but it would be very difficult to use them to predict the weather for the next several years.

The company's finance organization worked with the business-unit leaders to test and evaluate different forecasting models for each country-and-product combination empirically. In the relatively stable markets and product categories, simple statistical forecasts based on a handful of historical time series were enough. The more complex markets and product categories—for instance, those in which more than 20 inputs influenced demand—required advanced, machine-learning-based forecasting models.

Under this approach, the consumer-goods company created more precise forecasts for all countries and product categories and gained greater insight into the key drivers of demand. The variables ultimately included about 100 classic macroeconomic factors, such as real GDP, disposable income, unemployment, and consumption trends, as well as 150 esoteric variables, such as Google searches for the company's products, demographic changes, and consumer-confidence indicators.

Finance leaders must work with the IT and business functions to set the ground rules for data usage—what good data look like, who owns them, and who can access them.

Given the size and scope of the observations that Google-trends indexes capture, they serve as a powerful proxy for consumer behavior in forecasting models. A company can use the data from these indexes and machine learning to detect patterns, trends, and seasonality in users' web-search behavior. Then it can feed these data back into its forecasting models to help establish targets. The total number of variables in such forecasting efforts can exceed 1,000.

Implementation: Scaling up

Once opportunities to create value have been identified and benefits targeted, organizations implementing advanced analytics and machine learning at scale must emphasize three basic requirements for effective implementation.

Clean, accessible data

Perhaps more than other functional groups, a finance organization implementing or scaling up an advanced-analytics program must ensure the fidelity and accuracy of data. When business information isn't adequately sourced, aggregated, reconciled, or cleaned, staffers spend more time on tasks that don't add value and less on important, strategy-oriented discussions. As one data analyst told us, availability isn't an issue in most companies; accessibility is the bigger concern. At one chemical company, for instance, the machine-learning models couldn't read unorganized data sets, so certain key performance factors were excluded from the results. The data in question had to be cleaned up and reingested, which added time to the modeling process.

Finance leaders must work with the IT and business functions to set the ground rules for data usage—what good data look like, who owns them, who can access them, and so forth. The leaders of finance, IT, and business functions must also collaborate to ensure that employees at all levels are trained to understand the systems required to collect, access, and maintain the data.

Operations and organization

It won't matter how clean the data are or how easy they are to access if the finance function doesn't have the right operational and organizational structures to implement advanced-analytics programs. The function needs supporting processes and protocols to gather insights from the data, share those insights, and develop action plans in concert with business-unit leaders. These structures might include strategic data environments, such as data lakes, enterprise layers, cloud platforms, visualization tools, and development sandboxes.

The finance team will also need to focus on cultural issues—for instance, by highlighting "lighthouse" cases that might inspire other parts of the business to use advanced analytics. Leaders in one pharmaceutical company started with one small group charged with monitoring data on clinical trials. The company then gave a slightly larger group of users access to these data so it could determine how efficient and effective its clinical-trial process was. Eventually, it built out modules that thousands of users could access.

Talent

The company and the finance team looking to implement or scale an advanced-analytics program will likely need to hire data scientists, data engineers, and data-visualization specialists. They will probably need to retrain internal staffers to work with data specialists, as well. Otherwise, execution will stall.

In most cases, this will be difficult. Traditional organizations may not be able to lure top digital and finance talent. Smaller companies that don't have the payrolls to bring on data scientists and financial analysts full time will have to determine how much analytics work to outsource and how much to keep in house. One consideration is sustainability: models and regressions are never 100 percent stable over time, so they will need to be adjusted continually, which strengthens the case for in-house capabilities. It may be worth convening a small, hybrid group of finance and digital professionals to work on "no regrets" projects that make the case for deeper investments in digital talent.

In many companies, data governance can involve significant effort, which may be better managed in house. A global manufacturing company, for example, developed its own in-house programs and certifications for training digital translators and data scientists. The company began offering multiple modules and curriculums at all levels of the organization, and more than 300 managers and employees have gone through the program, which mitigated the need for an extended recruiting effort.

Vision: The CFO in the lead

Leaders of companies must have a clear vision of how they will use new technologies. In our experience, CFOs are well positioned to provide that vision and to lead the widespread adoption of advanced analytics. They have most of the necessary data in hand, as well as the traditional quantitative expertise to assess the real value to be gained from analytics programs. Project teams and senior leaders may suspect that their companies could streamline processes or export products more efficiently, for example, but the CFO can put these ideas in the proper context.

At investor days or in quarterly earnings reports, C-suite leaders tend to talk about analytics programs in broad terms—for instance, how they will change the industry, how the company will work with customers differently, or how digitization will affect the financials. What's missing is the impact for investors, and CFOs can supply that. In doing so, they can help fulfill the oft-repeated request, from both senior management and the board, that they serve not only as traditional transaction managers but also as key strategy partners and as value managers.

Of course, CFOs can't lead digital transformations all alone. They should serve as global conveners and collaborators, encouraging everyone, including leaders in IT, sales, and marketing functions, to own the process.

CFOs on the cutting edge of advanced analytics are positioning themselves not just as forward-thinking finance leaders but also as valued business partners to other leaders in their companies. Those who aren't doing so already will need to think about how analytics programs could change the ways they work—and then lead by example.

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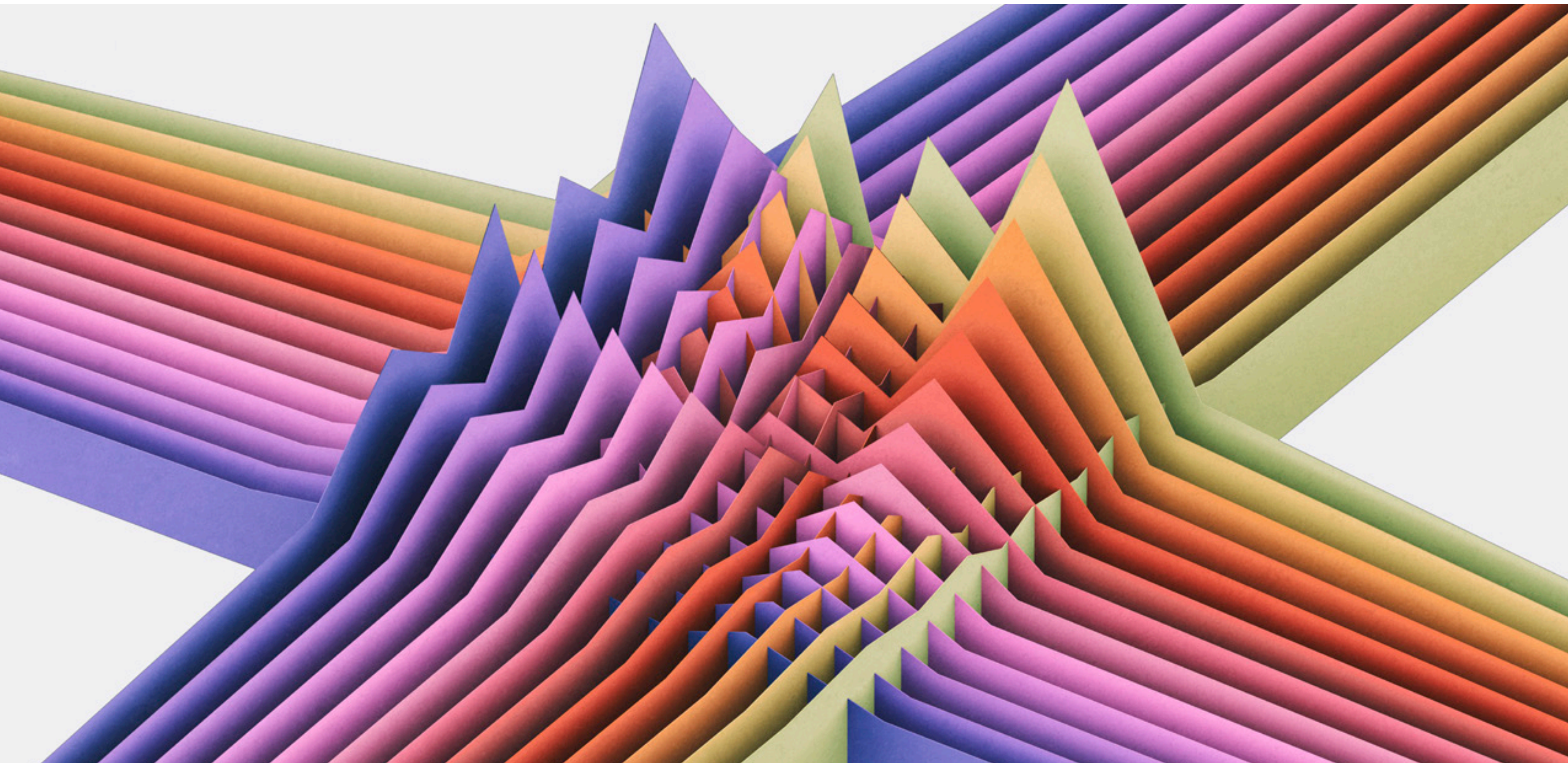
The authors wish to thank Davide Grande and Sebastian Kerkhoff for their contributions to this article.

Are scenarios limiting your pandemic-recovery strategy?

Parametric analysis can help finance chiefs expand their views of important variables for planning and decision making.

by Tim Koller, Aleksander Petrov, Yuri Polyakov, and Ishaan Seth



Even as the COVID-19 crisis continues to loom, business leaders are launching planning and budgeting discussions to seek the next best strategic steps for their companies to take. For some—those in technology and pharmaceutical companies, for instance—the planning exercise has likely been relatively straightforward. These companies may have entered the crisis in good shape financially; some may have even experienced increased demand for their products and services during the pandemic. With their strong balance sheets and liquid positions, they have been able to convene plan-ahead teams to build forecasts, develop scenarios, and identify strategic moves and related key performance indicators.

By contrast, planning has likely been more complicated for companies that are still reacting to the immediate effects of the COVID-19 pandemic or for which business uncertainty is not only an outgrowth of the current health and economic crises but also a natural state of play in their industries. Companies in electric power, natural gas, logistics, and manufacturing, for instance, must continually account for exogenous factors beyond their control—for example, credit spreads and the price of production inputs. Given the double dose of uncertainty, these businesses may benefit from a multidimensional approach to scenario planning.

Right now, most of these businesses are limiting themselves to three or four macrolevel scenarios that describe the general direction of the economy but don't give business leaders enough of the detailed information they need to explore all the future paths possible within those scenarios. A more effective model is to build an "uncertainty cube" that allows business leaders to assess accurately the probability that certain outcomes will materialize under various scenarios.

The cube model and its underlying analytics are similar to the ones that finance leaders routinely use to calculate cost, cash flow, and value at risk. Under this expanded view, however, a few generic response or recovery scenarios can be translated into up to 10,000 data points that reflect all relevant financing variables over a two- to three-year period. A company can then use data from the cube model to enhance its financial-planning and -analysis (FP&A) models and evaluate all the possible actions that management can take—thereby allowing for unbiased critical investment and allocation decisions.

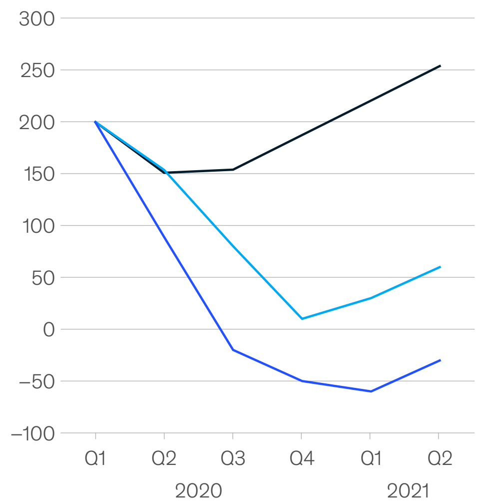
In our experience, expanding the number of scenarios isn't that much more difficult or time consuming than assessing the impact of only a handful is, as long as business leaders take the

Building an 'uncertainty cube' allows business leaders to assess accurately the probability that certain outcomes will materialize under various scenarios.

Exhibit 1

In the wake of the COVID-19 pandemic, a manufacturing company explored three planning scenarios.

Projected cash position in the United States, $ million



	Company-specific implications
Quick recovery Rapid, effective control of spread of novel coronavirus; partially effective interventions	Sales are down 60% for 3 months and recover over next 6 months; credit spreads normalize in 3 months; foreign exchange doesn't move materially
Moderate shock Effective public-health response; regional virus resurgence; partially effective interventions	Sales are down 60% for 3 months and recover over next 9 months; credit spreads normalize in 6 months; foreign exchange doesn't move materially
Severe shock High levels of health impact; prolonged downturn	Sales are down 80% for 3 months and recover over following 1 year; credit spreads stay elevated for 1 year; foreign exchange moves adversely

time to vet the initial financial variables they are plugging into those scenarios.

The power of the cube

As part of one manufacturing company's planning and budgeting discussions in the wake of the COVID-19 pandemic, business leaders needed to make a decision: Should they raise additional cash or take further cost-reduction measures to strengthen the balance sheet? The team reviewed three macroscenarios reflecting the effects of the COVID-19 crisis: the spread of the novel coronavirus (SARS-CoV-2) is contained and economic recovery is slow, the spread of the virus resurges and economic recovery is muted, and the spread of the virus escalates dramatically and economic recovery is slow (Exhibit 1).[1]

The business leaders identified the following six critical financial variables that would affect the company's P&L in any of these scenarios:

— US GDP

— appreciation or depreciation of European currencies

— appreciation or depreciation of Brazilian currency

— BBB-rated credit spreads

— steel prices

— oil prices

[1] Kevin Buehler, Arvind Govindarajan, Ezra Greenberg, Martin Hirt, Susan Lund, and Sven Smit, "Safeguarding our lives and our livelihoods: The imperative of our time," March 23, 2020, McKinsey.com.

The manufacturing company homed in on these six factors, but the number and type of relevant financial variables will differ, of course, based on company and industry. Most companies have taxonomies of financial risk. If they don't, their finance leaders should work with their business units to create some, ensuring that their perspectives are reflected in the selection of the most critical factors to model.

To represent three possible scenarios for each of these six variables across seven business quarters, the manufacturing company would have needed to examine more than 1,500 future paths—and yet that still may have not been enough information to capture the future uncertainty properly. The three base scenarios may have reflected where the economy was going, broadly, but what about activity in the white spaces?

To answer this question, the manufacturing company built an uncertainty cube, which allowed it to expand its analysis and assess 10,000 future paths, thereby ensuring that the broadest possible range of outcomes associated with the relevant market variables would be accounted for. For instance, in one future path, a sharp drop in GDP in the fourth quarter of 2020 was accompanied by a dramatic rise in credit spreads and increasing steel prices. On another future path, GDP similarly fell meaningfully, but credit spreads remained constant, and steel prices softened (Exhibit 2).

The company used the findings from this expanded analysis to adjust its FP&A models to be highly sensitive to movements in any of those six critical market areas. It was therefore in a better position to translate foreign revenues into home currency at simulated exchange rates, reflect input costs with simulated steel prices accurately, adjust sales volumes to be consistent with stochastic GDP, and shift funds to reflect corporate credit spreads.

Exhibit 2

The 'uncertainty cube' lets leaders explore all possible outcomes associated with relevant financial variables.

Financial-market variables	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022
US GDP (quarter on quarter)	–5.7%	–1.4%	–1.3%	0.6%	0.4%	0.7%	0.2%
$–€ exchange rate	1.10	1.00	0.97	1.02	1.01	1.00	0.98
$–BRL[1] exchange rate	5.16	5.70	5.20	5.60	5.90	6.10	6.20
BBB-rated credit spread	178	300	250	200	220	200	150
Steel price	198	207	210	200	205	199	201
Oil price	40	38	42	44	46	41	44

Time

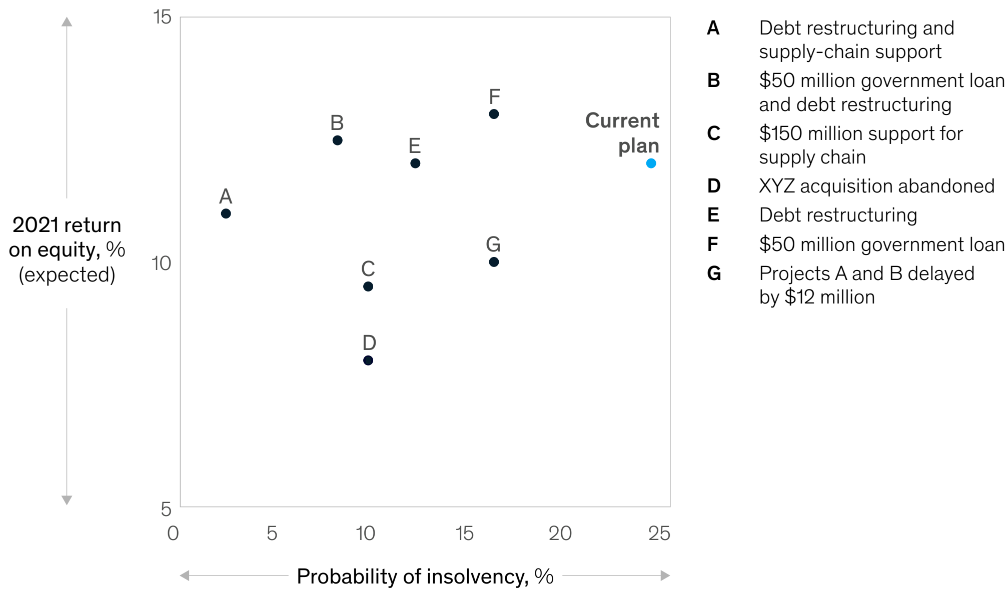
Future paths: Path 1 … Path 10,000

[1]Brazilian real.

Exhibit 3

A manufacturing company evaluated the expected return from various actions in response to the COVID-19 crisis.

Scenario-evaluation matrix



Additionally, the company was able to evaluate each potential managerial action by calculating the expected return on equity—the average across all simulated scenarios—versus the probability of a particular risk event occurring.[2]

After analyzing all the data, the business leaders were surprised to learn that the probability of insolvency was nearly 30 percent over the next 24 months, a result of the COVID-19 pandemic's effect on global currencies and oil prices. The findings highlighted the urgency for the business leaders to take further actions to strengthen the balance sheet. They knew that the possibilities could include applying for government help, restructuring existing debt, issuing new debt, issuing equity, pursuing an alternative financing structure, prioritizing capital-expenditure programs, and canceling M&A transactions.

In general, the "right" action to take will depend on industry, capital structure, and company-specific factors. But armed with information from the uncertainty cube, business leaders can better evaluate which management and financing options to pursue individually or in combination—free of the biases that can creep into high-stakes decision making.

In the case of the manufacturing company, the FP&A team's models (using data from the uncertainty cube) revealed that applying for a government loan and restructuring bank debt would significantly reduce the probability of insolvency. Similarly, not proceeding with an acquisition would allow the company to reduce the probability of insolvency (by saving cash); however, it would also compromise future returns. The company saw that supply-chain disruption was the single biggest possible point of failure. Hence it chose, as an optimal path forward, to combine debt restructuring with an accelerated purchasing program aimed at supporting suppliers (Exhibit 3).

[2] This number can be determined by dividing the number of scenarios in which the risk event occurred by the total number of evaluated scenarios.

The logistics of the cube

As the manufacturing-company example shows, the uncertainty cube promotes multidimensional thinking about a company's financial position. Particularly amid a crisis, it can help management teams find the balance between response and recovery strategies—between, say, reducing the probability of insolvency in the near term and compromising the company's future growth. And in those industries in which high risk is the norm, the cube allows business leaders to keep *all* time horizons in view when evaluating the effectiveness of proposed management actions.

Of course, not every business situation will warrant use of the uncertainty cube. To determine whether investing in expanded scenario analysis is warranted, a company should evaluate at least one deeply stressed future path. The FP&A team could, for instance, simultaneously carry out a stress test on a set of relevant market variables using their largest observed one-year moves and create a 12- to 24-month financial forecast based on these values. If this extreme stress test reveals that the company's balance sheet will remain strong, no further action would be necessary.

But if the stress test reveals weaknesses, the company may want to pursue an expanded review of future paths using the uncertainty cube. It's important to note that the incremental effort of evaluating management actions over thousands of future paths isn't fundamentally different from that required to evaluate even a few scenarios properly. Additional work will be required, but the uncertainty cube can be embedded as a module within the FP&A tool kit (and owned by the FP&A team) and may be linked to a company's existing cash-flow models. Once the future paths are defined across relevant market variables and FP&A models are made sensitive to these variables, fully adopting the suggested methodology is a straightforward task.

In times of crises (and beyond), business leaders need to build financial plans that not only reflect and acknowledge the ever-present uncertainty but also position their companies as resilient organizations. The uncertainty cube and FP&A models that are adjusted based on data from the cube are critical tools for doing just that—anticipating a range of future paths for the company and identifying the right type and mix of actions that leaders can take to respond effectively to and recover from economic shocks.

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Investors remind business leaders: Governance matters

Activists continue to poke holes in corporate performance and returns, but they are having their greatest success with governance structures. Here's how to think about their moves.

by Michael Birshan, Madeleine Goerg, Anna Moore, and Ellora-Julie Parekh

Even before the spread of the novel coronavirus (SARS-CoV-2),[1] investors were calling on senior-management teams and corporate boards to focus on environmental, social, and governance (ESG) concerns. Investors were, for example, prompting companies to consider questions of purpose and to pay more attention to the impact of their actions on the environment. Now the pendulum is swinging toward social issues raised by the spread of COVID-19—for instance, worker safety and rising unemployment.

For many businesses, governance remains a less discussed area of vulnerability. That is in part because it involves internal systems, controls, and procedures, which, in many cases, are less visible to stakeholders and the broader public. For instance, stakeholders can't always tell if boards and senior-management teams are preempting regulatory violations or communicating clearly with regulators above and beyond standard reporting—until it's too late.[2]

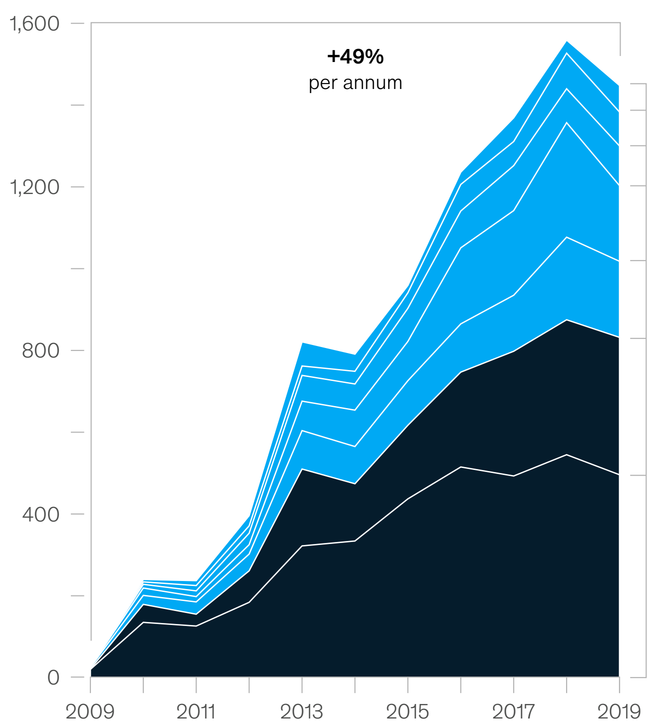
In the wake of the global pandemic, boards will play a key role in guiding their organizations into the next normal. Indeed, this may well be the moment when boards and leadership teams prove their value—or show their flaws.

Companies that don't regularly review and address governance issues may be ignoring them at their own peril. Governance-related demands by activist

Exhibit 1

The number of board- and governance-related campaigns conducted by investors have increased significantly.

Investor demands by type, number



	CAGR, %	
Structural demands	2009–19	2016–19
Voting rights	30[1]	29
Transparency and accountability	56	8
Remuneration	30[1]	3
Other bylaws	69	<1
Board composition	47	16
Personnel demands		
Leadership change	79	13
Board representation	38	–1

[1] 2010–19.
Source: Activist Insight

[1] "COVID-19: Implications for business," June 11, 2020, McKinsey.com.
[2] Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value," *McKinsey Quarterly*, November 14, 2019, McKinsey.com.

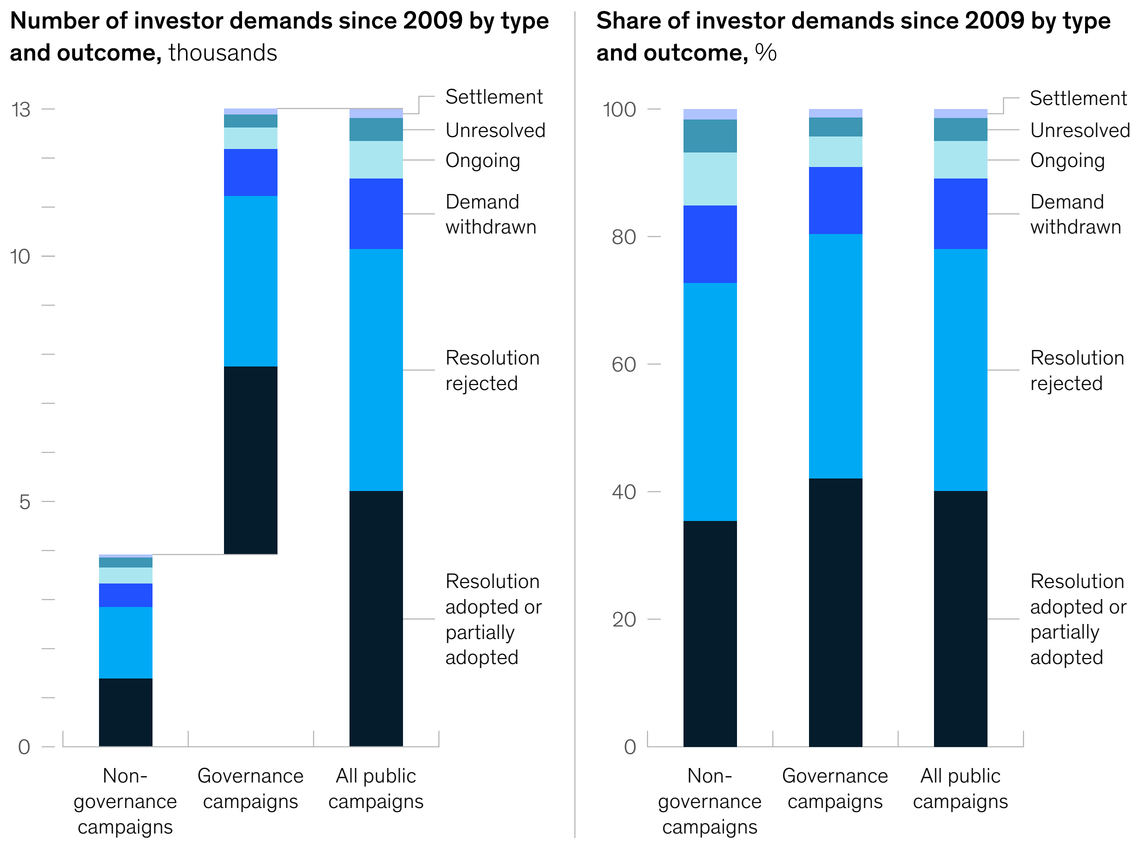
investors around the world rose from just 27 in 2009 to about 1,400 in 2019. These demands reflect activists' interest in a broad range of sectors, including the financial-services, basic-materials, energy, business-services, and technology sectors (Exhibit 1).[3]

What's more, about 70 percent of *all* activist-investor demands over the past decade have focused on governance, and many have garnered support from proxy advisers.[4] Governance is also increasingly top of mind for institutional investors.

Activists' demands fall into two broad categories: structural and personnel related. They cover a range of issues, including board composition, remuneration, accountability, voting rights, and leadership changes (see sidebar, "Two categories of investor concerns"). Governance-related demands have not only outnumbered others over the past decade but also more successfully achieved their targeted outcomes (Exhibit 2).[5] A typical example of such demands involves a manufacturer's delay in disclosing a transaction appropriately, as well as accusations that its executives had bought votes.

Exhibit 2

A significant number of governance-related campaigns have been successful over the past decade.



Source: Activist Insight; Proxy Insight

[3] Activist Insight Governance: 2009–19, Activist Insight, June 2020, activistinsight.com.
[4] Covers 9,093 governance-related demands and 3,919 nongovernance-related demands; Activist Insight Governance: 2009–19. In the 2017–18 voting season, Glass Lewis and Institutional Shareholder Service (ISS) supported most governance-related proposals from shareholders during shareholder meetings; in 2017–18, ISS and Glass Lewis supported 75 percent and 88.5 percent, respectively, of shareholder proposals for independent board chairs; both supported 100 percent of proposals to adopt majority voting for director elections; Proxy Insight Online: 2019, Proxy Insight, June 2020, proxyinsight.com.
[5] In the past decade, more than 42 percent of governance-related resolutions from shareholder activists were adopted, compared with 35 percent of nongovernance-related resolutions; Activist Insight Governance: 2020, Activist Insight, June 2020, activistinsight.com.

Two categories of investor concerns

Our research shows that activist investors' corporate-governance concerns, while many and varied, tend to fall in two broad categories: structural or related to personnel.

Demands relating to structural concerns typically focus on the following five areas:

- *board composition and independence*—the annual election of directors, the introduction of minimum requirements for the number of independent directors, changes to the number of board seats, and transparency about who is being appointed to top positions and about succession planning

- *remuneration*—the proportion of long-term incentives in executive compensation; the introduction of incentives related to environmental, social, and governance issues; and benchmarks for executive compensation, options, bonuses, and expense accounts

- *transparency and accountability*—changes in the auditing process or in the disclosure of financial statements, additional information on transactions, access to shareholder lists, and the results of internal investigations

- *voting rights*—majority voting at shareholder meetings, the amendment or repeal of poison-pill or shareholder-rights plans, and the implementation of a universal proxy card so shareholders can vote for individual director nominees or oppose proxy contests for board seats

- *other bylaws*—the threshold for calling special shareholder meetings, as well as proxy-access bylaws that require a company undergoing an election to include on the voting list the name of any person who meets agreed-upon ownership criteria and has been nominated by a shareholder

Proposals focusing on personnel-related concerns are typically related to the performance of individuals or teams. They challenge a company's stewardship by making demands in the following two areas:

- *board representation*—improving oversight and diversity by challenging the expertise or independence of individual candidates put forward for election

- *leadership change*—requesting the removal of senior executives or board members for failures of performance or campaigning to separate the roles of the chair and the CEO to increase checks and balances

These actions opened it up to a two-year shareholder-activist campaign, culminating in the company's breakup.

As the manufacturer and many other companies have learned the hard way, it's always better to be your own activist rather than have demands thrust upon you. Executives and board members should respond to increased external pressures by continually reviewing their governance efforts and considering the best ways to shore up their governance credentials. These efforts have an added bonus: a strong governance program can promote success in many other parts of the business—including improved operations, motivated talent, and increased innovation—and can strengthen shareholder relations.

In this article, we'll examine the primary governance factors that activist shareholders have targeted and the ways in which some of their concerns were mitigated.

Quantifying the concerns

Not all governance proposals from shareholders are created equal. It's important for companies to quantify the number and type of possible activist overtures. Some of them focus on improving management fundamentals, others suggest board or leadership changes to give activists seats at the table, and still others propose what may be sensible measures for unlocking value.

Data from Activist Insight show that personnel-related demands—to gain board representation and change leadership, for instance—have accounted for more than 40 percent of all governance-related proposals since 2009. The other 60 percent or so have focused on structural concerns. An industrial, for example, faced an internal investigation after several quarters of operational issues. It then decided to delay the announcement of quarterly results. These problems and a related decrease in share price prompted activists to demand more frequent earnings disclosures and the election of independent external directors to the board. The manufacturer swiftly agreed, and the results were greater transparency and, ultimately, increased corporate value.

Shoring up governance credentials

Conducting frequent governance reviews is not only a good hedge against demands from activist investors and other shareholders but also simply part of good corporate hygiene. Companies often don't conduct such reviews because their management teams are under less pressure to focus on these capabilities than they are on others. What's more, the acknowledgement of the direct links between good governance and value creation is a recent development in many companies. Our research and experience in the field suggest that businesses can take several steps to anticipate activists' concerns and shore up their governance credentials.

Change the board's composition

Activist shareholders are demanding more diverse, expert, committed, and independent boards. Rising shareholder expectations are prompting companies to bring in new profiles, adjust the sizes of boards, and review board-member terms and renewals. For similar reasons, a large company under pressure from activist shareholders cut its directors' terms to two years, from three, and reduced the size of its board to nine members, from 11. As a result of this board shake-up, four long-standing board members will step down by the end of 2020 or 2021 to allay concerns over a lack of sector-specific expertise and independence from the CEO.

Companies shouldn't wait to be prompted by activist shareholders to act. They should create more inclusive and professional boards by proactively adding to (and, if appropriate, shaking up) the current composition of the groups, clarifying expectations for board members, and reviewing their level of engagement. Such reviews could include a detailed comparison between the current directors' skills and a competency matrix (the skills the company deems critical). They could also consider the directors' prior affiliations with the company, potential conflicts of interest, and the board's overall responsiveness.

Clarify your remuneration policy

Shareholders increasingly want to understand how senior managers and boards have arrived at their levels of leadership remuneration and whether the methods are fair. They are asking, for instance, if the remuneration is tied to performance or to specific ESG metrics and if it's in line with the remuneration at peer companies. Aiming to align pay with performance, activist shareholders of one industrial conglomerate pushed to change the performance targets for all its top executives. The activists sought to cut the bonuses for those executives whose businesses had recorded losses in 2017, including those of the CEO and CFO.

To anticipate activists' concerns about pay and performance, companies can, for instance, ensure that they have clear and communicable metrics that support their decisions on remuneration. Reacting to a public ESG campaign by a group of shareholders, a major oil and gas company decided to link the compensation of more than 1,000 of its top employees to its success in meeting reduced carbon-emissions targets.

Communicate clearly

When companies are involved in major transactions, investigations, or audits, shareholders look for full transparency. In one large company, shareholders stepped in to demand a governance overhaul, given their concerns about an acquisition decision made by the board. As a result, the company created a board-level committee to consider the interests of noncontrolling shareholders in all major decisions.

To limit speculation and dispel concerns, it's critical for senior managers and boards to give stakeholders coherent narratives about major decisions and their potential effects on corporate performance. Establishing a rhythm of clear, frequent, and comprehensive updates on such decisions, as well as a mechanism for disseminating follow-on reports and metrics to key stakeholders, can help allay shareholder concerns.

Think about the rules of shareholder engagement

Given the pace of change in business and the world today, shareholders are demanding that companies adopt faster decision-making processes. Reviewing how shareholders participate (for example, by testing how voting rules affect shareholder engagement) can help keep up with changing shareholder expectations. A majority vote, for instance, is becoming the standard for board elections. According to the 2019 US Spencer Stuart Board Index, 89 percent of boards in the United States require directors to resign if they fail to receive a majority of the shareholders' votes, compared with just 65 percent in 2009.[6] More and more companies must also submit proposals for poison pills, takeover defenses, and other matters for ratification by shareholders.

Circle back to purpose and societal impact

Shareholders and stakeholders in all sectors continue to make it clear that the impact of any business on the environment and society matters to them. The decision by a large commodity-mining and -trading company to cap its global coal output, for instance, was directly linked to shareholder pressure to align with the targets of the 2015 Paris Agreement. To head off the activists' concerns, senior-management teams and boards can regularly review their portfolios of business activities and map their impact on major global initiatives. A growing number of companies benchmark themselves against the United Nation's Sustainable Development Goals, for example, thus actively positioning themselves to attract top talent and socially conscious consumers and to meet critical regulatory requirements.

With activist investors and other shareholders increasingly focused on stewardship, now is the time to evaluate where you stand. A governance review should form a big part of any program to prepare for and engage with activist investors.

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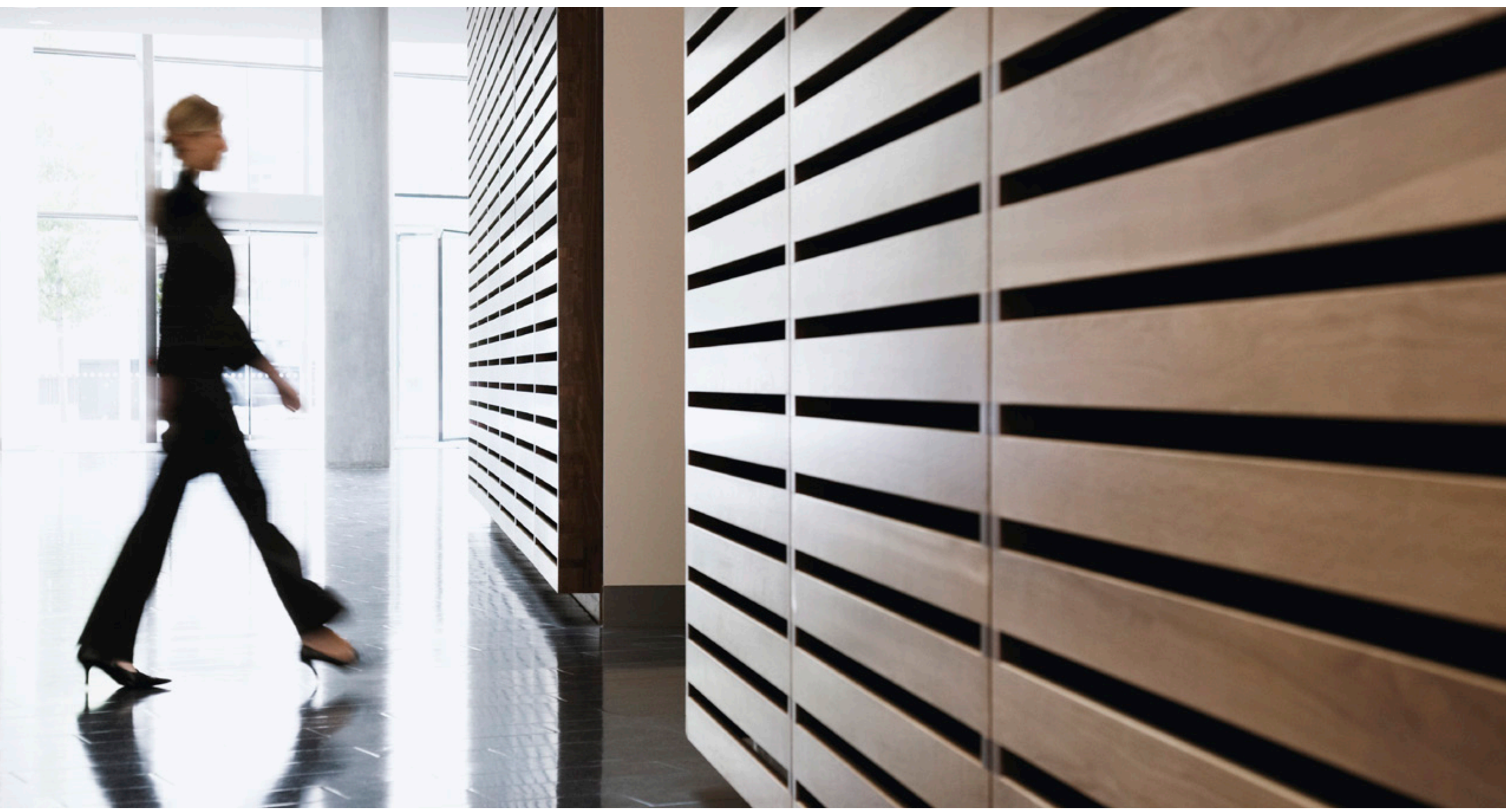
[6] "2019 U.S. Spencer Stuart Board Index," Spencer Stuart, October 2019, spencerstuart.com.

The private-equity-company CFO: Essentials for success

Private-equity-portfolio companies are crucibles for CFOs. Four priorities are essential for them to get started on the right foot.

by Ankur Agrawal, Jeremiah Connolly, and Matthew Maloney



The idea of leading a private-equity (PE) firm's portfolio company can seem attractive to many experienced CFOs. In some cases, the work may involve reviving ailing companies. In many instances, however, the finance leader will be participating in the development of a yearslong growth plan for the company, tasked with identifying opportunities to both control costs and improve operations.

Few opportunities offer CFOs the same prospects for putting their skills to the test, transforming a business, and opening doors for achieving even more impact in the future. Conversely, few opportunities offer the same perils. The skills and knowledge that make a CFO successful in more typical operating environments become table stakes in the PE world, in which borrowed capital means the risks are larger, the time to show results is shorter, and the scrutiny from investors is more intense.

The nature of reporting relationships can also be challenging. Some PE firms may trust the management teams that they have in place but may still want to be involved in the financial end of things, requiring frequent updates from the CFO. Others may be relatively hands off when it comes to communications and guidance. Moreover, a PE-portfolio company's CFO is typically new to the company—and often to the industry—so there are no existing relationships to fall back on within the C-suite team and no legacy within the company to draw upon.

The CFO will need every hand on deck to implement new processes and transform performance. Yet this individual will likely be leading smaller finance teams than would be standard—and will have just as many fires to put out.

The challenges will be new and daunting—but very addressable for CFOs who explicitly acknowledge the differences in managing people, processes, and performance in PE-owned companies. Based on our research, interviews, and experience with CFO transitions, we believe that focusing on four priorities can help ensure CFOs' success in portfolio companies or at least set them on the right path. Specifically, they will need to get up to speed quickly on the economics at play, identify the talent gaps on their teams, establish a reliable fact base for making critical decisions, and actively lead the transformation charge.

Get clear about the economics

The new CFO's primary responsibility, of course, will be to understand the company's balance sheet and cash flow, as well as its debt covenants. The economics are likely to be more complex in this context, however. With debt fueling PE firms' investments, some emphasize cash flow in a far more demanding way than is typical in most operating-company environments: weekly or even daily reporting on cash isn't unusual.

The CFO will need insight into the gritty details of what creates value and costs at the portfolio company, probing fixed and variable costs that reveal what matters most in the business's operating leverage. One CFO we interviewed estimated that developing this insight occupied as much as half of his time in his first six to 12 months. He faced IT issues (disparate systems) and cultural issues (isolated and protective business units), both of which limited his access to critical data.

The finance leader shouldn't expect that this information will be obvious or that preexisting reports will help them understand the business—or even tell a consistent story. Inertia is the main reason that there are boundaries among business units, so the fact that unit A is more profitable than unit B reveals nothing about which activities are the ones creating (or draining) profits. Yet a comprehensive fix will likely require a lot more time than the CFO has. Instead, the CFO will have to build a minimally viable level of clarity while running the current operation and launching improvement initiatives.

The CFO of a PE-retail company recognized that trying to pull all cost data for the company's product portfolio would be impossible because the IT

Even CFOs who pride themselves on their people and talent-management skills often face challenges in PE-owned companies, in which the management infrastructure can be in flux.

systems were too antiquated and there wasn't time to do manual cleanup. Instead, his team created a standard-cost model that it could apply, with minor adjustments, to the majority of the company's products. While not precise enough for close questions on profitability, the model revealed that whole categories of products were significant money losers—largely because their prices failed to account for all logistics costs. Eliminating the bottom-decile products entirely and raising delivery charges for products in the next few tiers allowed the company to stop much of the hemorrhaging in its cash position. That bought the team time to refine the model further in reviewing the rest of the company's product line.

Find the right people

Even CFOs who pride themselves on their people and talent-management skills often face challenges in PE-owned companies, in which the existing management infrastructure can sometimes be in flux, even as investors are demanding results. The CFO, who, again, is typically an outsider, must figure out which people can lead under which circumstances and empower them. As one CFO told us, while he's updating existing treasury systems and control processes, he's also using the process to assess talent, searching for diamonds in the rough—those people who might be able to drive special projects and help transform the company. It's a perfect moment to remember that skills matter much more than job titles. For instance, the financial-planning analyst who's eager to change the way things are done may be a natural to join the transformation team. And for the treasury manager who excels at that role but also covers other parts of the function, this might be the time to redesign the role.

Indeed, the CFO must encourage talented, engaged employees to lead initiatives that deliver on the portfolio company's investment thesis, thus democratizing value creation beyond the finance function. As the CFO at a midsize PE-owned company told us, "My team members have started creating automated dashboards, but they don't have the skills to tell me anything new. It's just one more thing to look at." His task is now to coach his team members so they can extract meaning from the dashboards and act on what they find.

Such efforts at empowerment and delegation will need to include teaching people from other fields to "speak finance"—at least enough to help them work more productively with the CFO and finance team. Those with a good understanding of the company's financial position can help shift the culture away from doing things the way they have always been done and toward active efforts to improve the bottom line—for example, by tweaking performance-management systems so that employees feel encouraged to find and eliminate waste.

Own the data

A third priority centers on the use of data. The CFO's outsider status, at least initially, makes it critical for the business leader to have an expandable, reliable fact base for uncovering new and powerful opportunities for value creation—ones that the company can capture quickly.

Few PE-owned companies have good data readily available; if they did, they probably wouldn't have become portfolio companies to begin with (exhibit). Moreover, they often lack the data-analysis and -tracking capabilities required to capitalize on value-creation opportunities. Yet the PE time horizon means that a multiyear rollout of a new enterprise-resource-planning system isn't feasible, even if it were desirable. Portfolio-company CFOs thus need to understand where and how to use lower-cost digital technologies to maximize the benefits in months or even weeks, rather than years.

Even in a relatively short period of time, a PE-owned company's CFO can make targeted investments in productivity-enhancing tools, such as off-the-shelf, cloud-based invoice-management software that reduces time and hassle while increasing transparency and policy enforcement. A useful approach is to identify those data initiatives that will deliver high-value, quick wins in the near term while also getting other middle- and longer-term projects in flight.

That's the approach an international retailer is taking. Before it was acquired by a PE firm, it had more than 100 separate IT systems, each siloed from the rest. With revenue falling, there was no budget or time for a major IT upgrade. But a targeted, million-dollar investment in a cloud-based data lake provided much of the same benefit—supporting business intelligence and data visualization, for instance, which are both essential for future investments in performance improvement—while requiring only a few weeks of design and implementation.

Lead the transformation charge

The final priority for the new CFO in a PE-owned company is to keep the overall transformation on track. That includes defining key performance indicators and monitoring metrics in ways that are robust but not overwhelming.

Almost invariably, the PE sponsor will have identified an investment thesis and will assume momentum. In daily operations, however, the CFO must understand

Exhibit

Data fragmentation is a top challenge for many CFOs.

Top challenge for CFOs, % of respondents (n = 50)

Source: Survey of attendees at private-equity CFO roundtable, *Financial Times* and McKinsey, September 2019 how value is created on both the cost and revenue sides of that thesis and then herd all resources toward the desired outcome. Ideally, the CFO will own or co-own a few key transformation initiatives, thereby giving the CFO a showcase to model the change that leaders want to see.

With a good handle on the finance function and a clear understanding of primary levers for value creation, the CFO can be a challenger and influencer within the portfolio company—holding overly optimistic CEOs and inwardly focused business-unit leaders to account. The CFO should lead monthly business reviews with leaders in all functions, examining the factual foundation of their activities and proposals (free from bias and emotions) and ensuring that their investment decisions are in line with the company's overall priorities. In so doing, the CFO becomes the strong right arm of the CEO (and the PE fund) on strategic questions, as well as on financial results and decisions.

Within PE-owned companies, CFOs are constantly measured against an ever-rising bar. The finance leaders who can master the four critical priorities described here can improve the odds of success not just in their existing roles but in other C-suite positions in future portfolio companies.

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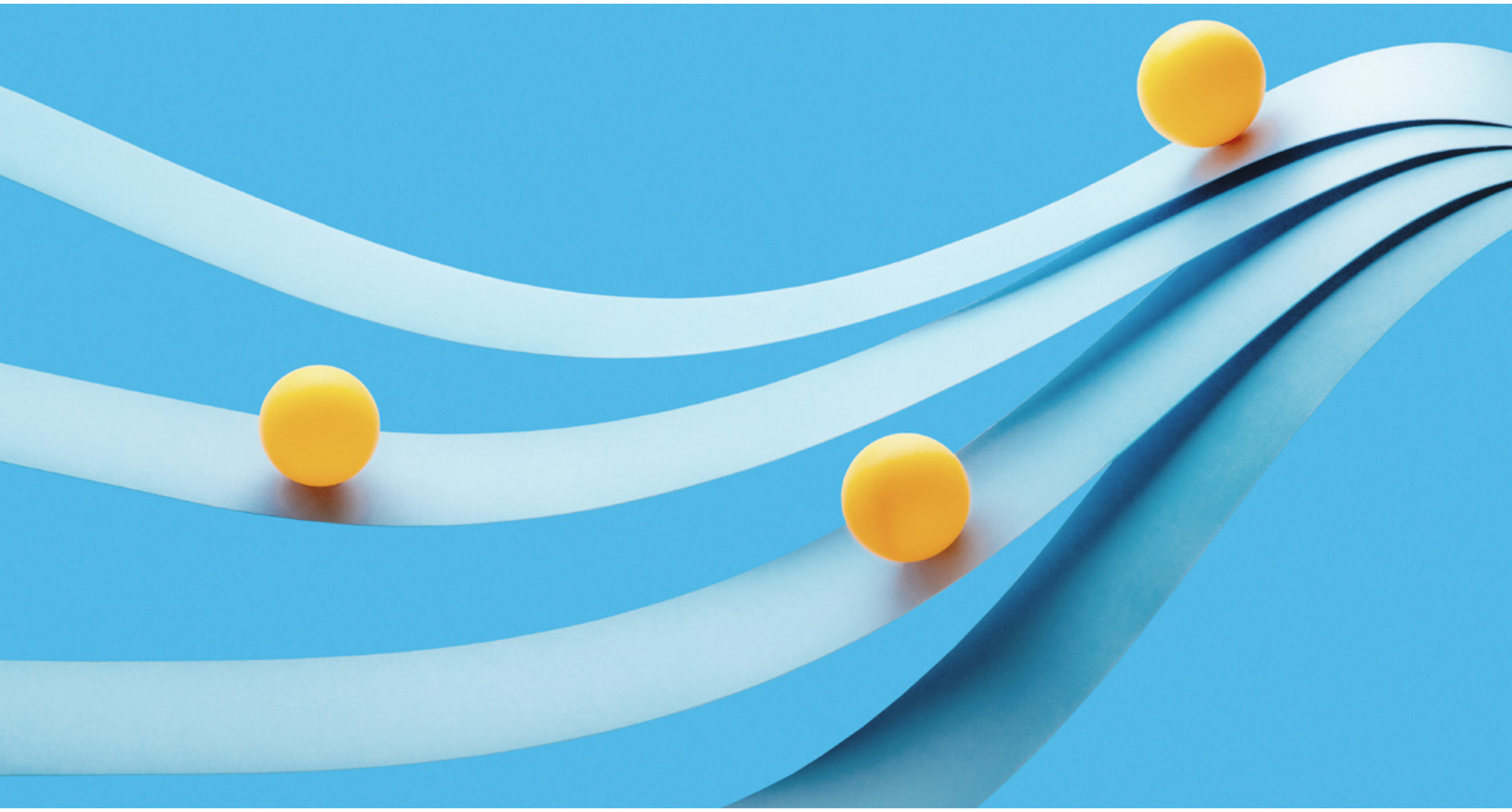
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

Lifting your head from the sand

by Eileen Kelly Rinaudo



The dilemma

It doesn't matter how well you prepare for a negotiation session if the people in the room aren't listening or are only half-listening. The team leader of a partnership between two consumer-goods companies had spent weeks reviewing market reports, developing sensitivity analyses, and otherwise building a perspective on how the partnership could work better over the next three years. So far, it hadn't created the intended results for either party—hence a scheduled meeting to renegotiate terms. Everyone was expecting a tense discussion. The team leader wanted to be ready for anything.

To the team leader's surprise, the mood in the room was far from contentious. There were nods and smiles as topics came up. Discussions about market shifts and potential new partnership roles were upbeat, albeit a bit flat. At the end, the legal teams agreed to draft revised contracts. Given the positive vibes in the room, the team leader was convinced that she had made all the right points. But when the documents were circulated several days later, the terms proposed were different from what was discussed—so different that the partner companies called for more data and more meetings. "Back to the drawing board," the team leader thought.

The research

What could account for the gap in perceptions? Research points to a cognitive bias called the "ostrich effect" in which individuals figuratively put their heads in the sand and avoid information they believe may be unpleasant. Specifically, they may ignore the information presented to them, or they may interpret that information in a way that ignores potentially troubling implications. One study, for instance, found that investors were more likely to check the value of their personal portfolios when the markets overall were rising but less likely to do so when the markets were flat or falling.[1]

Taking such a stance may preserve comfort levels in the room, but it won't necessarily lead to productive business conversations. The participants in the joint-venture negotiation nodded a lot, for instance, but they tended to gloss over problem areas, leaving them as open issues that they never returned to. No matter how well prepared the team leader was, senior leaders in the room held fast to their own perceptions of why the partnership wasn't succeeding and what would make it better.

The remedy

One way to counteract the ostrich effect in business conversations is to engage in a *readout process* in which individuals or teams produce an articulated summary of discussions as they occur. A real-time readout gives everyone the information they need to make good decisions. It also increases the likelihood that everyone will step away from meetings with the same understanding of what was just said.

There are typically five steps in a readout process: syndicating an agenda early, designating a scribe, and then, for each topic on the agenda, capturing critical points, sharing those points with the full group, and getting verbal confirmation from all attendees that the summary reflects their understanding of the discussion.

In the case of the consumer-goods partnership, for instance, the team leader should have circulated a list of detailed, mutually agreed-upon topics ahead of the meeting, even including the order in which they would be addressed. With such an agenda in hand, the partners couldn't have breezed past important but potentially uncomfortable topics—or simply nodded their heads in default.

The team leader should also have assigned someone on the team to be a scribe—someone responsible for capturing all feedback shared during discussions.

[1] Niklas Karlsson, George Loewenstein, and Duane J. Seppi, "The 'ostrich effect': Selective attention to information about investments," Social Science Research Network, August 10, 2005, papers.ssrn.com.

The readout process imposes accountability on everyone in the room and can reduce the risk of misinterpretation.

The scribe writes down everything, whether on a whiteboard or via some form of digital-file projection. The scribe in this case could have paused at the end of the discussion of each topic to summarize and reconfirm points made, noting which issues were outstanding, which were completed, and what any next steps might be. At that point, participants could have confirmed the summary as written and suggested changes. That comment process would have continued until all voices had been heard. Then the team could have moved to the next agenda item.

Plainspoken and practical, the readout process imposes accountability on everyone in the room and can reduce the risk of misinterpretation during business meetings.

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