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Perspectives on corporate finance and strategy

Managing for long-term value

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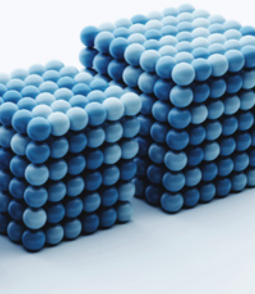

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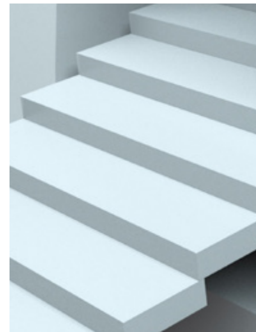

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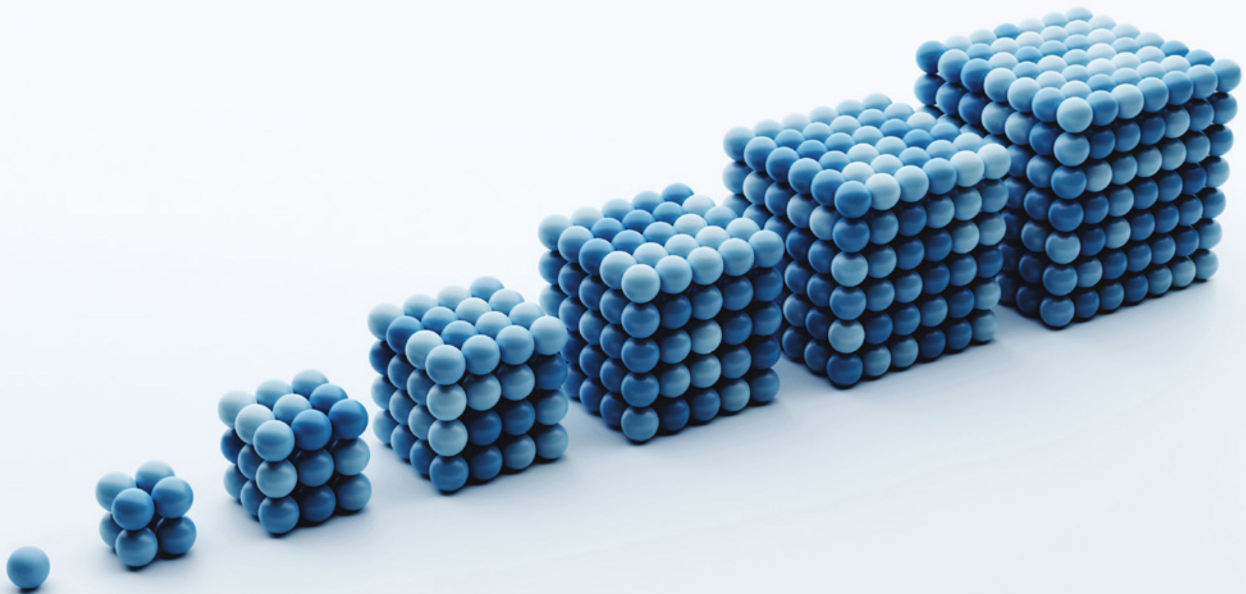
How executives can help sustain value creation for the long term

Joint research from FCLTGlobal and McKinsey highlights the behaviors that can help corporate leaders and board directors sidestep pressures and stay focused on the long term.

by Ariel Babcock, Sarah Keohane Williamson, and Tim Koller



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Ample evidence shows that when executives consistently make decisions and investments with long-term objectives in mind, their companies generate more shareholder value, create more jobs, and contribute more to economic growth than do peer companies that focus on the short term.[1] Data also show that companies can achieve better long-term performance when they address the interests of employees, customers, and other stakeholders.[2] But a survey of approximately 500 global executives conducted by FCLTGlobal and McKinsey shows that many continue to feel pressure from shareholders and directors to meet near-term earnings targets at the expense of long-term strategies.[3]

In one data point, respondents said they believed their companies would cut long-term growth investments by 17 percent, on average, when faced with a 15 percent decrease in revenue—even though the survey specified that the dip resulted from external factors (such as currency fluctuations), would not imperil the company's existence, and would not persist. Other survey responses were similarly short-term oriented—and not just because of the COVID-19 pandemic or other economic shocks.[4]

We wanted to understand better what differentiates long-term-oriented companies from others. How have they sidestepped the pressures? We reviewed and synthesized our own research and that of others in academia and the business world. We also surveyed executives and analyzed data on management and corporate performance. In the process, we identified five behaviors that managers and boards can take to reorient their organizations toward long-term value creation rather than just short-term performance:

— Invest sufficient capital and talent in large, risky initiatives to achieve a winning position.

— Construct a portfolio of strategic initiatives that deliver returns exceeding the cost of capital.

— Dynamically allocate capital and talent (through divestitures, if need be) to the businesses and initiatives that create the most value.

— Generate value not only for shareholders but also for employees, customers, and other stakeholders.

— Resist the temptation to take actions that boost short-term profits.

Global executives who choose to take these actions can, apart from gaining clear performance advantages for their organizations, resolve much of the perceived conflict between stakeholders' interests and shareholders' interests. In fact, the two sets of interests largely converge in the long run. Companies create long-term value for investors only when they satisfy customers, engage and motivate employees, and maintain good relations with communities and regulators across extended time horizons.

Invest sufficient capital and talent in large initiatives

Instead of playing to win, many established businesses play to avoid losing and, as a result, struggle to stay in front of competitors. Long-term-oriented companies identify strategic moves that will keep them ahead in the long run. They also commit ample resources to strategic initiatives, such as product innovation, marketing, sales, and talent development. Amazon and Microsoft are two such companies. During the past 15 years, both have invested large sums in their cloud-computing businesses. In 2020, those businesses generated revenues of around $45 billion and $59 billion, respectively—far more than competitors that put less money and talent into their cloud-computing plays.[5]

[1] Dominic Barton, Jonathan Godsall, Tim Koller, James Manyika, Robert Palter, and Josh Zoffer, "Where companies with a long-term view outperform their peers," McKinsey Global Institute, February 8, 2017, McKinsey.com.
[2] Witold Henisz, Tim Koller, and Robin Nuttall, "Five ways that ESG creates value," *McKinsey Quarterly*, November 14, 2019, McKinsey.com.
[3] The online survey was conducted from June 20, 2020, to July 20, 2020, and garnered responses from 481 participants at or above the director level from European and North American companies with annual revenues of $250 million or more.
[4] The survey was conducted at the beginning of the COVID-19 pandemic, but respondents were asked to focus on the long-term course of their businesses rather than on the immediate crisis.
[5] "Microsoft's cloud generated more revenue than Amazon and Google combined in 2020," *Entrepreneur*, February 24, 2021, entrepreneur.com.

Sustained investments in strategic priorities matter for long-term performance because they lead to higher rates of revenue growth, and revenue growth is an important driver of long-term TRS. Our research shows that companies in the top third of their industries in revenue growth generated TRS that exceeded those of their bottom-third peers by six to eight percentage points per year. Those trends held over a ten-year period—the additional gains of top-third companies yielded shareholder returns that were 80 to 110 percent greater than those of the bottom-third companies.

Of course, revenue growth alone won't deliver shareholder value over the long term. It's just as critical to deliver strong ROIC.

Construct a portfolio of initiatives whose returns exceed the cost of capital

According to a fundamental principle of corporate finance, companies create long-term shareholder value only when their ROIC exceeds their cost of capital. That seems obvious, yet large numbers of companies around the world still misplace their focus.[6] They should consider reviewing the empirical evidence—among companies with similar growth rates, for instance, those with higher ROIC achieve higher valuation multiples and produce greater shareholder returns over the long term, according to McKinsey research (Exhibit 1).[7]

The objective for long-term-oriented companies, therefore, should be to find the combinations of growth and ROIC that work for them, given the conditions in their industries and the opportunities they face. Consider how two US companies, retail giant Costco and spirits and wine maker Brown-Forman, created substantial long-term value in different ways. From 1996 to 2017, Costco's after-tax operating profits grew by 11 percent per year, whereas Brown-Forman's grew by 7 percent per year.[8] Yet the two companies generated identical shareholder returns of 15 percent a year. Brown-Forman matched Costco on that count because its ROIC of 29 percent exceeded Costco's 13 percent.

Not every investment a company makes has to earn more than its cost of capital. Large companies can simultaneously make multiple bets—and not just on those initiatives with the highest chances of succeeding. They may make some risky bets with the potential to yield high rewards. If an entire portfolio of strategic initiatives earns more than its aggregate cost of capital, the company can expect to create value over the long term.

Dynamically reallocate capital and talent to high-value initiatives

Managing for the long term requires executives to monitor their companies' standing in the market and to enter or exit businesses as the competitive landscape shifts—even if it involves shrinking a company. They must also be willing to move talent and other resources to the highest-value initiatives and to do so frequently.

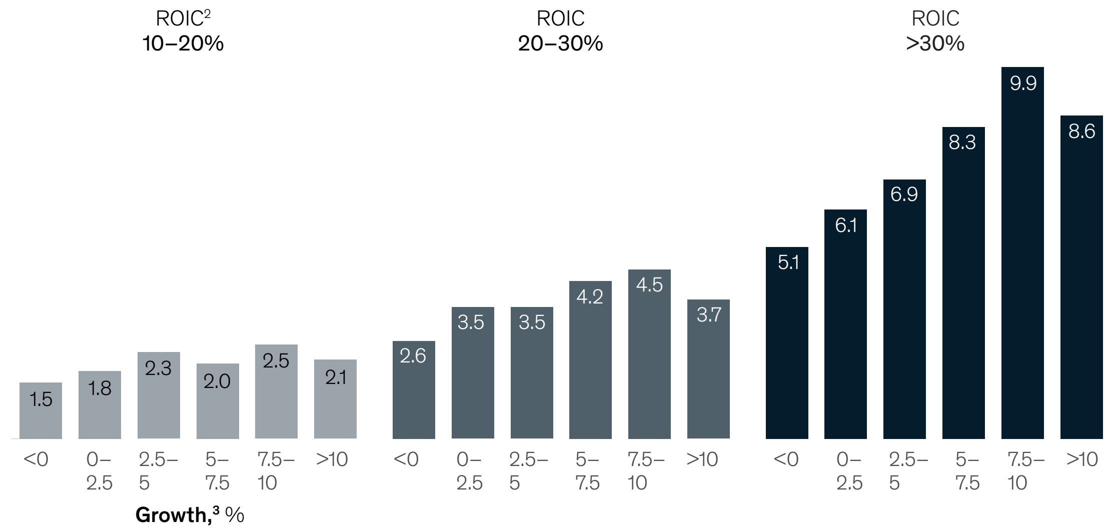
Consider the situation at Walmart. Leaders at the company chose to commit to a major omnichannel initiative, even as they anticipated that some investors would object to the short-term financial hit from the move despite its potential long-term benefits. Since 2014, the company has invested more than $5 billion per year in its e-commerce and omnichannel capabilities. It dynamically reallocated capital to match its new approach to serving customers by increasing funding for supply-chain improvements, store transformations, and digital initiatives. It also made strategic acquisitions, including Jet.com in the United States and a controlling stake in India's e-commerce giant Flipkart. The strategy continues to evolve as Walmart adapts to changes in customer needs and the competitive landscape.

[6] Chris Bradley, Wonsik Choi, Jeongmin Seong, Ben Stretch, Oliver Tonby, Patti Wang, and Jonathan Woetzel, "The future of Asia: Decoding the value and performance of corporate Asia," McKinsey Global Institute, June 3, 2020, McKinsey.com.
[7] Bin Jiang and Tim Koller, "How to choose between growth and ROIC," September 1, 2007, McKinsey.com.
[8] Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, 2020.

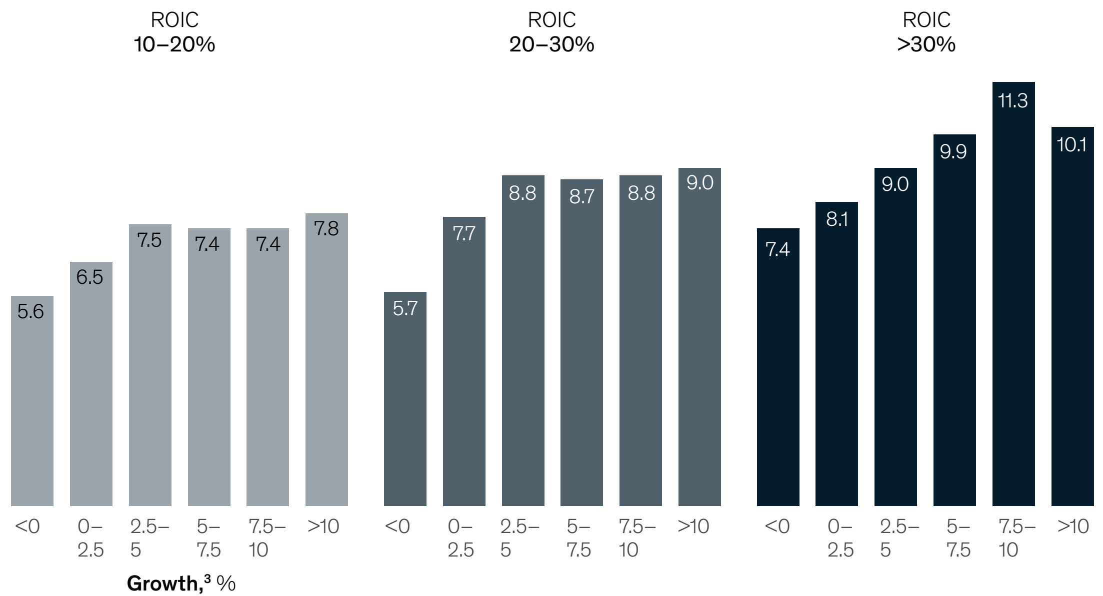
Exhibit 1

Companies that produce higher ROIC achieve higher valuation multiples at all levels of growth.

2018 median ratio of enterprise value to capital[1]



2018 median ratio of enterprise value to EBITDA



[1]Capital includes invested capital, excluding goodwill.
[2]Average ROIC, excluding goodwill, from 2016 to 2017.
[3]Analyst consensus forecast of annual earnings growth from 2018 to 2020.

McKinsey research shows that companies that rapidly reallocated resources and talent were 2.2 times more likely to outperform their competitors on TRS than were those that reallocated resources and talent at a slower clip.[9] It also reveals that taking swift action in anticipation of long-term trends is better than waiting too long: 43 percent of respondents in a survey on divestitures said they parted with assets too late or didn't divest them when they should have.[10] Among the reasons they cited for delay were "waiting for business performance to improve" and "difficulty of replacing lost earnings" (Exhibit 2).

Those who worry that investors will frown on acquisitions and divestitures should take heart: the research shows that the stock market consistently reacts positively to both sales and spin-offs.

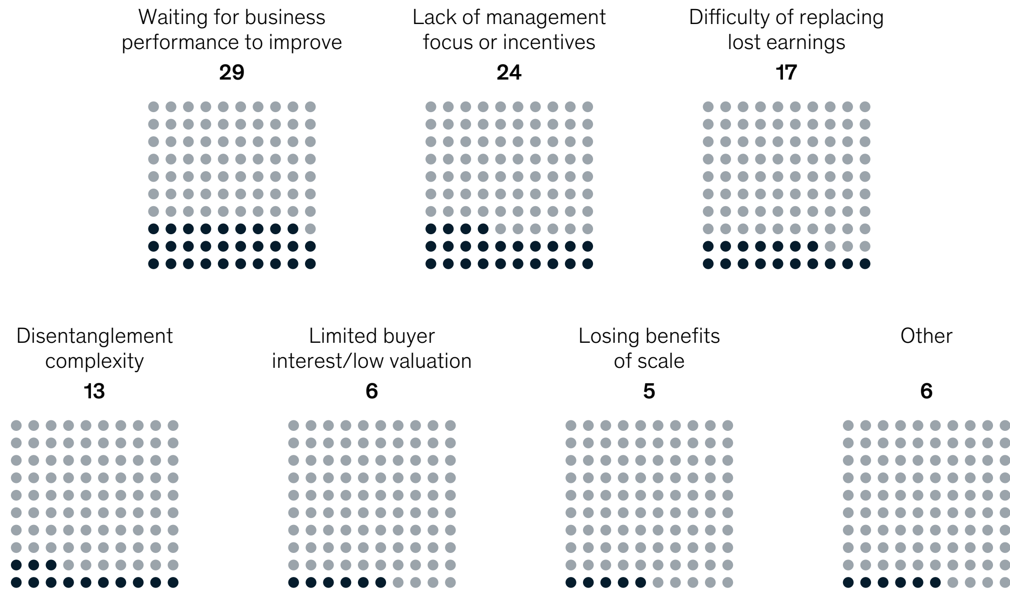
Generate value for all stakeholders

Long-term-oriented companies focus on improving outcomes for *all* their stakeholders, not just those who own shares in the business. They typically rely on environmental, social, and governance (ESG) initiatives to address the needs of a range of stakeholders. In doing so, the research shows, they

Exhibit 2

Some executives say their companies waited too long to divest.

Reasons why companies waited to divest, % of respondents[1]



[1]June 2020 survey of 128 executives, board members, and corporate-development leaders at companies with revenues >$1 billion.

[9] Mike Barriere, Miriam Owens, and Sarah Pobereskin, "Linking talent to value," *McKinsey Quarterly*, April 12, 2018, McKinsey.com.
[10] Results are from a June 2020 survey of 128 executives, board members, and corporate-development leaders at companies with revenues of more than $1 billion.

stand to improve revenue growth, reduce costs, optimize investment decisions, improve employee productivity, and reduce regulatory and legal interventions.

In a 2019 McKinsey survey, 57 percent of respondents said they believed ESG programs create long-term value, and 83 percent said they expected ESG programs to contribute more shareholder value in the long term than they did at that time.[11] Respondents also said they would be willing to pay a 10 percent median premium for a company with a positive ESG record compared with a company with a negative ESG record.

Such responses don't mean that a company should act on every ESG idea that comes along. Rather, executives should actively search for and invest in initiatives that benefit both stakeholders and shareholders. The executive team at Walmart, for instance, will undertake environmental projects with negligible financial returns if managers agree, after debate, that those projects will yield other significant benefits to stakeholders. Many of Walmart's other environmental initiatives offer positive net present value, and so, using a portfolio-level approach to managing risks and returns, the company can cover the costs of those that don't.

Resist temptation

When temporary changes in fortune—dips in revenue, for example—occur, moves to boost short-term results can seem very appealing to pressured executives. Such moves seldom turn out well, however. In our survey, respondents who said executives at their companies tried to meet short-term financial targets by taking actions that created no long-term value also said their companies had worse financial outcomes than others did. Respondents said those companies were half as likely as their peers were to realize more organic revenue growth and 27 percent less likely to generate higher levels of ROIC.

In our experience, long-term-oriented companies actively seek to resist three common temptations. The first is to starve long-term growth investments to make up for short-term challenges, such as earnings deviations.

The second is to cut costs to an extent that could weaken the company's competitive positions. For example, to achieve ambitious earnings targets, a new leader at a retail company cut spending on the frontline sales force by reducing the number of in-store workers and curtailing training programs for those who remained. Over time, customers took notice—and took their business elsewhere. The company's stock price soon plummeted.

In both cases of temptation, executives would do well to lay out their strategic plans. They can explain to key stakeholders that they aren't choosing to depart from those plans just to hit short-term targets.

The final temptation is to reduce the natural volatility in revenue and earnings artificially. Many executives believe that "smooth" earnings growth somehow contributes to value creation. But according to our research, plenty of companies with more volatile earnings growth in the short term generate high TRS in the long term, and plenty of low-volatility companies generate low shareholder returns.[12] Indeed, when institutional investors were asked to rate the importance of various factors in their investment decisions, very few prioritized companies' ability to maintain low earnings volatility. More important to them were management teams' credibility and willingness to take risks with the long term in mind.

Changing mindsets and behaviors

Getting a company to manage for long-term performance requires considerable effort. CEOs and directors must take up new behaviors, abandon old ones, and empower managers to make decisions with long-term outcomes in mind.

[11] "The ESG premium: New perspectives on value and performance," February 12, 2020, McKinsey.com.
[12] Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," January 30, 2017, McKinsey.com.

Few boards spend enough time assessing the strategies and investment plans of the businesses they direct, yet they can help orient management toward the long term.

Board behaviors
A board of directors ordinarily has a well-established role: thinking about the future of a company, approving its strategy, reviewing its performance, and evaluating management. Few boards spend enough time assessing the strategies and investment plans of the businesses they direct. Yet they can help orient management toward the long term in three ways:

— Ensure that strategic investments are fully funded each year and have the appropriate talent assigned to them. To formalize the practice, boards can ask management teams to report on the funding and progress of strategic initiatives and review that report for signs of effective strategic implementation.

— Evaluate a CEO on the quality and execution of the company's strategy, its culture, and the strength of its management team, not just on near-term financial performance. Responses to the survey by FCLTGlobal and McKinsey indicated that companies that evaluated executives' performance primarily based on financial results—rather than on how they achieved those results—were 13 percent less likely to have revenue growth above peers.

— Structure executive compensation over longer time horizons, including the time after executives leave their companies. Adjusting some elements of executive-pay structures, such as the time horizon over which CEOs are compensated, appears to encourage long-term behaviors on the part of CEOs.

CEO behaviors
CEOs, supported by their top teams, are ultimately responsible for creating a focus on the long term in their companies. They must serve as role models for the rest of their management teams when making big decisions. They can also apply their influence and authority in four ways:

— Ensure that strategic initiatives are funded and staffed properly and protected from short-term-earnings pressure. Our survey found that companies whose CEOs allocated resources to critical growth areas were more likely than their peers to exhibit greater organic revenue growth.

— Adapt management systems to encourage bold risk taking and to counter biased decision making. For example, implementing a company-wide rather than a business-unit-level approach to resource allocation can help managers see that their portfolios can accommodate bets on relatively risky endeavors.

— Actively identify and engage long-term-oriented investors—and have the courage to ignore short-term-focused shareholders and other similarly

minded members of the investment community. CEOs should spend more time talking with long-term investors. Such conversations can help reassure executives that a long-term outlook best serves their company and its shareholders.

— Demonstrate the link between financial and nontraditional metrics to prevent short-term trade-offs. To enrich the dialogue with long-term shareholders and other stakeholders, executives can select, track, and report on the nontraditional indicators, such as employee satisfaction, that are most material to their companies' long-term performance.

Executives undeniably face real pressure to focus on and deliver satisfactory short-term results. However, they must weigh short-term demands against the flood of empirical evidence showing that companies that seek strong long-term results outperform companies that optimize short-term gains. By understanding which management behaviors distinguish successful long-term companies and expressly fostering those behaviors, CEOs and boards can help their companies produce value for stakeholders over the long run.

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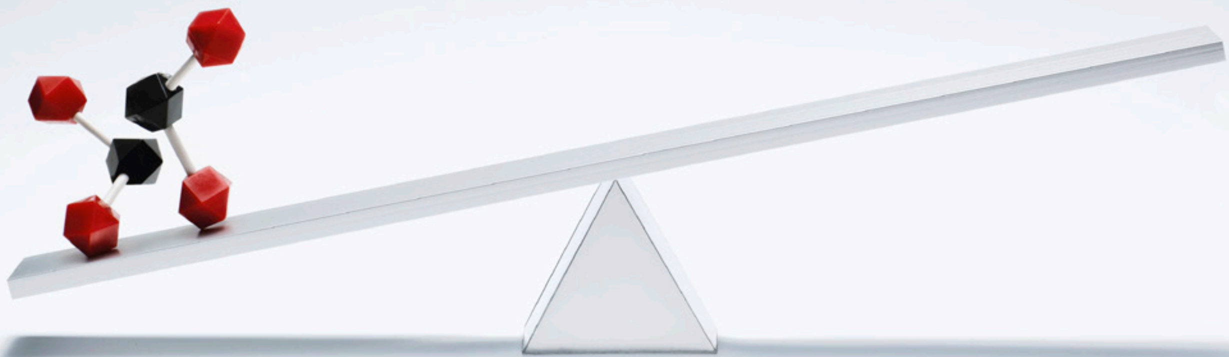
The state of internal carbon pricing

More and more companies are experimenting with internal carbon charges—but are their pricing thresholds correct?

by Jessica Fan, Werner Rehm, and Giulia Siccardo



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Business leaders know that sustainable growth is possible only when they anticipate inevitable shifts in policy, social norms, and technology that could affect their companies. One of the most prominent of these so-called transition risks is in the area of carbon emissions and the potential introduction of a universal price on carbon.

Given impending policy changes in this area, and with an eye toward protecting the health and livelihoods of customers and employees, some companies are experimenting with internal carbon pricing. That is, some companies are setting an internal charge on the amount of carbon dioxide emitted from assets and investment projects so they can see how, where, and when their emissions could affect their P&L statements and investment choices. Internal carbon pricing was a key factor, for instance, in a European energy company's decision to close several power plants, as the internal charge on increased carbon emissions cut into the expected profitability of those plants. Meanwhile, some US financial-services companies are using internal carbon pricing to identify low-carbon, high-return investment opportunities.

To better understand who is using internal carbon pricing and in which industries, we looked at data from companies that have disclosed information from their internal carbon-pricing programs.[1] Our research reveals growing interest and high variability in companies' use of these internal charges. Specifically, 23 percent of the approximately 2,600 companies in our data set indicated they are using an internal carbon charge, and another 22 percent plan to do so in the next two years. Of the top 100 companies in our global data set (based on 2019 revenue), the ones that most frequently reported using internal carbon pricing were those in the energy, materials,

Some companies are setting an internal charge on the amount of carbon dioxide emitted from assets and projects to see how emissions affect P&L statements and investment choices.

[1] Disclosures on internal carbon-pricing policy are documented by the Carbon Disclosure Project, a global organization focused on promoting corporate disclosure of environmental risks and impacts.

and financial industries. They were followed closely by the technology and industrial sectors (Exhibit 1).

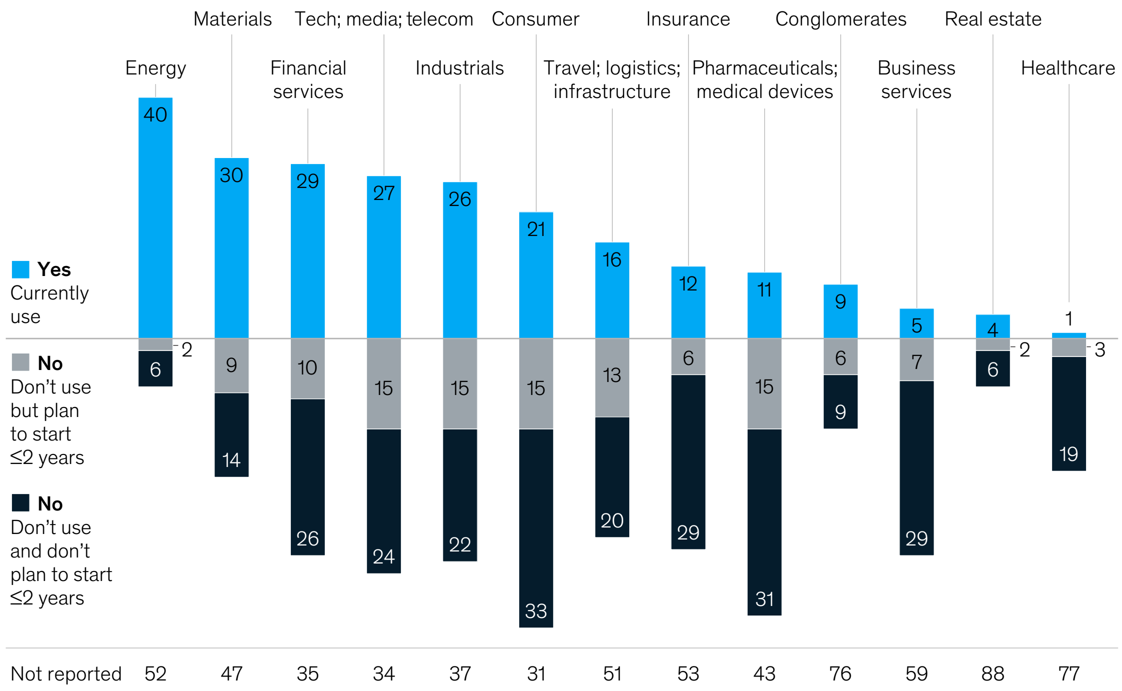
A geographic breakdown shows that 28 percent of companies in Europe are using internal carbon pricing. Japan, the United Kingdom, and the United States have the highest percentage of companies using this mechanism—with 24 percent, 20 percent, and 15 percent, respectively, of companies in those countries tallied.

A closer look at the data also shows that companies' thresholds for the price per metric ton of carbon used vary widely by region and industry. In Europe, for instance, the median internal charge is $27 per metric ton, while in Asia, it's $18. This isn't necessarily surprising, as there are currently no formal, defined global standards for pricing of carbon emissions. Companies are therefore selecting values that are most useful within their own business contexts and regions (Exhibit 2).

Exhibit 1

Internal carbon pricing is most prevalent in energy, materials, and financial-services industries.

Use of internal carbon pricing by industry sector,[1] %



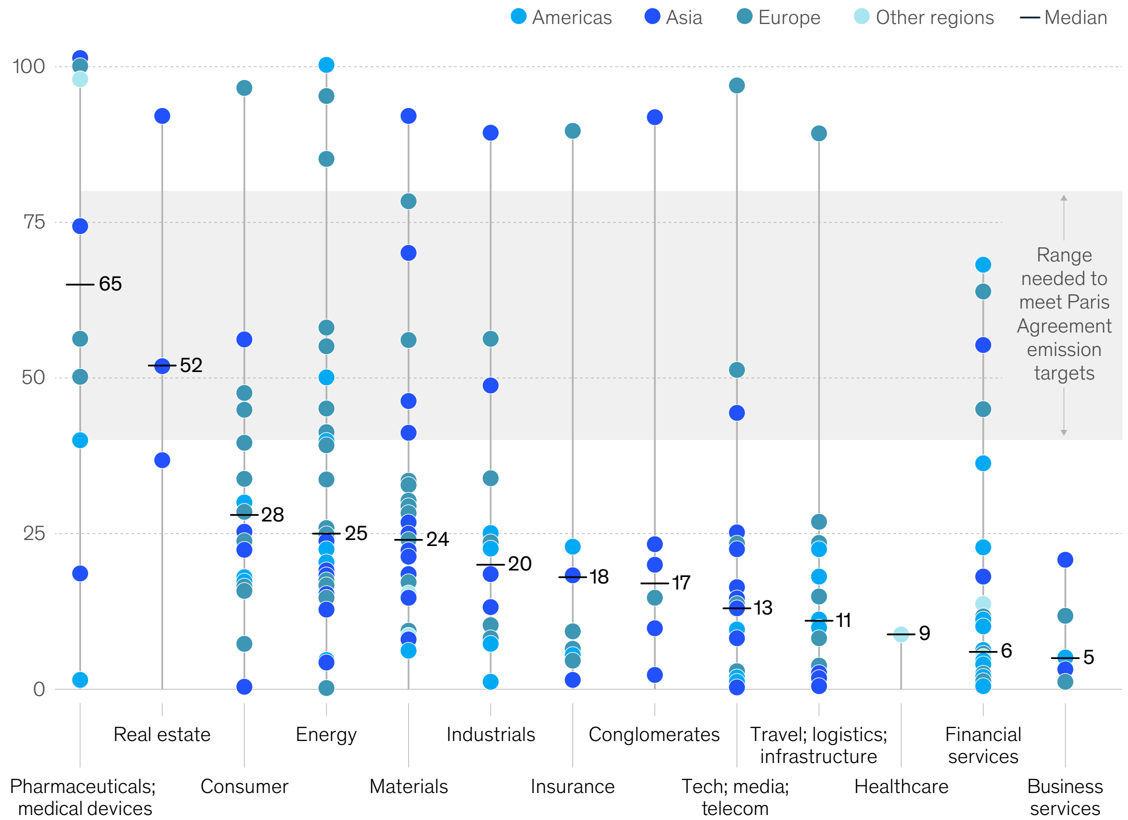
Not reported	52	47	35	34	37	31	51	53	43	76	59	88	77

[1]Determined by a sampling of the top 100 companies ranked by 2019 revenue.
Source: Responses from 2,600 companies reporting to the Carbon Disclosure Project (2019)

Exhibit 2

The internal pricing of carbon emissions varies within and among industries and regions.

Distribution of internal carbon prices in 2019, $



Source: Responses from 2,600 companies reporting to the Carbon Disclosure Project (2019)

Attempts to help companies identify optimal pricing standards are under way. Economists and advocacy groups have posited a broad range of potential pricing levels—from a few dollars to well over $100 per metric ton, depending on the discount rate used—but the topic remains a point of contention.[2] For instance, the Environmental Defense Fund, a not-for-profit environmental-advocacy group, has estimated that the societal cost of carbon is greater than $50 per metric ton emitted. It recognizes, however, that this figure could be low because it doesn't yet factor in all potential externalities from the impact of climate change.[3]

[2] The choice of a discount rate is made by considering the trade-off between a known payment for carbon today and the potential negative impact of carbon in the future. There are different frameworks for evaluating which discount rates to use—for example, internal carbon pricing based on market-based discount rates (which result in lower charges), ethics-driven discount rates (which result in higher charges), "descriptive" approaches determined by economic price, and "prescriptive" approaches that conform to an ideal. See Lawrence H. Goulder and Roberton C. Williams III, "The choice of discount rate for climate change policy evaluation," *Climate Change Economics*, 2012, Volume 3, Number 4, worldscientific.com; William Nordhaus, "Critical assumptions in the Stern Review on climate change," *Science*, July 2007, Volume 317, Number 5,835, pp. 201–2, science.sciencemag.org.

[3] "The true cost of carbon pollution," Environmental Defense Fund, EDF.org.

Meanwhile, the High-Level Commission on Carbon Prices has estimated that companies would need to set internal carbon pricing between $40 and $80 per metric ton in 2020 and between $50 and $100 per metric ton by 2030 to reduce emissions so they are in line with the standards set in the Paris Agreement.[4] By contrast, most of the companies that report using internal carbon pricing have set their thresholds at around $40 per metric ton. French company Danone, for instance, publicly reports its carbon-adjusted EPS using an internal carbon pricing of €35 per metric ton emitted. Danone's adjusted EPS has grown faster than its regular EPS has because of the company's reduced carbon intensity—for instance, in 2019, Danone's carbon-adjusted EPS grew 12 percent compared with the company's headline EPS growth of 8.3 percent.[5]

Corporate carbon accounting is just one means by which business leaders can manage transition risk, support corporate values, and improve their investment decision making—but it's a good step to take. Companies' internal carbon-pricing initiatives are already affecting 22 percent of global greenhouse-gas emissions, up from 15 percent in 2017.[6] But as the research shows, the pricing thresholds currently being used are lower than they need to be to account for possible negative externalities from carbon emissions. If companies want their strategic decisions to fully reflect the risks and opportunities inherent in carbon emissions, they should take another look at internal carbon-pricing programs and recalibrate.

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[4] *Report of the High-Level Commission on Carbon Prices*, Carbon Pricing Leadership Coalition, May 2017, carbonpricingleadership.org.
[5] "2019 full-year results," Danone, February 2020, danone.com.
[6] "State and trends of carbon pricing 2020," World Bank, May 2020, openknowledge.worldbank.org.

On target: How to succeed with carbon-reduction initiatives

McKinsey research reveals which industries are on track to meet green objectives and how they got there.

by Leonardo Banchik, Werner Rehm, and Giulia Siccardo

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The argument for global companies to reduce their greenhouse-gas (GHG) emissions is clearer than it has ever been:

— Business operations around the world are now subject to greater climate and transition risks.

— Consumers are clamoring for eco-friendly products and responsible corporate behaviors.

— Investors are increasingly embracing capital-allocation strategies that take environmental, social, and governance (ESG) issues into account.

— Policy makers and government organizations are exploring the potential regulation of carbon emissions.

In response, organizations across all industries have declared GHG-emission-reduction targets—including, in some cases, a "net-zero commitment," in which a company ensures that emissions from its value-chain activities create no net climate impact.

In 2020, more than 4,500 companies worldwide self-reported their GHG emissions for public disclosure, and about 40 percent of those companies have committed to specific emissions targets as part of their strategic and financial plans.[1]

What about the companies that haven't—what sort of goals should they set? To find out, we reviewed the 2020 data on disclosing companies' carbon-emissions targets. We wanted to see which companies and industries seem to be on track to meet their goals and how they got there.[2] Among our observations: the more aggressive the targets, the better the results.

Time and scope are critical factors

Our analysis shows that 44 percent of the organizations that are currently disclosing their GHG emissions are focused on short-term targets (that is, they are aiming for emission reductions by 2025), 27 percent of the disclosing companies are focused on medium-term targets (with reductions by 2026 to 2040), and 2 percent are focused on long-term goals (with reductions by 2031 to 2050 or later). The remaining 27 percent of organizations have set targets across all three time horizons.

Most of the disclosed targets (74 percent) are from companies trying to reduce GHG emissions that are closer to the core—that is, from sources they

Investors are increasingly embracing capital-allocation strategies that take environmental, social, and governance issues into account.

[1] More than 9,500 companies around the world self-report their greenhouse-gas (GHG) emissions to the not-for-profit CDP Worldwide, but only about 4,500 have made their data available for analyses. The targets studied include goals for tonnage of GHG emitted per year, also known as absolute-emission targets.
[2] To do this analysis, we calculated a linear progression between a company's starting GHG emissions and its reduction target. A company was considered on track to hit a target if its emission trajectory was lower than or equal to that linear progression.

own or control (Scope 1 emissions) and from the generation of the electricity, heat, or steam that they purchase (Scope 2).[3] By contrast, only 26 percent of the targets are aimed at reducing Scope 3 emissions, which are not directly owned by the business but are related to its activities—in air cargo or supply chain, for instance (Exhibit 1). That is likely because Scope 3 emissions are much more challenging for companies to track and control. However, in our experience, it's worth the effort to do so because Scope 3 emissions can account for more than 50 percent of a company's total GHG emissions.

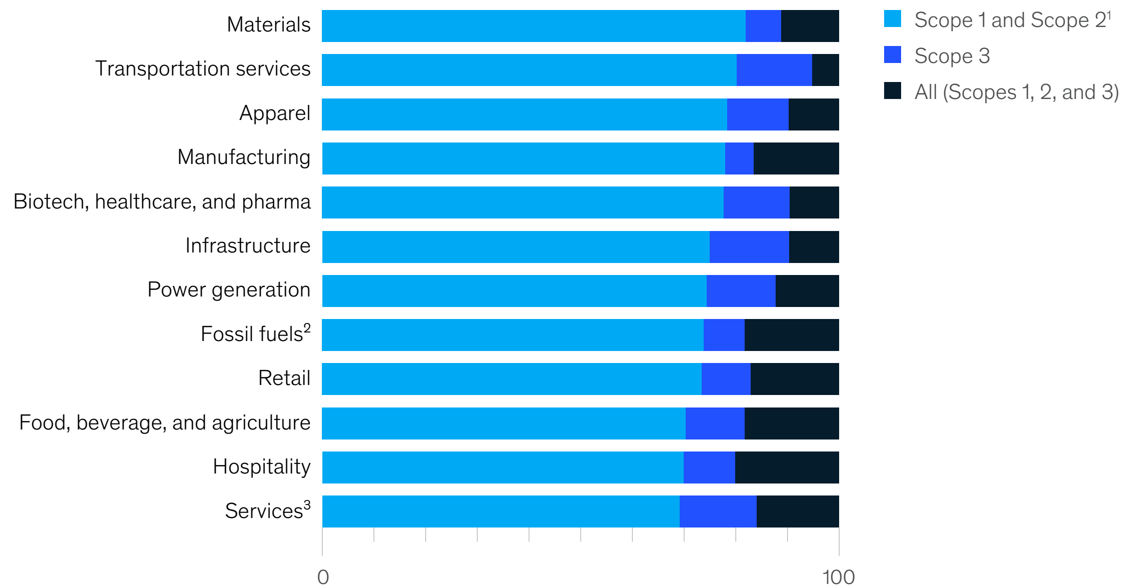
Some industries are more on track to achieve targets than others are

Our analysis shows that nearly 65 percent of the disclosed targets are on track to be achieved between 2020 and 2050. As might be expected, the companies that are above average in meeting their GHG-reduction targets are in industries that tend to be less extractive—the apparel, infrastructure, manufacturing, power-generation, and services sectors, for instance. Within these industries, however, some companies are still lagging behind in achieving the targets they disclosed. The message

Exhibit 1

Most companies are setting targets to reduce Scope 1 and Scope 2 greenhouse-gas emissions, which are closer to their cores.

Type of emission-reduction target by industry, % share



Note: Companies can set ≥1 target and for a variety of scopes, or sources of carbon. Scope 1 refers to emissions from sources that companies own or control; Scope 2 refers to emissions from the generation of electricity, heat, or steam purchased by companies; and Scope 3 refers to emissions from sources not owned or directly controlled by companies but related to company activities. Data set excludes international bodies.
[1]Targets reported include Scope 1 only, Scope 2 only, and Scopes 1 and 2 only.
[2]Includes diversified metals and mining (coal) and oil and gas activities (marketing, refining, storage, transportation, and integrated activities).
[3]Includes financial and insurance services, IT and software services, HR and employment services, oil and gas services, real estate, healthcare services, consulting services, environmental and facilities services, security and alarm services, and diversified support services.
Source: CDP Climate Change Questionnaire 2020; McKinsey analysis

[3] There are three sources, or scopes, of carbon emissions: Scope 1, Scope 2, and Scope 3. Companies can disclose more than one target; and each target must refer to one of five sources of emissions: Scope 1 only, Scope 2 only, Scope 3 only, Scopes 1 and 2, or Scopes 1 through 3.

to above-average companies, then, is to continue their decarbonization efforts and stave off complacency.

The companies that are below average tend to fall in one of several categories: they are in more extractive industries (such as agriculture and fossil fuels), are in sectors that are harder to decarbonize (such as transportation), or simply have a lower number of disclosures about target setting. These companies must contend with, among other factors, fragmented supply chains, heavy machinery, high carbon use, and the lack of viable economic alternatives that would allow them to decarbonize unilaterally (Exhibit 2).

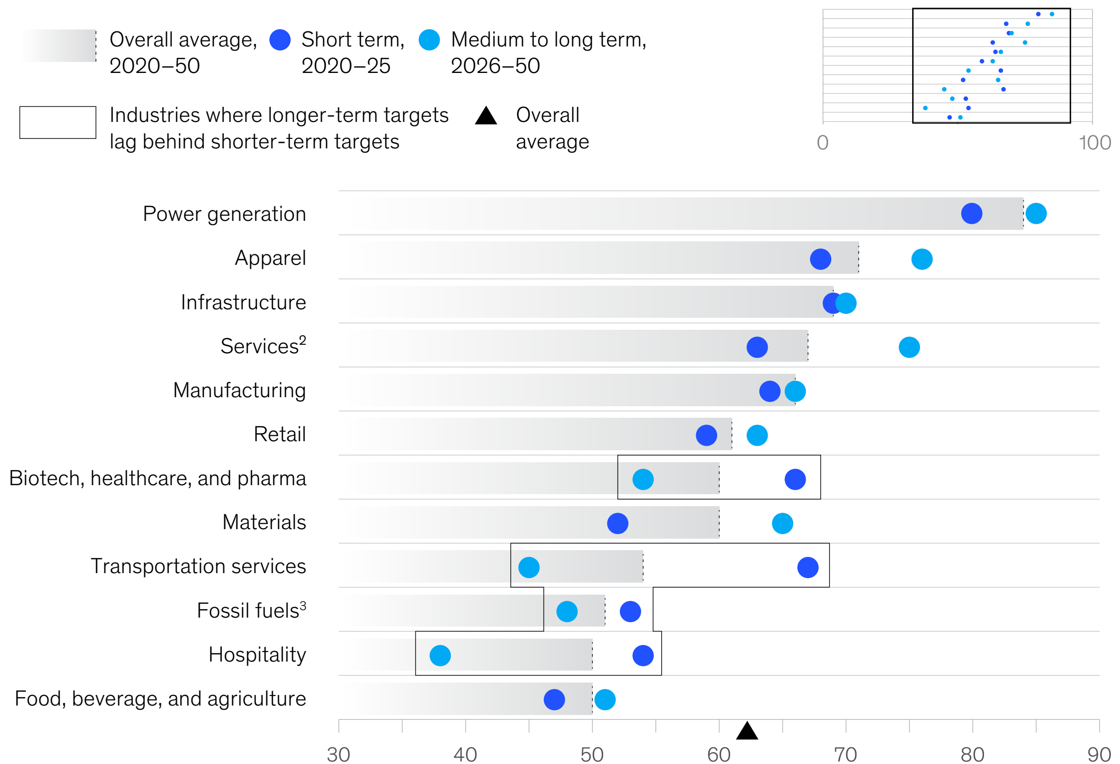
For most industries, at least 50 percent of their emission-reduction targets are on track, according to our research. But a closer look at target time frames reveals that industries that are on track with their short-term targets (2020–25) tend to stay on the rails and, in many cases, are projected to perform well with their targets over the longer term.

Four industries proved to be the exception, facing relatively more challenges with meeting their long-term targets, even when performing well in the short term: transportation, fossil fuels, hospitality, and healthcare and biopharmaceuticals. A key factor in these industries is the role of technology in reducing GHG emissions. Long-term decarbonization

Exhibit 2

Certain industries are more on track than others to hit 2020–50 emission-reduction targets.

Emission-reduction targets that are on track by industry,[1] %



Note: Excludes international bodies.
[1]Targets include Scope 1 only (emissions from sources companies own or control), Scope 2 only (emissions from electricity, heat, or steam generation), Scope 3 only (emissions from sources not directly owned by companies but related to their activities), Scopes 1 and 2 only, and all 3 scopes.
[2]Includes financial and insurance services, IT and software services, HR and employment services, oil and gas services, real estate, healthcare services, consulting services, environmental and facilities services, security and alarm services, and diversified support services.
[3]Includes diversified metals and mining (coal) and oil and gas activities (marketing, refining, storage, transportation, and integrated activities).
Source: CDP Climate Change Questionnaire 2020; McKinsey analysis

efforts in both transportation and fossil fuels, for instance, will require significant technological breakthroughs—alternative fuels, electrification of heavy-duty vehicles and commercial aviation, carbon-capture-and-storage technologies—as well as a commitment to execution. Technologies to reduce carbon emissions are generally available to companies in hospitality and in healthcare and biopharmaceuticals, but a commitment to execution will be critical.

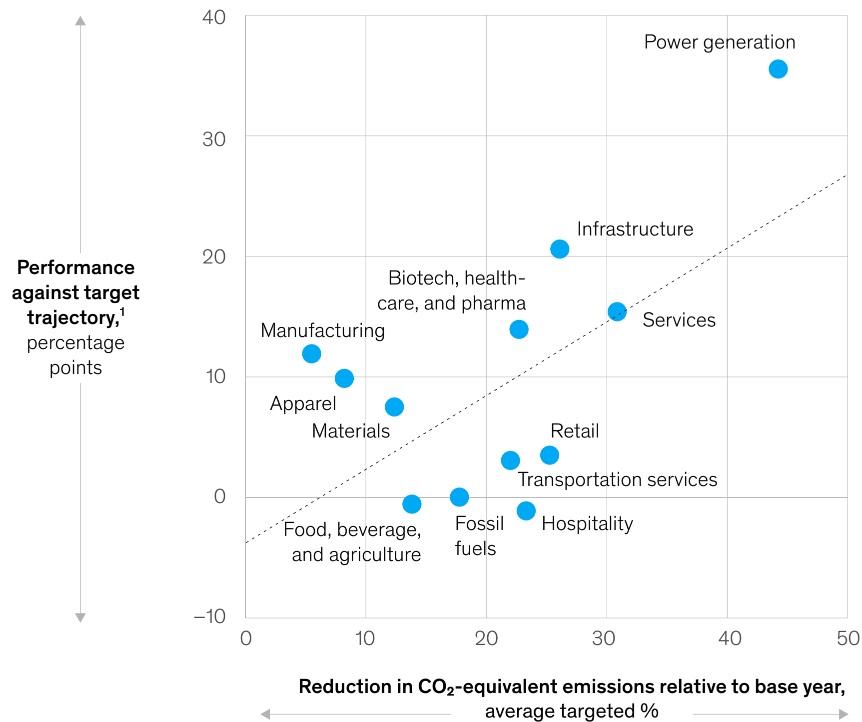
Aggressive targets may improve performance

We found a positive correlation between companies' average targeted percentage reduction of emissions (relative to the base year) and their progress at the time of reporting.[4] In other words, companies with more aggressive targets appeared to overperform on the path toward achieving those targets. This trend holds true even for carbon-intensive industries such as materials, manufacturing, and power generation (Exhibit 3).

Exhibit 3

Aggressive greenhouse-gas-reduction targets are correlated with industries' overperformance on the path toward those targets.

Projected industry adherence to greenhouse-gas-reduction targets (2020–50)



Note: Excludes international bodies.
[1]Calculated as the median of percentage-point differences between emissions in reporting year (2020) and the linear fits between starting and target-year emissions. Performance >0% represents percentage point of target trajectory exceeded. Performance <0% represents percentage point of target trajectory unmet.
Source: CDP Climate Change Questionnaire 2020; McKinsey analysis

[4] Calculated as the median of percentage-point differences between emissions in reporting year (2020) and the linear fits between start and target-year emissions.

Implications for target-setting companies

In total, the data suggest several things for companies seeking to set targets for GHG-emission reduction. First, don't forget targets that seek to reduce Scope 3 emissions, as alongside Scope 1 and Scope 2 emissions, they make up a big part of the total carbon footprint of an organization. Second, recognize that success today in hitting emission-reduction targets is a good predictor of future success. And finally, remember that businesses that set bold targets are more likely to make more headway against them.

The very exercise of setting carbon-reduction targets can be an important step for organizations; it presents both risks and opportunities to create value from decarbonization. Throughout this exercise, then, executives should consider how or whether the company's carbon-reduction efforts can help differentiate it from competitors. Additionally, they should be intentional about shorter-term targets for 2025 and 2030, as those targets will be critical for mobilizing the organization to act.

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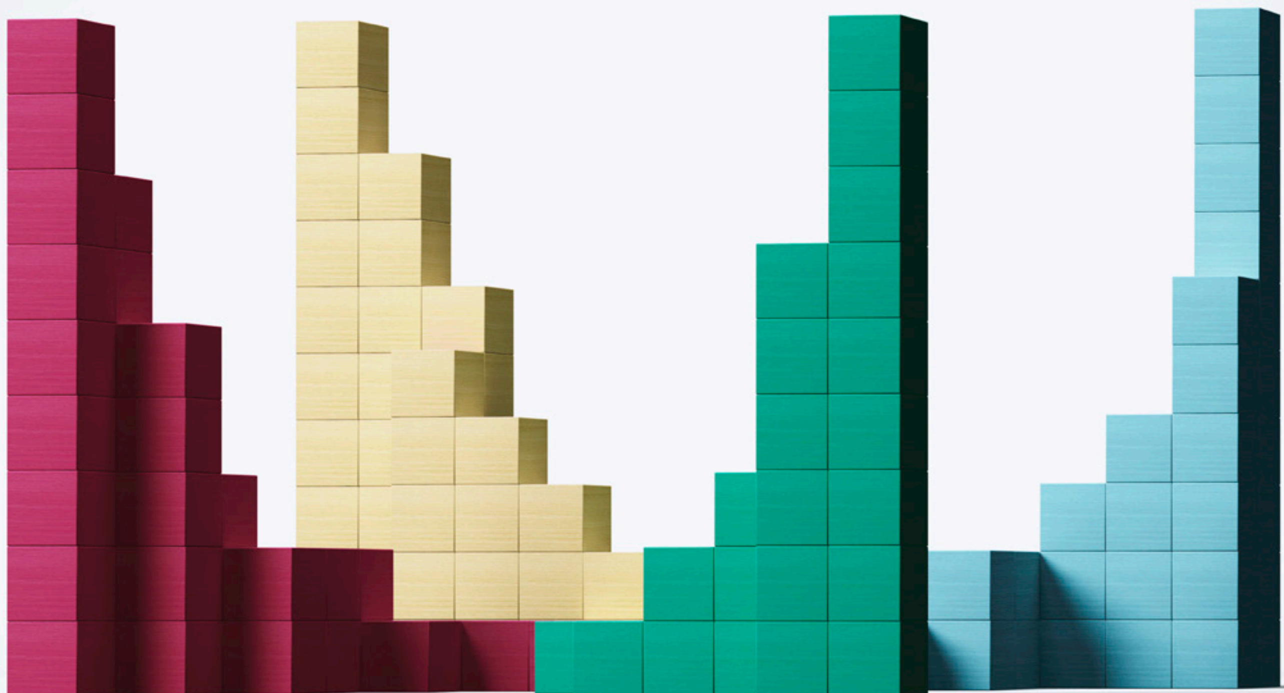
Accounting for values and valuation

Former UPS finance chief Kurt Kuehn describes how the SASB framework can help companies measure, manage, and disclose material ESG and other nonfinancial risks.



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Early in 2020, several of the world's largest asset managers called for companies to be more transparent about how they're managing environmental, social, and governance (ESG) issues and other nonfinancial risks.[1] Climate change was a primary catalyst for the push. After the onset of the COVID-19 pandemic, however, *all* companies—not just investment institutions—became much more aware of how vulnerable they are to ESG-related issues and how important the disclosure process is, says Kurt Kuehn, the former CFO of United Parcel Service of America (UPS) and a board member of the independent Sustainability Accounting Standards Board (SASB).

Accounting disclosures that are material, consistent, and reliable can help reassure shareholders and other key stakeholders about ESG-related risks, Kuehn says, but many of these characteristics have been lacking in typical sustainability-reporting processes, which has been frustrating for investors and corporate leaders alike.[2] In a conversation with McKinsey's Roberta Fusaro and Tim Koller, Kuehn explains the challenges and benefits of companies sharing information about their nonfinancial risks, as well as SASB's evolving "industry-specific, market-informed" approach to sustainability reporting. An edited version of the conversation follows.

McKinsey: Why has it taken so long for sustainability reporting to gain traction?

Kurt Kuehn: Until very recently, companies and investors often thought of ESG reporting as a form of greenwashing—an issue more relevant for marketing and communications than an actual financial issue. Now we're seeing more tangible effects from climate change, and companies and investors have come around. They're witnessing firsthand how nonfinancial risks can significantly affect corporate valuations. I think they understand now that many ESG issues are really all about business opportunity and risk. The COVID-19 pandemic also opened their eyes.

McKinsey: In what way?

Kurt Kuehn: The combination of climate change and COVID-19 has been humbling for everyone. Business leaders learned how critical their human capital is and how nonfinancial events can create huge swings in corporate value in a very short period of time. Recent events have also made executives—particularly CFOs—aware of how important it is to be able to think through multiple scenarios and adapt. Annual forecasts, however perfect they might have looked in January 2020, probably weren't all that useful for the rest of 2020 in most organizations. Meanwhile, oil and gas companies, real-estate companies, transportation companies, and others have become adept at modeling climate-related scenarios to, say, vet investments in shoreline properties or estimate the effect of carbon restrictions. Unsurprisingly, many are now realizing the broad relevance of measuring, managing, and disclosing key sustainability issues.

McKinsey: What's the biggest reporting challenge for companies?

Kurt Kuehn: The lack of consistency. Companies often just tweak what they report every year—maybe adjust it for what looks good and what looks bad. Different industries use different metrics. Even within the same industry, companies use different thresholds for performance on ESG issues, or they focus on different types of exposure. Meanwhile, a whole cottage industry has developed around trying to interpret sustainability-related data and helping investors understand which companies are at risk from ESG issues and which are beginning to take action. Even when companies do disclose material risks, they may find that they rank high on one rating company's ESG index and low on another. That makes it tough for investors to create fair comparisons or to get an accurate read on how companies are thinking about and managing ESG programs. Corporate leaders want simpler reporting processes. Investors want clearer data. And both have indicated that they are looking for a standard way to report and assess ESG activities and impacts for themselves.

[1] Annie Massa, "BlackRock puts climate at center of $7 trillion strategy," Bloomberg, January 14, 2020, bloomberg.com.
[2] Sara Bernow, Jonathan Godsall, Bryce Klempner, and Charlotte Merten, "More than values: The value-based sustainability reporting that investors want," August 7, 2019, McKinsey.com.

McKinsey: How has SASB stepped in to fill this gap?

Kurt Kuehn: SASB's mission is to provide information in a format that the financial community can use to understand prevailing ESG issues and make good long-term investment decisions. It was intentionally mirrored after FASB [Financial Accounting Standards Board] and IASB [International Accounting Standards Board]. Think about it: there are a thousand different ways to interpret a company's financial statements. Investors who are momentum oriented will look at one set of numbers while others who are focused on ROIC will search for a different set of numbers. In all this, we don't expect a single interpretation of financial results. Similarly, I don't think we can expect a single vision of sustainability. But companies, investors, and other stakeholders will still need to use a set of standardized metrics as a starting point for their analyses.

McKinsey: How is SASB's reporting framework different from others?

Kurt Kuehn: There are two things that make SASB's approach unique. First, SASB standards are focused on ESG issues that are likely to have material financial effects. In recent years, we've seen a concept emerge of double, dynamic, or nested materiality, which guides the different levels of reporting that companies undertake. At a base level, companies report on "traditional" information that is already reflected in their financial accounts. This is where IASB and FASB standards come into play. Companies also report on the subset of sustainability topics that are material to the creation of enterprise value. This is where SASB standards fall. Or they may report on matters that affect the broader economy, the environment, and society; organizations such as GRI [Global Reporting Initiative] focus on such topics [exhibit].

Second, the SASB framework is industry specific. The board developed a matrix of potentially material factors for business leaders in 11 industries and 77 subsectors. These areas of focus were developed in a multiyear effort that included input from investors and companies. We had high-level support from an investor advisory group that now represents 55 of the largest investment companies in the world. We asked the group questions including, "What ESG issues do you think would be most relevant in a given industry?" and "Which topics would you like companies to talk more about?" The investors told

Exhibit

Emerging reporting standards and frameworks address different environmental, social, and governance use cases.

Framework	Reporting needs: Information that is already reflected in financial accounts[1]	Reporting needs: The subset of sustainability topics that are material for enterprise value creation	Reporting needs: Matters that reflect the organization's impacts on the economy, environment, and people
IASB; FASB[2]	●		
IIRC[3]	●	●	
SASB; CDSB[4]		●	
GRI[5]			●
CDP Worldwide[6]			●

[1]Includes assumptions and cash-flow projections. [2]International Accounting Standards Board; Financial Accounting Standards Board. [3]International Integrated Reporting Council. [4]Sustainability Accounting Standards Board; Climate Disclosure Standards Board. [5]Global Reporting Initiative. [6]Reflects the scope of the CDP Worldwide survey, insofar as it functions de facto as a disclosure standard for climate, water, and forest topics, as well as the scope of CDP Worldwide's data platform.
Source: "Statement of intent to work together towards comprehensive corporate reporting," Impact Management Project, September 11, 2020, impactmanagementproject.com

Kurt Kuehn

Education
Holds an MBA from the University of Miami

Career highlights
Sustainability Accounting Standards Board
(2017–present)
Sector chair, transportation and infrastructure

United Parcel Service of America
(2010–15)
Senior vice president and CFO

(2008–10)
Senior vice president, CFO, and treasurer

(2004–08)
Senior vice president, worldwide sales and marketing

(1993–2004)
Vice president, investor relations

Fast facts
Serves as senior adviser to McKinsey and board member of Atlanta Shakespeare, Henry Schein, LocatorX, and Woodruff Arts Center; served as a board member of NCR

us they look at four factors: Is the company at least aware of the nonfinancial risks? Does the company actually have a plan to mitigate these risks? Does it have targets for performance and a way to measure performance against risks? And, most important, is the company making progress against plan?

When business leaders are asked to fill out surveys or issue annual overviews, the SASB framework outlines a core set of data to share with the markets to address their concerns. The industry-specific approach appeals to me personally, as a former CFO, because it's very tangible and practical.

McKinsey: Can you provide an example?

Kurt Kuehn: Take the social issue of animal rights. It may be a major economic issue in some industries, such as poultry or food production, where demand may be significantly affected if there's a perception that animals are being mistreated, but it may be less of an issue in other industries, such as consulting or mining. SASB's discipline is to say, if you are in poultry, that issue could be material and should be included in your ESG reporting. For the other 70 industries out of the 77 we identified, animal rights may be a heartrending issue, but as it's less likely to cause financial impact, it wouldn't necessarily be reported.

Or think about the industry I grew up in—transportation. The biggest material ESG risks there might include carbon footprint, labor policies, and human relations—think about the effects of the gig economy. The CFOs and other senior leaders in these companies could enhance their ESG reporting by focusing on those factors, and without much extra work, they'd likely address investors' key questions and concerns.

McKinsey: How have companies responded to SASB standards?

Kurt Kuehn: Since we launched the framework in November 2018, we've seen increased interest in reporting standards across the globe, especially in Europe. Currently, more than 600 US and non-US companies are reporting with SASB metrics. More recently, we announced plans to join forces with another organization, the International Integrated Reporting Council, so we can better harmonize global corporate reporting standards. We expect to work with other groups as well.

We're seeing companies use SASB standards to report on ESG issues in different ways—it could be as small as a four-page insert tucked inside a sustainability report, with maybe a page on metrics, a page on trends, and the rest setting some context. What's clear is that the barriers to investor-grade sustainability reporting are coming down. And we're seeing some enlightened CFOs and CEOs trying to educate investors about how ESG factors could affect the financial performance of their companies. Rather than simply reporting out the numbers as a bit of PR, they are contextualizing them as part of corporate strategy.

McKinsey: What is the CFO's role in sustainability disclosure?

Kurt Kuehn: The CFO must be involved to ensure that there is some level of credibility, that the reporting process has been sufficiently documented, and that the numbers could be replicated if needed. Companies need to make sure they are not being too naive when it comes to projecting potential risks and opportunities from ESG issues. Initiatives that have a strong environmental or social benefit over the long term usually come with some costs in the short term. Right now, for instance, alternative vehicles cost more to produce and often don't create returns as high as those for traditional vehicles. So the CFO can help manage expectations about what's important to the community versus what's important to the company—focusing the company's best efforts on addressing ESG issues in ways that aren't too detrimental to financial health.

At UPS, for instance, we set a goal of using a certain proportion of biofuels in our airplanes; then I found out about all the hoops we were jumping through to incorporate biofuels at $12 a gallon when, for that same amount of money, we could be putting up low-carbon vehicles, electric vehicles, and so on. We redirected our focus toward doing just that. Just wanting to do good isn't the only factor; companies have to do it in a way that makes sense for the company and leverages the right resources.

McKinsey: What's your advice to companies that are not doing any ESG reporting currently?

Kurt Kuehn: There are lots of good reasons to report on ESG factors—among them, your community, your reputation, and your employees' morale. But the real reason is, investors care a lot, probably more than you realize—and not just the socially conscious funds. As McKinsey has pointed out in its own research,[3] there is an important question of value creation or destruction—it's getting harder to ignore the effects of ESG issues on, say, a power company in California that is managing increased loads because of successive heat waves or a beverage manufacturer that faces potential water shortages. Companies and investors need to be able to think through different alternatives, and the more tangible they can be, the better the decisions they'll make.

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[3] "The ESG premium: New perspectives on value and performance: McKinsey Global Survey results," February 12, 2020, McKinsey.com.

Climbing the private-equity learning curve

Commentary

CEOs who are used to engaging with public-company boards need a different playbook when it comes to private-equity boards. Here's what they can expect.

by Conor Kehoe and Tim Koller

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Successful executives from public companies may be eager to take on the new challenges of leading a private-equity (PE) firm's portfolio company. However, they may not realize the differences in approach between the boards of public companies, which often view themselves as stewards, and the boards of PE portfolio companies, which frequently take a far more active role. As a result, C-suite leaders who are making the switch face a learning curve—which, based on more than 30 interviews conducted with CEOs of PE-owned companies over the past few years, typically spans three phases: the initiation, a realization of benefits, and full integration. It's an adjustment that may require the experience of several PE-ownership cycles, but here we describe the stages mapped onto one deal cycle.

The key differences

Our research has shown that public companies and PE portfolio companies alike can have engaged boards. However, boards of PE portfolio companies tend to systematically take a coleader role with the CEO on important topics; engaged directors not only help set strategy and manage performance but also master the details needed to stress-test, push back on, reset, and dramatically improve the business.

Indeed, PE board members feel like owners themselves. Senior managers of the portfolio company typically own about 5 to 8 percent of the company stock, and the PE firm votes the rest of the shares, which are owned by the PE fund (in which the PE firm is a major investor). While there is no uniform board size or lineup, the boards of PE portfolio companies usually include the "deal partner," who is typically a midcareer financier, and one other member of the PE firm. There is typically a chair, who is frequently an ex-CEO, often from a much larger company than the portfolio company in question. Additionally, the boards will include one or two other nonexecutives—for example, experienced external nonexecutive directors with specific know-how in the company's core sector or in a functional topic, such as digitization or artificial intelligence, that is key to the company's future.

PE portfolio companies' boards are generally younger and smaller than public-company boards, thereby increasing each individual's engagement. This engagement and PE board members' bias toward active ownership are what drive much of the "alpha"—outperformance relative to quoted peers—in any deal.

The learning curve

The active ownership of PE boards can take some getting used to. CEOs accustomed to working with boards of publicly traded companies typically go through three stages to climb the PE learning curve.

The first phase, *the initiation*, can last about six months. During this period, a PE portfolio company's executives come to realize that the PE board's approach is both hands on and focused on the medium and long terms. Short-term earnings targets, particularly in the first two years, matter far less than robust value creation by year four.

Right from the start, the board will be geared to engage. As part of the diligence in acquiring the portfolio company, the incoming nonexecutive board members often will have spent three or more months steeped in due-diligence reports, including reviews of management plans and projections. The board's commercial due-diligence team will have reported back on 50 to 100 interviews of suppliers, large customers, regulators, and former employees of the company and of rival companies; other due-diligence teams will have delved deeply into financial accounts, legal commitments and liabilities, and environmental, social, and governance (ESG) risks. It adds up to the incoming board having a considered, research-based viewpoint on the company and its industry.

Almost certainly, the members will have developed their own multiyear value-creation strategy for the company as part of their investment plans.

Moreover, they will know that the plans can change: the new board members will expect that the management team will have ideas they had not thought of and that new facts will come to light. The same will apply for CEOs when they present their plans to the PE board. They should be ready for detailed scrutiny and a robust back-and-forth.

PE boards have a determined focus on performance management and associated key performance indicators to meet longer-term strategic plans. This longer-term approach should, of course, apply for publicly listed companies as well—thoughtful public-company board members also recognize that a focus on short-term EPS targets is usually detrimental to long-term value creation. The reality is, however, that outside-driven, short-term targets can distract even the most conscientious public companies. These distractions are less of an issue in the PE context.

Indeed, new CEOs of PE-held companies may find that they need *less* time for formal board meetings overall because board members will already be highly engaged between meetings—visiting sites, customers, and suppliers and conducting ad hoc calls to advise management on opportunities or threats arising between board meetings.

The second phase of the learning curve is when PE portfolio companies' executives begin to *see the benefits* of working with PE boards. For example, should an executive need to fire a senior member of her team, it can be quite a lonely spot. With an active board, however, CEOs aren't alone; they have full thought partners on their boards who know the companies inside and out. An actively engaged board also helps inoculate a CEO against second-guessing; directors are right there, making the hard decisions, too.

The pace of decisions is quicker as well. Business isn't run at the artificial pace of board-meeting dates. Senior executives will come to realize that the quality of their proposals to the board is higher; this, when combined with well-informed decision making, can be a double step-up.

With this realization, PE portfolio companies' executives are at phase three: *fully up the learning curve*. At this point, they will find themselves enjoying the flow of ideas and encouragement from the chair and nonexecutives and from the deal partner. Based on anecdotes we have heard, at this stage, transitioning executives often feel like they are becoming better managers. In their public-company experience, they may have grown used

In a deeply engaged private-equity board, members not only grasp the business circumstances immediately but also vote the stock and can form an almost 'instant shareholder meeting.'

to putting their ideas for enhancing the company through two filters: first, how hard it would be to explain this idea to their board and second—should they succeed with their board presentation—how hard it would be to convince a dispersed set of shareholders. In the process, they may weed out good ideas too early. That isn't the case with a deeply engaged PE board. Its members not only grasp the business circumstances immediately but also vote the stock and can form an almost "instant shareholder meeting," if need be.

The lessons of longer-term orientation, open dialogue, and support for bold moves are ones that successful public companies can internalize, as well. In fact, companies of all types can learn from what makes good boards even better.

As senior executives confront the transition to PE ownership, experienced PE board members can let them know that they understand how discomfiting a manager's experience can be, particularly at the start. For the CEOs' part, those who are transitioning to PE-held companies should understand what awaits them and how they can expect the experience to unfold. As in value creation itself, it's a process for the longer term.

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The CFO’s role in capability building

Organizations developing new skills for the next normal must determine exactly how and where to invest in them. The finance leader is uniquely suited to provide the necessary combination of insights.

by Rawi Abdelal, Kevin Carmody, Meagan Hill, and William J. Pearson

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It's becoming increasingly clear that some of the most critical responsibilities of CFOs in coming months will be supporting efforts to build new capabilities—the mindsets and behavior an organization needs to reach and sustain its full potential—and raising the bar on talent development.

A focus on capability building is especially relevant now as businesses attempt to rebound from the health and economic effects of the COVID-19 pandemic.[1] The pandemic has accelerated the use of automation, artificial intelligence, and other digital technologies to enhance or streamline processes. It has affected the management of supply chains and business partnerships. It has changed the priorities and demands of customers and investors in ways that haven't totally revealed themselves yet. And all this is happening as the world of work continues to change rapidly. It would be a lot for C-suite leaders—including the CFO—to navigate, even in the best of times.

However, many CFOs are likely to say that their experience with capability building has been both underdeveloped and underutilized. Over the past decade, the CFO's role—and that of the overall finance function—has expanded so that it now affects more parts of the organization directly. More functions now report to CFOs, who now have more oversight of tasks that traditionally hadn't been part of their mandate. In a 2018 McKinsey survey, four in ten CFOs said they created the most value for their organizations through their strategic leadership and performance management. But less than half of the CFOs surveyed reported having the time to focus on capability building, either within the finance function or across the organization.[2]

It's critical for companies to give CFOs enough space to play this role in capability building. They are uniquely positioned not only to ensure that business units get the resources they need to invest in the infrastructure, technology, talent, and organizational changes required to thrive in the next normal but also to model critical cross-functional behavior and skill sets.

Other denizens of the C-suite are only now catching on to the CFO's growing and varied responsibilities and emerging profile as financial controller, value manager, *and* strategic partner. In this article, we look at the primary ways CFOs can help companies build capabilities to prepare for the future—as well as the skills and mindsets that finance chiefs may need to ensure that their recommendations are heard.

Capabilities: How the CFO can help the organization

As organizations shift from responding to the COVID-19 pandemic to recovering from it, many are discovering that the capabilities of the workforce no longer match the needs of the marketplace.[3] Grocers, restaurants, and retailers that quickly shifted to online ordering and sales during the crisis, for example, have had to rethink their systems, processes, and supply chains and, in many cases, had to incorporate new technical capabilities and skill sets. But at a time when executives need to double down on capability building, they are finding that their efforts are falling short. In a 2020 McKinsey survey, for instance, just one-third of the respondents reported that capability-building programs often or always achieve their objectives and business impact.[4] To improve the odds of success, companies should leverage the CFO's expertise in three critical ways: identifying opportunities to invest in capabilities that can create significant value, boosting financial acumen at all levels, and supporting the company's overall talent-development efforts.

[1] "Rethink capabilities to emerge stronger from COVID-19," November 23, 2020, McKinsey.com.
[2] "The new CFO mandate: Prioritize, transform, repeat," December 3, 2018, McKinsey.com.
[3] Jon Garcia, Garrett Maples, and Michael Park, "Closing the capability gap in the time of COVID-19," *McKinsey Quarterly*, November 13, 2020, McKinsey.com.
[4] "Rethink capabilities," November 23, 2020.

Identify opportunities to invest in value-creating capabilities

Capability building and financial performance are inextricably linked—having the right people with the right skills in the right places can promote operational efficiency, customer satisfaction, and other elements that feed sales, revenues, profits, and many other measures of performance. The good news is that CFOs have most of the required financial and operational data, as well as a cross-functional understanding of the business, in hand. They can therefore help companies identify the capabilities that can differentiate them from competitors.

One stumbling block for the CEO and other C-suite leaders, however, is the idea that investments in capability building must show immediate payoffs. In reality, most of the value from human-capital investments accrues over time. As U.S. Bank's Tim Welsh has noted, "Capability building never ends. It's an ongoing task. So you have to look for markers along the way that make you feel comfortable you're moving in the right direction." Those markers of success might include an increase in the number and quality of customer engagements and higher employee-satisfaction scores. "The likelihood is that these markers will point to more tangible measures: sales, deposit growth, loan-balance growth," said Welsh.[5]

Indeed, one of the biggest mistakes we've seen companies make in capability building is a failure to link learning and other development efforts directly to performance improvements. The CFO must guide other C-suite leaders through the long- and short-term trade-offs associated with investing in capability building and help them define the means and metrics to monitor progress toward stated performance goals.[6] The CFO at one food manufacturer, for instance, has assigned financial analysts to work directly with the operations team to collect and interpret real-time data on consumer preferences. The CFO uses the data and cross-functional relationships to help C-suite leaders track the need (and build the business cases) for skills and capabilities in specific areas of the business: as online sales increase, more investments may be required for user-experience designers, supply-chain specialists, or other kinds of experts.

Boost the organization's financial acumen

Employees across an organization often use the same terms to mean different things. "Profit," for example, can refer to profit dollars, profit per unit, profit margins, or even gross margin; "costs" can mean overhead, marketing investments, or even capital. To reduce confusion and increase efficiency in both operations and communications, CFOs must ensure that leaders up and down

One stumbling block for C-suite leaders is the idea that investments in capability building must show immediate payoffs. In reality, most of the value accrues over time.

[5] "'An environment where everybody can thrive': A conversation with U.S. Bank's Tim Welsh," *McKinsey Quarterly*, November 20, 2020, McKinsey.com.

[6] "The capability-building imperative: Make 'purposeful investments' in people," February 26, 2021, McKinsey.com.

the organization use a common language to discuss finance. In this way, the CFO can build core functional capabilities for monitoring cash flows, establishing base and momentum cases, and using a range of scenarios in decision making, which are all critical to understanding how an organization can unlock more value.

At one consumer-goods company, the CFO became concerned enough about the general lack of business acumen outside the finance group to design an internal mini-MBA program and curriculum for high performers. This program aimed to help business-unit leaders better understand their divisions' roles within the global organization, the function's value-creating role within the division, the importance of the individual roles of the business-unit leaders, and how key performance indicators were wired into the company's operating model and strategic plan. The business-unit leaders also learned how the company made resource-reallocation decisions, what trade-offs might be required, and how they themselves could contribute to the company's success.

After the first sessions ended, the CFO noted instances when teams "really seemed to get it." Some, for instance, accepted fewer resources in the short term so that resources could be applied to other initiatives, which the business-unit leaders now understood to be more important for the company over the long term—with the benefits ultimately redounding to their own units over time. The CFO also organized frequent town halls and presentations about the organization's strategy so all functions could understand how the business model worked and their role in it. In this way, the CFO celebrated wins and reinforced the kind of behavior that drives success.

Now—and, frankly, always—it's critical for the CFO and CEO to work together to empower business-unit leaders and other employees to take ownership of cash-related decisions.[7] Particularly in the wake of the COVID-19 pandemic, cash preservation remains a critical concern for most organizations. How are they managing receivables, payables, and inventory? Are they wringing the most value from the balance sheet? Are operating and capital expenditures under control? To build and reinforce a cash culture, the CFO can help highlight the executives and teams tackling these questions and managing cash well—for instance, rewarding teams that have reduced spending during the COVID-19 crisis without sacrificing product quality or customer satisfaction.[8]

'Lean in' for talent development

CFOs and their executive peers have a critical postpandemic opportunity to develop talent by systematically reviewing the talent profile, identifying the skills needed now and in the future, and working with HR leaders to map skill sets to strategic and operating plans. Retailers that shifted to a digital-ordering model during the COVID-19 pandemic, for instance, may require more data analysts, programmers, or other types of digital talent to maintain or build new online capabilities. If so, the CFO and other senior leaders may want to establish a skills matrix that outlines key roles and responsibilities relevant to the changed business context. Using this tool, which will need to be refreshed continually, managers can have frank conversations (during performance reviews, for instance) about the new skills and mindsets required in various parts of the organization and understand the associated investments in them.[9]

The CFO can also make the argument for preserving some or all of an organization's employee-training budgets. According to industry reports, overall training expenditures dropped significantly in 2009 and 2010 (the Great Recession), followed by a surge in 2011 and a drop back to 2008 levels in 2012. Rather than sacrifice long-term efficiency and resilience for short-term gains, organizations might

[7] Michael Birshan, Michael Park, and Matt Stone, "Transforming the culture of managing working capital," January 4, 2018, McKinsey.com.
[8] "Cash preservation in response to COVID-19," May 26, 2020, McKinsey.com.
[9] Steven Eklund, Michele Tam, and Ed Woodcock, "New technology, new rules: Reimagining the modern finance workforce," November 2, 2018, McKinsey.com.

CFOs should complete capability programs themselves. Apart from role modeling the desired mindsets and behavior, they can also help C-suite leaders think about strategic imperatives as a cohesive whole.

be wise to stick with their existing talent-development investment plans, to the extent possible.[10]

More broadly, CFOs should walk the walk and complete capability programs themselves.[11] Apart from role modeling the desired mindsets and behavior, they can also, better than most, help business-unit and fellow C-suite leaders think about strategic imperatives as a cohesive whole, the skills needed to execute the plans, and the impact of these activities on the financial health of the company.

Capabilities: How CFOs can help themselves

Along with increased responsibilities, CFOs have taken on a broader set of challenges, and many of them may feel less than comfortable. For that reason, CFOs may need to reskill themselves in two key areas before they can help others reskill.

Amplify their voices

Most CFOs likely don't need to learn new finance skills—they are already well versed in the mechanics of budgeting, forecasting, and planning. But they may need to take a closer look at how they communicate: What are the best ways for them to impart key strategic information or finance concepts to others? If CFOs get this part right, they have an opportunity to amplify their own voice within the performance dialogue.

In one European metals company, for instance, the CFO and finance managers were the first points of contact for transforming the data generated by the advanced-analytics team and data scientists into specific actions the business could take to improve production-volume forecasts, factory usage, and pricing. The CFO was seen as a clear communicator and independent arbiter and therefore gained the trust of general managers. The suggested changes were implemented, raising the company's overall profitability. Most important, the CFO led from the front, proactively shaping the corporate agenda in addition to managing the traditional responsibilities, such as closing the books, reconciling actuals to budget, and generating month-end reports.

Step outside the finance silo

The CFO's worldview—or sense of how macro trends affect micro decisions—is unique, for it includes a comprehensive understanding of where individuals

[10] Sapana Agrawal, Aaron De Smet, Sébastien Lacroix, and Angelika Reich, "To emerge stronger from the COVID-19 crisis, companies should start reskilling their workforces now," May 7, 2020, McKinsey.com.
[11] "Capability building in 2030," February 26, 2021, McKinsey.com.

fit within teams, where teams fit within the company, where the company fits within its industry, and where the industry fits within a national and global context. To construct (and reconstruct) that worldview, the CFO must step outside of the finance silo and continually scan company operations, the industry, and the ever-changing global, political, and economic context. The CFO can complement this outside view with a perspective on the company's organizational dynamics, its strategic principles, and how it creates returns for shareholders. With this information, the CFO can help other C-suite leaders create a compelling vision for the future and share that vision with inspiration and conviction.

One high-growth organization, for example, faced a range of threats, such as new entrants in the market, rapidly changing costs, and competitive pricing. It responded effectively, in part because the CFO and other executives had such a clear view of the shifting landscape. They assessed their existing business model against those of the new entrants, identified its strengths and weaknesses, and retooled it to better meet changing demand. The team built an empirical case for change, drawing on data and insights from the company's analytics efforts. Then it shared a compelling narrative with the rest of the organization, highlighting the opportunities for improvement and gaining buy-in. Over time, the organization operated more efficiently, gained more value from its key assets, and boosted its ROI to all-time highs.

Capability building must be front and center in any company's plans to prepare for the next normal. CFOs have access to data, a cross-functional perspective, and an expanding role as value manager and strategy partner. They therefore have a critical role to play in ensuring that companies develop the skills, mindsets, and behavior required for long-term success.

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Should you start issuing EPS guidance again?

Commentary

You may have suspended the practice of giving earnings guidance because of the COVID-19 crisis. But if you resume it now, you may miss an opportunity to improve communications with investors.

by Tim Koller, Werner Rehm, and Zane Williams

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Many companies suspended their quarterly EPS guidance during the COVID-19 crisis. Assets and operations were incredibly volatile during businesses' initial responses to the crisis; performance projections beyond even the next week quickly became out of date. Rather than risk missing the numbers when too much was simply unknowable, companies stopped providing guidance altogether. What's more, about 52 percent of 285 S&P 500 companies that historically provided annual EPS guidance say they will not do so for either fiscal year 2020 or fiscal year 2021, given the continuing uncertainty.[1]

Their actions raise the question: Does it make sense to resume the practice at all?

Finance executives face all kinds of internal and external pressures to preserve the status quo. But even before the COVID-19 crisis, many finance leaders were second-guessing the impact of quarterly or annual earnings guidance. According to FCLTGlobal, in 2017, only about 28 percent of S&P 500 companies provided quarterly earnings guidance, 31 percent provided annual EPS guidance, and 40 percent offered no EPS guidance at all.[2]

A growing body of evidence, going back more than a dozen years and continuing today, suggests that earnings guidance can be more of a distraction than a help to investors and that many of them don't put as much weight on quarterly EPS guidance as executives believe they do.

Since executives have already experienced the effects of temporarily suspending quarterly earnings guidance, they can feel emboldened to do away with such guidance altogether. At the very least, they can change the process so that they're sharing the most useful data—the operating metrics and key indicators that give investors a broader, longer-term view of corporate performance.

The limits of EPS guidance

To help manage investors' expectations of performance, companies provide regular estimates of revenues, capital spending, units sold, cash flow, and other key financial metrics. But not every data set is meaningful to stakeholders in the same way.

The notion that quarterly EPS guidance may be of limited use to investors is not new. Back in 2006, the chief investment officer at Merrill Lynch explained that analysts there were advised "not only to discount heavily and to question earnings guidance but also to analyze what the guidance—and the way it's constructed—says about the management."[3] More recently, business lions Jamie Dimon and Warren Buffett penned a *Wall Street Journal* op-ed on how quarterly earnings guidance can lead to "an unhealthy focus on short-term profits at the expense of long-term strategy, growth, and sustainability."[4] BlackRock CEO Larry Fink echoed that sentiment, saying, "Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need."[5]

A range of research validates such views. McKinsey compared the market performance of companies that offer quarterly earnings guidance with the performance of those that don't. It found that the companies that did not provide EPS guidance did not generate lower TRS.[6] That same body of research revealed no difference in TRS between companies that regularly met the earnings consensus and those that occasionally missed it. Lower TRS occurred only if companies missed consensus consistently over several quarters because of systematically lower performance.[7] Further, McKinsey research showed that only 13 percent of investors surveyed thought that consistently beating EPS estimates was important for assessing a potential investment.

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[1] John Butters, "More than one in four S&P 500 companies are still not providing EPS guidance for 2020 or 2021," FactSet, October 9, 2020, factset.com.
[2] *Moving beyond quarterly guidance: A relic of the past*, FCLTGlobal, October 23, 2017, fcltglobal.org.
[3] Candace Browning, "Companies should drop quarterly earnings guidance," *Financial Times*, March 19, 2006, ft.com.
[4] Warren E. Buffett and Jamie Dimon, "Short-termism is harming the economy," *Wall Street Journal*, June 6, 2018, wsj.com.
[5] Russ Banham, "Quarterly earnings reports at center of debate," *Journal of Accountancy*, August 17, 2018, journalofaccountancy.com.
[6] Peggy Hsieh, Tim Koller, and S. R. Rajan, "The misguided practice of earnings guidance," March 1, 2006, McKinsey.com.
[7] Tim Koller, Rishi Raj, and Abhishek Saxena, "Avoiding the consensus-earnings trap," January 1, 2013, McKinsey.com.

What's the harm, then, in providing quarterly earnings guidance if investors don't weigh such information heavily? One potential problem is the overemphasis of quarterly earnings when evaluating management teams' performance, which can create unnecessary noise in corporate boardrooms. More important, EPS-focused companies are known to implement actions to "meet the number"—deferring investments or cutting costs excessively, for instance. Such moves might end up hurting a business. Consider those large conglomerates, for example, that buy and sell small businesses to close the last-penny gap. In addition, companies overly focused on EPS growth can become overly reliant on stock buybacks, potentially diverting cash from reinvestment in the businesses.

A better form of guidance

The COVID-19 pandemic may have provided a platform for change, but the evidence all along has showed that companies should consider shifting their focus permanently—from giving investors quarterly earnings guidance to giving them guidance on the underlying drivers of the business over longer time frames. In 2018, the National Investor Relations Institute (NIRI) changed its policy, recommending that "companies provide long-term guidance (that is, one year or longer) on a consistent set of financial and nonfinancial metrics that, together, constitute the key long-term value drivers of its business."[8]

For most companies, this would mean providing three-year targets (at a minimum) for revenue growth, margins, and returns on capital. For capital-intensive companies, such disclosures could also include plans for future capital expenditures. And companies can seek to marry this outlook with data on operating metrics—number of customers, revenue per customer, and so on.

We agree with NIRI that, in some circumstances, companies may need to furnish short-term guidance—to address seasonality, for instance, and unexpected market developments. But to maintain good communications with analysts and investors, in good times and bad, companies should try to focus their guidance on business fundamentals and long-range goals.

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[8] "NIRI 2018 Policy Statement—Guidance Practices," National Investor Relations Institute, June 2018, niri.org.

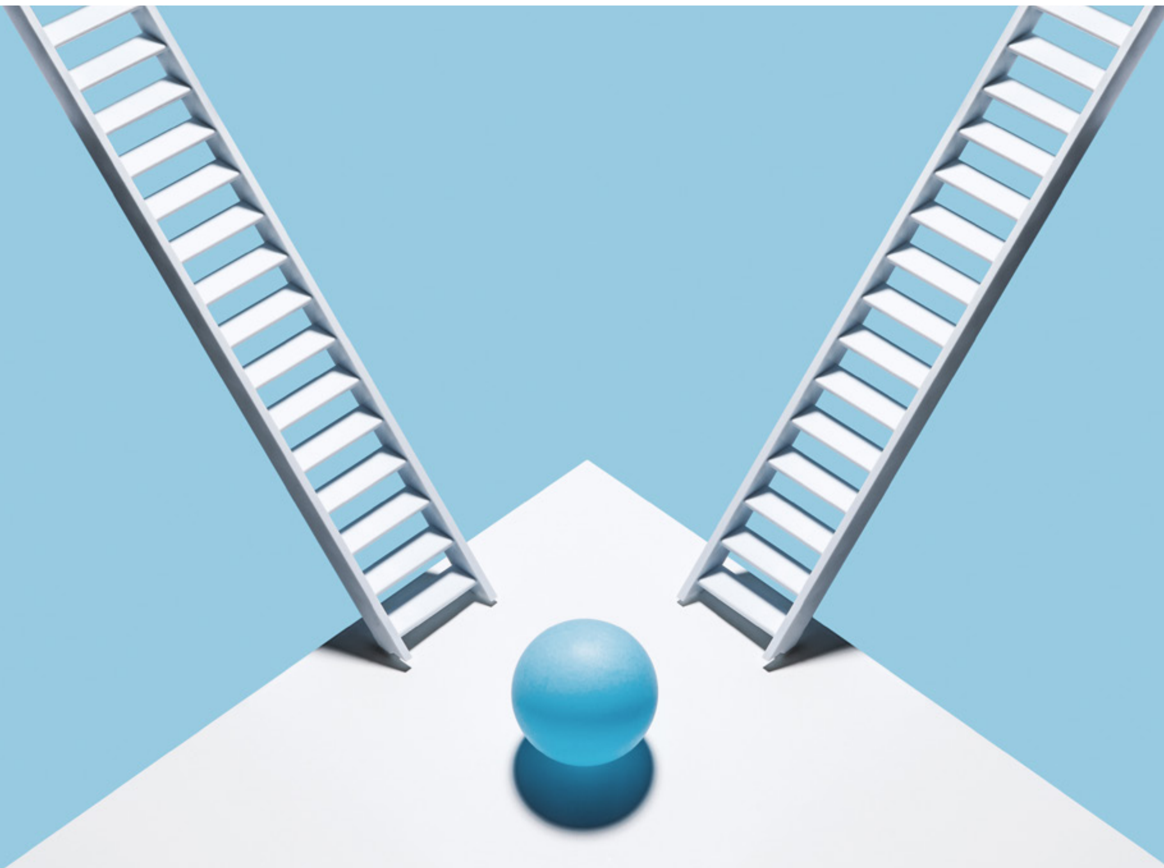
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

Don’t steer your strategy by the wrong star

by Giovanni Gavetti, Martin Huber, Dan Lovallo, and Magdalena Smith



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The dilemma

After some success trading in natural gas and electricity, an energy company wanted to diversify. "What about entering the market for tele-communications broadband?" members of the strategy team proposed. Trading bandwidth is just like trading gas and electricity, right? With the same capital intensity, complicated monitoring and distribution systems, and real-time pricing and sales cycles? The team seized on the analogy, gained the board's approval for the idea, and began to put funding and other resources toward the opportunity. It came to realize, however, just how different the markets were: it was difficult to set standard contracts for bandwidth, they found, and more expensive than anticipated to deliver capacity the last mile to customers. The losses mounted, and within a matter of months, the energy company was looking for buyers for the broadband business.

The research

Business leaders often use analogies to draw bold lines around problems and find new, creative solutions—especially in novel or complex situations.[1] They do this casually and more often than they even realize. But, as leaders in the energy company learned, if an analogy is weak or similar to the issue at hand in only a superficial way, teams risk anchoring themselves to potentially ineffective solutions. A range of research bears this out. In one study, Stanford University students of international conflict were asked to assume the role of a State Department official and determine how to respond to a hypothetical act of aggression. Instructors gave students different sets of information to use to support their decisions. Those who heard cues designed to make them think of events that preceded World War II were more likely to decide to use force, while those who heard cues that reminded them of the dynamics of the Vietnam War tended toward a hands-off policy. Neither war had any real similarity to the situation at hand. Analogous reasoning played a role in the students' responses, even if none of them recognized it.[2]

The remedy

One way for business leaders to avoid using superficial or "false" analogies is to engage in *similarity mapping*.[3] This exercise, which should be conducted by a dedicated "red team," prompts business leaders to look at the source problem (the apparently similar problem from another context) and the target

Business leaders often use analogies, but if an analogy is weak or similar to the issue at hand in only a superficial way, teams risk anchoring themselves to potentially ineffective solutions.

[1] See Colin Camerer, Carmina Clarke, and Dan Lovallo, "Robust analogizing and the outside view: Two empirical tests of case-based decision making," *Strategic Management Journal*, May 2012, Volume 33, Number 5, pp. 496–512, onlinelibrary.wiley.com.
[2] See Giovanni Gavetti and Jan W. Rivkin, "How strategists really think: Tapping the power of analogy," *Harvard Business Review*, April 2005, Volume 83, Number 4, pp. 54–63, hbr.org.
[3] See Giovanni Gavetti, "The new psychology of strategic leadership," *Harvard Business Review*, July–August 2011, Volume 89, Number 7–8, pp. 118–25, hbr.org.

problem (the actual problem a company faces) and actively identify structural similarities between the two. Through this process, business leaders can determine the conditions that must be met for the analogy to make sense in a new context and can fine-tune the proposed solution accordingly.

A classic example of similarity mapping comes from Charles Merrill. The cofounder of Merrill Lynch had a hunch (based on firsthand knowledge and experience) that Safeway's business model could be translated into a "financial supermarket" model at E. A. Pierce, the brokerage he was being asked to lead. Such an approach could help differentiate the brokerage from competitors, he thought. But rather than trust his gut, he tested the validity of his analogy. He identified two key structural traits of supermarkets: one, customers care deeply about pricing and product quality across a range of brands, and two, grocery stores boast economies of scale and scope. He and his colleagues conducted customer surveys, performed cost studies, and gathered other data to determine whether similar conditions existed for financial-services businesses. They formally tested the similarities rather than just talking about them. The mapping exercise confirmed Merrill's hunch, although it also revealed that the economies of scale and scope would need to be structured differently in the financial-services business. Merrill made those adjustments, and the rest, as they say, is history.

Had the executives at the energy company taken time to do the same, they may have identified the key differences between the broadband and energy markets sooner, thereby avoiding the biggest danger of analogical thinking: using a solution to a problem that isn't deeply similar to the target problem.

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