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McKinsey on Finance

Perspectives for CFOs and other finance leaders

Crunch time

Inside: Hard calls on allocation, bold action on divestitures, perils of typecasting, and the rising stakes for global net economic profit.

Number 83,
August 2023

McKinsey on Finance is a quarterly publication offering perspectives drawn from across—and beyond—McKinsey for CFOs, those who aspire to be CFOs, and other finance professionals.

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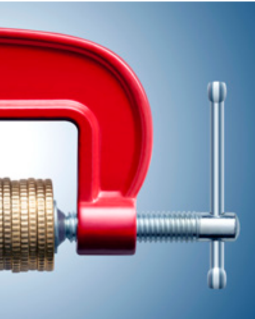

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Item 1: This edition

'Life,' writes poker champion and decision-making strategist Annie Duke, "is poker, not chess."[1] While luck plays a role, good outcomes result mainly from quality decisions, an awareness of what others think and do, and the willingness to act boldly over the longer term. Consider Ken Frazier, the former CEO and executive chairman of Merck. This edition of *McKinsey on Finance* excerpts a portion of his interview with colleagues Vik Malhotra and Steve Van Kuiken, in which Frazier discusses his determination to make remarkably consequential decisions, including withdrawing earnings guidance and allocating more capital to value-creating R&D. In a piece authored jointly by Tim Koller from McKinsey's Strategy & Corporate Finance Practice and Aaron De Smet from the People & Organizational Performance Practice, we also dive into the *governance* of capital allocation—who makes decisions and how strategy-minded governance works in practice. Bold thinking is also critical for successful divestitures, as our colleagues explain in "The power of goodbye: How divesting can unleash value."

Winning, it turns out, is getting harder. In "Working hard for the money: The crunch on global economic profit," Marc de Jong, Tido Röder, Peter Stumpner, and Ilya Zaznov describe how companies have been generating less economic profit from invested capital over the past two decades. The findings become even more compelling the more one disaggregates the data: CFOs from companies of different sizes, operating in various regions and competing within distinct sectors, face separate *and* intersecting trends. For example, the typical European-headquartered pharmaceutical company, the authors find, is likely to *outperform* materials companies across regions but *underperform* its North American pharmaceutical peers.

Seasoned CFOs know that it's essential to dig into the details. In "The times for multiples: Why value creation always comes first," our colleagues offer some practical tips about when multiples can obscure, rather than inform, a clearer perspective about a project's value-creating potential. Individual and organizational biases can also cloud effective decision making. In the latest edition of our *Bias Busters* series, the authors explore the challenges of executive typecasting and suggest ways that CFOs can help lead colleagues to achieve better outcomes.

Of course, the dynamics are not just internal: activist investors are always apt to come knocking, particularly when market valuations decline. In this edition's "Looking back" infographic, we present a ten-year snapshot of companies' performance before, during, and after an activist campaign has launched.

Finally, today's CFOs confront large-scale digital and AI challenges.[2] Indeed, we're increasingly seeing firsthand—including at our latest CFO Forum, where we hosted about 130 global group CFOs—just how highly new technologies rank on financial leaders' agendas. We'll be sharing insights on these and other Forum topics online and in our next edition. As CFOs recognize, the stakes are only getting higher.

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[1] Annie Duke, *Thinking in Bets: Making Smarter Decisions When You Don't Have All the Facts*, New York, NY: Portfolio/Penguin, 2018.
[2] Eric Lamarre, Katie Smaje, and Rodney Zemmel, *Rewired: The McKinsey Guide to Outcompeting in the Age of Digital and AI*, Hoboken, NJ: Wiley, 2023.

Working hard for the money: The crunch on global economic profit

Global economic-profit pools have been shrinking over the past two decades. What's going on?

by Marc de Jong, Tido Röder, Peter Stumpner, and Ilya Zaznov

The wider the spread between a company's ROIC and its cost of capital, the more economic profit[1] its capital will create. Since global GDP has grown impressively over the past two decades—even given significant geopolitical and market shocks along the way—one might expect that companies' aggregate economic profit has been rising as well. After all, the high-tech industry has seen the ascendancy of some of the world's largest corporations, markets within Asia have dramatically expanded, and companies across the globe have been getting better and better at operating their businesses. All the while, global GDP per capita has been increasing.

Yet over the past two decades, companies' economic profits have, in the aggregate, been *shrinking*. Their capital has had to work harder just to keep up with historical results. Even so, aggregate levels of economic profit—as with any metric—can also obscure more granular insight. Companies that are headquartered in some regions (in particular, North America) are doing better than others (in particular, those in Europe and the rest of the world). And some industries are doing better too. In this article, we dig into key sectoral, regional, and other differences and explore important implications. Here, too, we find some surprises.

Studying the topic

To gauge economic-profit dynamics, we examined the world's 4,000 largest public companies, by revenue, in each year, starting in 2005. Because there are important differences between developments prior to the COVID-19 pandemic and those throughout the pandemic, we divided our analysis into a longer 15-year period, ending in 2019. Then we contrasted this time horizon with a two-year period, 2020–21.

This latter view is less definitive than longer time frames because of a shorter averaging period and the unique characteristics of the COVID-19 crisis. Yet those years, particularly when considered together with longer, prior periods, reveal that net economic-profit pools aren't expanding in lockstep with companies' revenues or accounting profits.[2] Even considering that global economic profit halved from 2005 to 2019 and then rebounded in 2021, global net economic profit is experiencing a notable long-term crunch (Exhibit 1).

Drilling down to details

Three major shifts explain many of the dynamics. First, the cyclical, commodity-driven energy and material sectors endured a pronounced decline in performance. Second, even when excluding energy and materials, economic-profit pools failed to significantly expand, except for companies that are headquartered in North America. Indeed, Europe and the rest of the world, across sectors, lagged behind North America; a typical European-headquartered pharmaceutical company, for example, was likely to underperform its North American peers. Third, smaller "big companies"—those that are large but not large enough to be in the world's top 500 companies by revenue—have deteriorated severely in their contribution to global economic profit.

The long-term decline of energy and materials

Beware of letting the postpandemic uptick in energy and materials sectors distort a more complete picture. While the 2020–21 recovery was indeed driven mostly by energy and materials, the longer-term historical trend of shrinking global economic-profit pools has been led by a sharp decline in those same sectors, which were weighed down by low commodity prices paired with low

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[1] We define "economic profit" as the spread between a company's ROIC and its weighted average cost of capital, multiplied by the capital invested. *Economic* profit is distinct from *accounting* profit, which is the net income that a company reports in its income statement.

[2] Global economic profit is also diverging from the trajectory of the global balance sheet. See "Global balance sheet 2022: Enter volatility," McKinsey Global Institute, December 15, 2022.

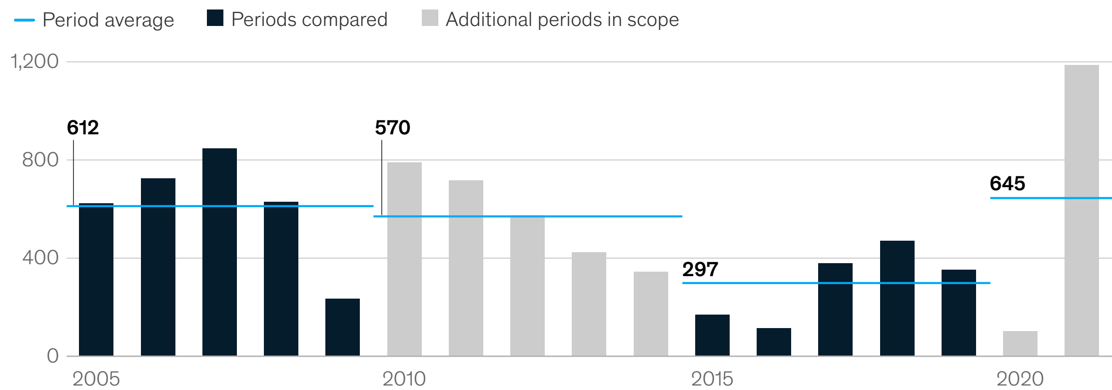
investments (Exhibit 2). The remaining industries showed modest economic-profit growth of 26 percent over ten years, or 2.3 percent on an annualized basis, which is slightly above global real GDP growth of 1.8 percent per annum.

At a global level, industries based in technology and intellectual property, such as advanced industries and technology and media, were able to expand their economic-profit pools. The air and travel, consumer goods, and pharmaceutical and medical-product

Exhibit 1

Global economic profit halved from 2005 to 2019 and then rebounded in 2021.

Top 4,000 companies' economic-profit pools,[1] $ billion



[1] Including goodwill and adjusted for inflation to 2021 prices. Based on a sample of the top 4,000 companies by revenue globally, excluding banks, insurance companies, and real-estate companies.
Source: S&P Global; Corporate Performance Analytics by McKinsey

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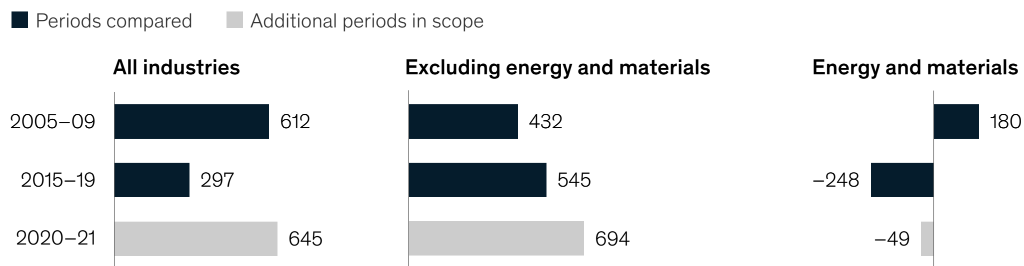
Exhibit 2

The energy and materials industries have played an important role in spurring economic-profit dynamics.

Top 4,000 companies' economic-profit pools, period averages,[1] $ billion



[1] Including goodwill and adjusted for inflation to 2021 prices. Based on a sample of the top 4,000 companies by revenue globally, excluding banks, insurance companies, and real-estate companies.
Source: S&P Global; Corporate Performance Analytics by McKinsey

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industries contributed a moderate expansion of global economic-profit pools.

Other industries—though not as hard hit as energy and materials—found it harder to grow economic profit. The global telecommunications industry, for one, faced declining economic-profit pools; competitive intensity increased as markets became both more saturated and more prone to tighter regulation. Conglomerates, particularly in Asia, also saw their cumulative economic profit decline significantly.

The gap between North America and the rest of the world

Europe and the rest of the world demonstrably failed to keep up with North American companies in economic profit. To gain further insight, we disaggregated the change in economic profit (excluding energy and materials) into its five drivers: revenue, operating margin, capital turnover, tangible capital ratio, and weighted average cost of capital, or WACC (Exhibit 3).

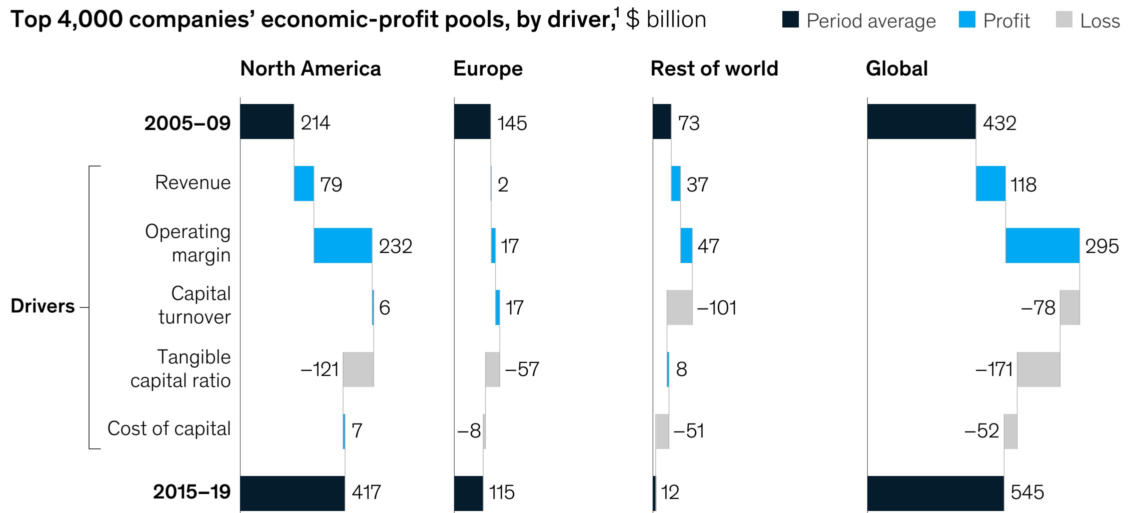
Comparing 2005–09 and 2015–19 numbers, companies headquartered in North America (excluding those in the energy and materials sectors) rose to a share of 77 percent, from 50 percent, in global economic-profit pools (Exhibit 4). Companies from all other regions, on the other hand, saw their shares of economic profit cut in half. European companies' shares fell dramatically; the rest of the world went from 17 percent to only 2 percent of economic profit, even though non–North American and non-European companies represent half of the companies in the global 4,000 sample, and even though China has been the world's renowned growth engine as measured by revenues.

The stunning reduction has been driven largely by local underperformance of conglomerates and travel and logistics companies; the telecom-

Exhibit 3

From 2005 to 2019, Europe failed to maintain economic growth and margin expansion.

Top 4,000 companies' economic-profit pools, by driver,[1] $ billion



[1] Including goodwill and adjusted for inflation to 2021 prices. Based on a sample of the top 4,000 companies by revenue globally, excluding banks, insurance companies, and real-estate companies. Also excludes energy and materials. Figures may not sum to totals, because of rounding.
Source: S&P Global; Corporate Performance Analytics by McKinsey

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Exhibit 4

From 2005 to 2019, North America contributed an outsize share of economic profit across sectors.

Top 4,000 companies' economic-profit pools, by sector,[1] $ billion

Change from 2005–09 to 2015–19: Decline by more than 10% | Increase by more than 10%

	North America		Europe		Rest of world	
	2005–09	**2015–19**	**2005–09**	**2015–19**	**2005–09**	**2015–19**
High technology	66	116	15	9	8	2
Pharma and medical products	52	78	50	38	11	8
Consumer	62	77	33	34	14	20
Advanced industrials	21	73	–3	25	14	25
Other	15	29	–3	–5	–8	–68
Media	–3	26	8	2	5	17
Air and travel	–7	15	–2	2	–6	–6
Telecommunications	9	4	46	11	34	15
Materials	6	–2	11	–6	8	–43
Energy	75	–96	84	–52	–4	–49
Total profit pool, period averages	**296**	**320**	**239**	**57**	**77**	**–80**

[1] Including goodwill and adjusted for inflation to 2021 prices. Based on a sample of the top 4,000 companies by revenue globally, excluding banks, insurance companies, and real-estate companies. Figures may not sum to totals, because of rounding.
Source: S&P Global; Corporate Performance Analytics by McKinsey

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munications industry has faced difficulties in every region. Overall, North America generated more than 3.5 times as much economic profit as Europe in the 2015–19 period and a staggering 30 times as much as the rest of the world.

At first glance, it's perhaps unsurprising that North America would have surged ahead. The US technology sector is a global dynamo and accounts for a significant part of the difference between North America and all other regions. But technology isn't the whole story. The technology and media industries accounted for only about 39 percent ($79 billion) of North America's increase in economic profit. The advanced-industrial ($52 billion), pharmaceutical and medical-technology ($26 billion), air and travel ($22 billion), and consumer ($15 billion) sectors strongly contributed to the uplift.

Telecommunications was the only large sector in North America in which economic profit declined (–$5 billion).

In Europe, only one sector was able to grow economic profit considerably: advanced industrials, which added $28 billion. Europe's sizable consumer sector stagnated, while the economic profit of its technology and media (–$12 billion) and pharmaceutical and medical-technology (–$12 billion) industries declined. The European telecommunications industry took the biggest hit; its economic profit shrank by $35 billion.

Outside Europe and North America, the advanced-industrial sector ($9 billion) was able to expand cumulative economic profit the most, given the strong performance of the automotive and

semiconductor industries in Greater China, Japan, and Korea. The rest of the world's consumer ($6 billion) and technology and media ($6 billion) industries were also able to grow economic profit considerably. At the other end of the spectrum, conglomerates, relatively common in Latin America and parts of Asia, saw economic-profit pools decline sharply (–$49 billion).

We found that companies headquartered in North America were able to grow revenues by an aggregate 3.2 percent per annum in real terms. Even more important, they improved their margin for net operating profit after taxes (NOPAT) to 10.7 percent, from 8.4 percent. This more than compensated for the considerable capital that they spent on M&A, as evidenced by a decline in their tangible capital ratio to 49 percent, from 60 percent. It remains to be seen how long North American companies can maintain their strong margins.

European-headquartered companies trailed other regions considerably in growth and margin improvement. Their average revenue grew at only 0.1 percent per annum, and their average operating margins improved only slightly (to 9.6 percent, from 9.3 percent). In capital efficiency, European companies showed slightly better improvement than North American companies but continued to trail in absolute terms. A leading driver of European economic-profit decline was M&A, which failed to add enough revenue growth and margin expansion to compensate for the hit that deals imposed on balance sheets.

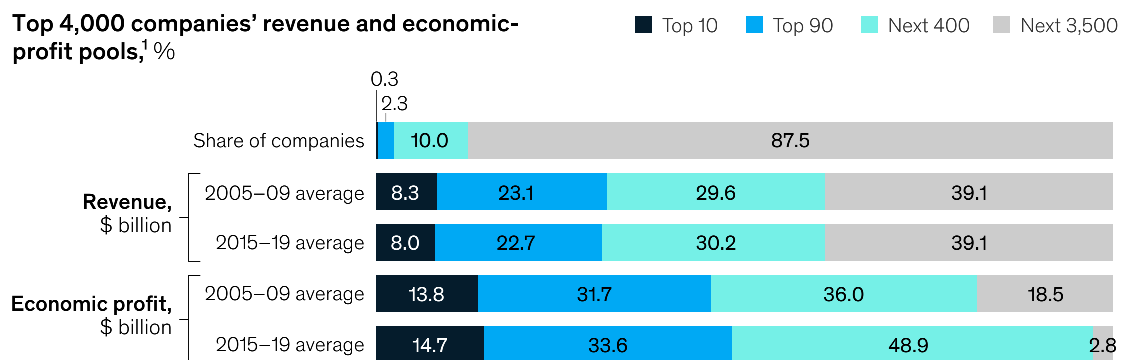
Companies in other regions of the world fared even worse, driven down by poor capital efficiency and an increasing cost of capital (to 7.6 percent, from 6.9 percent). Their decline in economic profit was, again, particularly striking, given that they demonstrated considerable revenue growth (3.2 percent per annum) and margin expansion (6.1 percent, from 5.4 percent, in average NOPAT margin).

The increasing importance of scale

While achieving higher revenue doesn't necessarily translate to creating more value, there has been an intriguing development from 2015 to 2019: the bulk of economic profit has been concentrated in the top 500 companies by average revenue (Exhibit 5).

Exhibit 5

Scale matters—the largest 500 companies in the pre-COVID-19 decade significantly increased their share in global economic profit.



[1] Including goodwill and adjusted for inflation to 2021 prices. Based on a sample of the top 4,000 companies by revenue globally, excluding banks, insurance companies, and real-estate companies. Includes energy and materials. Figures may not sum to 100%, because of rounding.
Source: S&P Global; Corporate Performance Analytics by McKinsey

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This concentration has become more pronounced over time, as globalization and digitization have amplified the effects of scale.

The share of the top 500 companies in the total revenue pool has been stable over time, at approximately 60 percent. However, larger companies have been able to translate economies of scale into higher ROIC, which helps explain the disproportionate increase in their share of total economic profit. When we decomposed companies by revenue size, we found that from 2005 to 2009, the average ROIC–WACC spread was 8 percent for the ten largest companies, 4 percent for the next 90 largest companies, and slightly less than 3 percent for the next 400 companies. The smallest 3,500 companies by revenue size, on the other hand, had a spread that barely exceeded 1 percent.

Over the following decade, ROIC–WACC spreads deteriorated across all groups of companies but squeezed the smallest 3,500 companies the hardest; on average, their spread approached zero. As a result, the share of the smallest 3,500 companies fell to only 3 percent, from 19 percent, of global economic profit.

Emerging implications

The future is always uncertain, and the dramatic shocks during and since the outbreak of the COVID-19 pandemic highlight how sharply scenarios may diverge in the years ahead.[3] Yet given the long period studied, the large number of companies examined across geographies, and the current macroeconomic information and developments now available, important implications of the global economic-profit crunch can be drawn:

— *A wake-up call for Europe and Asia.* While some of the largest companies in the world are headquartered in Europe, they and other European corporations are clearly losing ground to their North American peers. Corporations and regulators alike should pay particular attention to the innovation of North American companies—their "secret sauce." As our colleagues have detailed in a report on securing Europe's competitiveness, Europe can create conditions for new, profitable, high-growth segments to flourish.[4] Regulators play an important role in making sure that consumers are protected and determining equitable divisions of profits among workers and shareholders. From a growth perspective, effective regulation also strives to ensure that regulated sectors can succeed in the global arena in a sustainable way. Similarly, our colleagues have published a discussion on a practicable path for Asian companies to reallocate capital to higher-return opportunities.[5]

— *Keeping up with big players.* While large but not super-large companies are often described as the backbone of the global economy, their share of global economic profit is weakening. Of the 4,000 largest companies studied, those ranking outside the top 500 generated $8.3 billion in economic profit—which comes to less than $2.4 million per company. It's becoming increasingly imperative for these companies to scale up or find new opportunities with the potential for value creation. They can also capture opportunities by adopting professional-management best practices, investing in digital and analytics, and attracting and retaining talent. *The Titanium Economy: How Industrial Technology Can Create a Better, Faster, Stronger America* (PublicAffairs, 2022) describes small and midsize companies that raised their game significantly in such areas.[6]

— *Practicing judicious M&A.* The underperformance of smaller companies may turn them into targets for larger companies in a new wave of M&A. But while current conditions hold promise

[3] See "2023, a testing year: Will the macro-scenario range widen or narrow?," McKinsey, January 16, 2023.
[4] "Securing Europe's competitiveness: Addressing its technology gap," McKinsey Global Institute, September 22, 2022.
[5] "The future of Asia: Decoding the value and performance of corporate Asia," McKinsey, June 3, 2020.
[6] Gaurav Batra, Asutosh Padhi, and Nick Santhanam, *The Titanium Economy: How Industrial Technology Can Create a Better, Faster, Stronger America*, New York, NY: PublicAffairs, 2022.

for acquirers, capturing the opportunities may become harder. For instance, regulators in Europe and the United States are approaching larger deals with increasing scrutiny. Additionally, goodwill incurred from M&A transactions alone has, on aggregate, wiped out progress made in operating-margin improvements outside North America. Europe, across sectors, and the global consumer industry have seen value destruction during recent M&A waves. Value-creating deals are more likely when companies follow a programmatic M&A approach, which has been shown to boost the odds of achieving market-beating returns and growth rates compared with other dealmaking approaches. The relatively weak economic-profit performance of the "next 3,500 companies" might also provide compelling M&A opportunities for the top 500.

— *Energy playing offense.* Massive investments are needed to make the net-zero transition a reality and to increase the resilience of the global energy system. The strong decline in economic profit that energy and materials companies experienced in 2015–19, compared with the prior decade, has become increasingly evident. It has contributed to a decline in global energy investment since 2014 (despite a modest increase in nonfossil-energy investments during the same period). But leading energy companies are learning to play offense as they address the consequences of climate change and capture new opportunities from the transition. In 2020–21, the performance of the energy and materials sectors improved. Meeting the world's energy needs while focusing relentlessly on the long term can help ensure that increased profitability translates to sustainable value creation.

Global economic profit has been under a significant crunch, and capital has needed to work harder. Yet the developments that have had the most impact lie beneath the headlines. It's essential to disaggregate global aggregates and explore differences across regions, sectors, and company sizes to gain a more actionable perspective. These analyses enable companies, stakeholders, and regulators not only to recognize what has changed but also to understand how capital can unleash more value-creating opportunities now and in the decades ahead.

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The power of goodbye: How divesting can unleash value

Separations can be a once-in-a-lifetime opportunity to create value for the remaining and separated companies. The secret? Get granular about support costs and personal about talent.

by Luigi Dufour, Gerd Finck, Anna Mattsson, and Marc Silberstein

The rationale for combining businesses into one company, or for splitting them apart, should be the same: to create more value. Yet we often hear leaders describe separations as the *opposite* of M&A integrations, at least in terms of "capturing value" in the near term. M&A, done well, unlocks value by realizing synergies. But it needn't follow that separations must present a drag on near-term value creation under the assumption that the separated entity ("CarveCo") needs to build back the same support structure it had used when it was a part of the divesting company ("RemainCo"), or because the transaction poses insuperable risks to business continuity.

There are costs and risks of separations, of course, but like every key business decision, these should be considered under a cost–benefit analysis. In fact, what may seem to be the most daunting costs of separations are often more perceived than real. Does CarveCo need an effective support structure? Yes, but that doesn't mean it needs the same, equally expensive support structure that it had under RemainCo; the "scale benefit" of general and administrative (G&A) can be vastly overstated. Could business disruptions arise as a result of a separation? Yes, but in the aggregate, there is typically a greater cost to standing still, and identifying potential disruptions is the first step toward mitigating or even preventing threats to business continuity. And might employees of CarveCo feel unnerved by the changes, or perhaps even leave? Yes, again—but employees can also be reenergized by the transformation, attracted to a more nimble, purposeful company and inspired to make it even better.

Any "keep versus divest" decision will always be highly fact specific; even the very term "separation" encompasses significantly different types of transactions (Exhibit 1). For all of the variation, however, common lessons clearly apply—the most important of which is that separations present an unrivaled opportunity for both transacting and *transforming*—by anchoring in the question "what is most value creating?" The answer is almost never to do things the same way that they've always been done.

Separations present an unrivaled opportunity for both transacting and transforming.

Exhibit 1

Decisions to ‘keep or divest’ are always case specific.

Examples of divestment options and dimensions to assess

Divestment options	Example	Details
Carve-out sale	Sale to strategic buyer (including PE[1] with platform)	Competitor acquires a business unit or assets carved out by the seller
	Sale to PE	A PE fund buys the business unit or assets and creates a new, private company
Capital market exit	IPO	The carved-out business unit is listed as a newly formed public company; parent company usually retains a stake for a period of time
	Spin-off/ split-off	A new public company is formed and all existing shareholders receive stock in SpinCo (or “swap” stock in parent for NewCo stock)
Merger/partial exit	Merger with strategic buyer	Competitors merge business units or assets; parent retains a stake in MergeCo
	Joint venture/ sell stake	Creation of a new entity, which the parent company owns jointly with strategic or financial partners

Assessment dimensions

Feasibility/complexity

- Carve-out complexity/ operational separation
- Legal restructuring
- Tax impact
- Regulatory/antitrust considerations

Value/costs

- Value creation/realization
- Transaction costs
- Recurring costs/dis-synergies
- Stranded costs

Timing

- Expected completion
- Time-to-value realization (cash in hand)
- Impact of other corporate actions

[1] Private equity.

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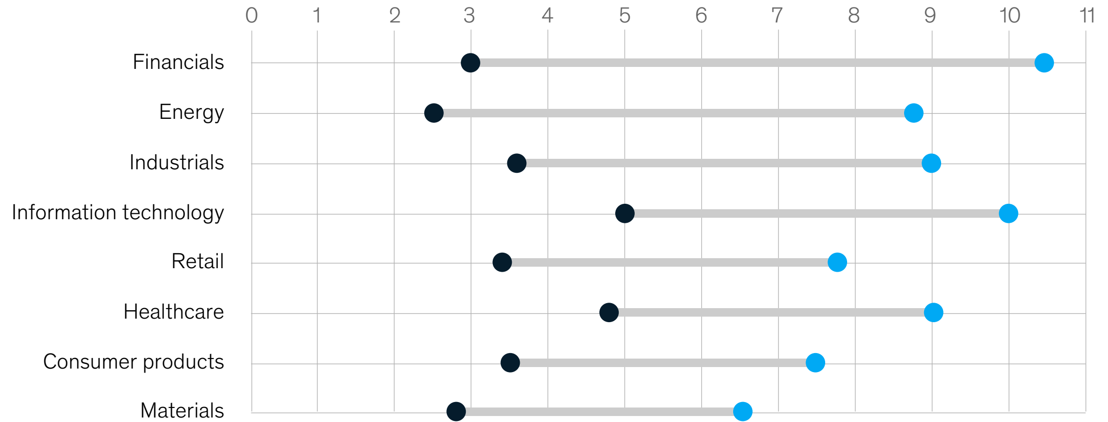
The right support structure

Building and maintaining effective support functions requires significant investment, no question. Across industries, there is a significant “G&A gap” between high and low performers of 4 to 8 percent of revenues (Exhibit 2). Understanding and addressing the gap can translate to significant value.

While both RemainCo and CarveCo require robust support structures, it’s a mistake to assume that RemainCo’s support structure will be necessarily applicable to CarveCo, or that CarveCo—given its purpose, size, and type of business—needs to scale all the way back up to its RemainCo levels for its business to thrive. In fact, we’ve found that companies can leave tremendous value on the table if they default to making CarveCo’s structure a RemainCo “mini me,” and elevate continuity as an end in itself, rather than to use the separation as an opportunity to transform. Companies should choose the right operating model for CarveCo, not just the familiar one. Five steps can be particularly helpful.

Exhibit 2

General and administrative costs are significant across industries, and the gaps between industry high and low performers are notable—and expensive.



Source: S&P Capital IQ; S&P 1200

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1. Create transparency

The first step in any separation is transparency. What specific roles, activities, assets, contracts, and people should support each business? Transparency provides a baseline. Achieving transparency is much more demanding than just a superficial review. It requires disaggregation. Think of the way, for example, that a mechanic would disassemble a motorcycle to understand what makes it go, or where its inefficiencies may lie. The goal should be clarity on a microlevel, with an eye to not just "what resources is this company using to support its operating model" but also "what resources *should* it be using given its specific circumstances as a stand-alone business?" While that degree of atomization may sound daunting, there are highly replicable templates that CarveCos can use to create and assess detailed, structured fact bases. Typically, many of the support costs and processes that CarveCos uncover when they create transparency and get down to constituent parts *are* rightsized—were CarveCo still to be a part of RemainCo. But when that's no longer the case, applying RemainCo's cost as the default setting for its constituent businesses is almost never optimal.

2. Compare and contrast with peers

To gain a clearer sense of what the actual "right size" is, it's essential to present a neutral, fact-based comparison both with peer businesses and with other parts of the business. Key focal points when comparing peer businesses include levels of automation, degrees of specialization, numbers of interfaces per process (this typically reveals clear opportunities for simplification), IT systems and applications that peers use, and the legal conditions in which peers may operate in achieving a leaner (or less lean) operation (for example, with respect to labor rules, reporting requirements, and occupational health and safety).

Across industries, there is a significant 'G&A gap' between high and low performers. Understanding and addressing the gap can translate to significant value.

It's important to bear in mind that, while it's insightful to better understand peers' choices and outcomes, an effective separation shouldn't solve for CarveCo to be like its peers any more than it should solve to be like RemainCo. For example, in one separation, RemainCo found that the finance function of CarveCo was significantly larger compared with other companies in the same business benchmark. Rather than immediately starting to slash full-time equivalents (FTEs), however, the senior team looked deeper. As it disaggregated activities within the finance function, it discovered that beyond what could be considered traditional "transactional" financing activities (such as reporting, controlling, and budgeting), RemainCo's finance function was actually contributing to a number of value-adding strategic projects for CarveCo. Much of the separation and transformation efforts, the team determined, should therefore be devoted to the finance functions—bearing down, in particular, on what to protect, what to preserve, and how to improve. By gaining clarity at a granular level, the function was able to achieve a relatively fast 20 percent reduction—the "easy wins." The next 20 percent of reductions required significant investments in automation. These could not be made in parallel with the carve-out—but, importantly, RemainCo, CarveCo, and any new owner would have a clear understanding of necessary next steps and dangerous third rails.

3. Be open to nuance

While baselining and benchmarking help to recognize and prioritize areas where significant value may be untapped, actually realizing meaningful opportunities again requires teams to get very granular—to understand the specific activities that CarveCo needs to conduct and to identify the appropriate level of support that its business or businesses need, including spans of control and reporting lines. Many activities may, but need not, be provided by CarveCo in-house. But others can often be either outsourced or stopped entirely.

In one effective separation, team leaders discovered that CarveCo's human resources function was spending several days onboarding new employees and conducting additional training sessions on an ongoing basis. Those activities were necessary before the separation, when there were certain details and updates that many employees of the RemainCo conglomerate needed to know. But those additional details and steps simply weren't relevant for the single-business CarveCo, where learning the ins and outs of the larger corporation wasn't necessary. Much of the onboarding, the team found, could be scaled back, and several trainings could be eliminated. Business-specific training was made available on an as-needed basis from a third-party provider.

By examining and aggregating individual use-case examples, companies can begin to identify significant efficiencies. Being open to nuance helps avoid the trap of too easily sorting into "keep/outsource/eliminate" outcomes. It's often the case that a function that had employed, say, ten or more people when the business was part of RemainCo should neither be eliminated nor outsourced, but instead reduced to a fewer number of people who may (or may not) perform other roles. It may also be the case that in order to achieve *net* reductions, hiring or reskilling people with different capabilities will be a necessary precondition. Reductions may also need to be scheduled in sequence, as complications can arise if every move is executed at once. Continuity, after all, matters a lot—but as a means to preserving and creating value rather than as an end or coequal objective.

4. Rethinking technology

Technology is a unique consideration in separations. IT is itself a separate function, and like every function, it should be scrutinized for potential cost savings and efficiency improvements once the business is no longer part of a larger company. At the same time, the use of IT systems, infrastructure, and support is integral to and runs across every part of CarveCo. While RemainCo may require a more expansive range of hardware and software, CarveCos can, in many cases, perform many—and sometimes all—of their core needs using common applications (such as Microsoft Excel) and off-the-shelf or lightly tailored options. This can greatly reduce IT expenses without sacrificing much (if any) of the functionality that a smaller company needs.

Many effective CarveCos conduct joint workshops among support functions and IT in order to align on business needs and to identify outdated and unused IT systems, which should be eliminated. They also align on a separation approach, transitional service agreements, and appropriate lead times to ensure that essential technology is operationally ready from the moment the businesses are separated.

In one successful separation, the leadership team decided to stop using an advanced HR management software; the technology was ideal for larger organizations but expensive, and indeed obtrusive, for a company of CarveCo's size. Choosing a less bespoke option not only immediately and directly reduced expenses but also eased the transition to CarveCo's "day one": the transfer of data to Excel could be done ahead of time, with no need to negotiate a new software license or to draft transitional service agreements.

5. Create your road map

Identifying the appropriate G&A within and across CarveCo functions is a necessary but insufficient step to building a more value-creating business. To get from point A to point B, companies need to create a road map that spells out how to turn ideas into action. The details and timing of next steps should be clear.

The exercise should begin with outlining the new organizational setup based upon the activities reviewed, the opportunities identified, and the program conceived for IT simplification. A robust road map encompasses all functions, highlights key milestones, and identifies the interdependencies that will be critical to achieve a business-ready CarveCo. It can also define the spans of control, reporting lines, and how different functions should interact with one another. While traditional road maps are useful to see the big picture, for great maps, granularity is once again essential. Any practicable (as opposed to merely aspirational) road map sets forth FTE sizing at the level of an individual employee—or, more precisely, the specific activities and roles that individual employees should undertake. The detail reaches well beyond senior management.

Better practice, still, is to anticipate what could come next and plan for scenarios under a "next generation" organizational setup. Best practice is to spell out the next-generation arrangement and define changes that are implemented in the

premarketing, preclosing, and postclosing phases. Those, of course, can differ depending upon the specific buyer and real-world time constraints. Sometimes, a buyer will offer a price that is so clearly value creating for RemainCo and above what RemainCo could reasonably expect to receive in even the best-planned separation; in those cases, the main goal will indeed be to get the deal done as quickly as possible while making a clean, legal break. But usually, judicious forethought is a value multiplier. By thinking about a separation in a rigorous and imaginative way, challenging assumptions about support structures, identifying potential disruptions, and being very clear in planning (and communication), companies can create the conditions that add up to a higher price—and that drive better businesses. The more detailed the road map, the more likely that RemainCo and CarveCo will create more value.

In addition to transaction timing, another major factor influencing the degree of implementation of the transformation plan is the likely exit route. A spin-off or IPO will, by definition, require a capital-market-ready organization; a divestiture to a strategic buyer should keep degrees of flexibility to avoid postclosing restructuring costs; a financial buyer will likely focus most on RemainCo as a stand-alone business (though likely with some differences to come, depending upon the specific acquirer). But any buyer, even a disbursed group of shareholders in the case of a spin-off, would recognize the upside in transforming legacy structures and building a fit-for-purpose G&A function.

Culture as catalyst

Precisely because the opportunities are so great in separations—when every support cost is on the table and a highly technical, bottom-up analysis is so essential—it's possible to overlook the personal aspect that can make or break a separation. Research shows that about 70 percent of the time, transformations beyond the separation context fail, and that the human element is a critical reason why. It's natural for people to resist change; in the context of separations, trepidation is heightened. While some jobs are added, others are eliminated or transferred; the uncertainty would put anyone on guard. Moreover, even the most high-performing, critical-to-retain employees can be subject to the same cognitive biases that are long programmed into the human condition. These include the status quo bias ("this is the way the job has always been

Research shows that about 70 percent of the time, transformations beyond the separation context fail, and that the human element is a critical reason why.

done, so this is what we should keep doing") and the "prudence trap" ("this is all I can reasonably achieve, to be on the safe side").

Yet just as separations are a unique opportunity for companies to shake off old perceptions about the "right" support structures and systems, the transactions can be uniquely fortuitous for employees, as well: a chance to break free from old expectations, benefit from a fresh start, and help build something new. We've found that it's especially important for senior leaders, particularly at the CEO level, to lead calls to action. McKinsey research has found that respondents were nearly four times more likely to report a successful transformation when managers prioritized leading and developing their teams, more than five times more likely when leaders role modeled desired changes, and a remarkable eight times more likely when senior management communicated openly about the changes.[1]

In a recent carve-out, company leaders invested significant time crafting their change stories and sharing them with immediate teams and a broader range of employees in small group discussions and in town halls. The excitement was palpable. We've also seen the enormous benefits that can come when leaders put words into action and role model change. Even small actions add up; for example, in one separation, the leadership team requested for the first time that HR collect upward feedback about the leaders' own performance. Executives also moved their offices so that they would not sit among themselves but instead with their respective teams. Additionally, every key team meeting had someone play the role of "value-adding police," empowering team members to speak up any time they felt a request for information or analysis was not value adding.

It's natural to be skeptical of change—but it should be even more concerning when the default is for more of the same. Separations can unlock tremendous value. The odds for success improve when the separate company adapts a cost structure and culture that befits its specific needs—not those of the original conglomerate. Newly divested businesses can continue to generate and even grow revenues with a much smaller, more appropriate support structure. But it's the employees who may reap the greatest reward. It's exciting to be in a company that operates under its own unique business model and that isn't just a smaller version of a larger conglomerate. After all, why be a duplicate when you can be your own best self?

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[1] "The T-word," *McKinsey Quarterly Five Fifty*, March 20, 2018.

Capital allocation starts with governance—and should be led by the CEO

CEOs should be relentless in allocating resources toward growth. That calls for decision making to be strategy-driven, granular, and framed by an influential team.

by Aaron De Smet and Tim Koller

It's easy to go along to get along: give lots of managers an equal say and allot each division its "fair share" of capital. Usually, however, a laissez-faire approach underserves a corporation's most promising opportunities for growth. Companies typically provide lump sums to division heads, often in proportion to current revenue; choices about funding get pushed across the organization and down its hierarchies, with the result that historic performance repeats itself—and forward-looking strategy goes unfulfilled. High-growth initiatives often don't receive the resources they urgently need.

But in our experience, highly effective companies manage capital allocation differently. That starts with corporate governance—in other words, the processes of informing good decisions, as well as the power to make them. The "who" of decision making is the subject of this article, the first in our *Strategy to Action* series on practical steps for effective capital allocation. We believe the CEO should be the decision-maker-in-chief.

Governance achieves the greatest impact in this area when it is marked by a meaningful investment of CEO time; is driven by a mindset ardently focused on growth; has a clear set of strategic priorities; maintains an appropriate level of granularity; and is empowered by a capable, insightful, and organizationally influential support team. While not every element will necessarily be optimal for every organization—there are nuances in each case, and companies should focus on what is most effective in their specific set of circumstances—these prescriptions help to ensure that businesses and initiatives with a high potential for massive, profitable growth won't be starved for resources. Business lines or projects that don't fit the company's strategy, for their part, can receive a lower proportion of capital or be divested entirely. That's easier said than done, but all the more reason why CEOs should take the lead—and why a failure to decide leads to stagnation.

Investing significant CEO time

Strategy won't translate into a positive outcome unless it's based on a clear set of implications and business priorities. No one can simply intuit what the most value-creating opportunities are or how future scenarios will unfold. The groundwork for an informed decision—and the follow-through to make additional funding or no-go decisions thereafter—requires a significant investment in CEO time.

How much of a CEO's already full calendar should be reserved for capital allocation? While no single answer is right for every company, a good rule of thumb is at least 10 percent of a CEO's time. Often, the time requirement is even higher. One effective CEO commits 20 percent of his time; he makes sure

The groundwork for an informed decision—and the follow-through to make additional funding or no-go decisions thereafter—requires a significant investment in CEO time.

to review at least one strategic initiative each week. At the Dutch publishing company Wolters Kluwer, CEO Nancy McKinstry devotes an outsize number of hours to resource allocation, both organic and through M&A. Under her direction, Wolters Kluwer discontinued funding or divested about $1.0 billion in lower-growth initiatives and acquired $1.5 billion worth of companies that advanced its digital strategy.

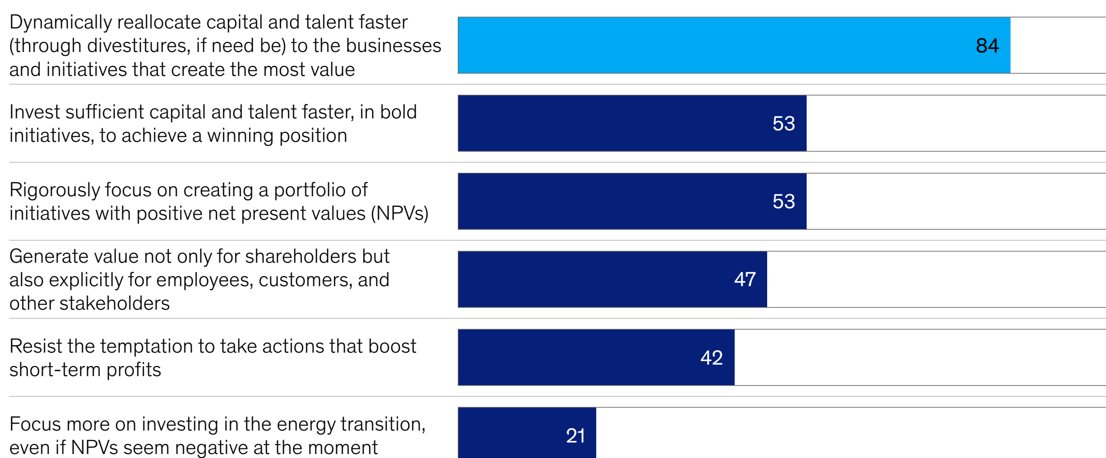
Many CEOs believe, understandably, that the bulk of their time should be spent as the face or voice of the company. No one disputes that a CEO has an enormous amount to do. Yet if a company doesn't deliver profitable growth, it won't attract sufficient capital, and will disappoint stakeholders across constituencies. We recently surveyed a broad, global group of chief investment officers from large funds. By a huge margin, these seasoned investors favored CEOs who dynamically reallocate resources for sustainable long-term value creation (exhibit).

There is no such thing as a "fair share" in capital allocation. Fair is a judgment call; someone's got to make that decision, and only the CEO can ensure—as Winston Churchill would mark urgent memoranda—"action this day." When CEOs fail to decisively reallocate capital, huge growth opportunities can go unrealized. Imagine, for example, if Satya Nadella, the CEO of Microsoft, had not forcefully championed Intelligent Cloud, which is currently the company's most profitable and fastest-growing division? Or if Morgan Stanley CEO James Gorman had not allocated billions of dollars to wealth and asset management, honing a growth engine? These were courageous decisions—but also utterly rational. Companies that keep

Exhibit

Intrinsic investors overwhelmingly favor CEOs who dynamically reallocate capital.

Behaviors CEOs should take to sustain long-term value creation,
% of chief investment officer respondents



Source: McKinsey Investor survey (Q3 2022), n = 19

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The ‘investment committee’—though a more accurate designation would be the ‘strategic resource allocation committee’—is the forum where strategically critical capital allocation decisions are made.

allocating capital to the same core businesses will inevitably be surpassed by more committed innovators. Eventually, these once-great corporations will likely be acquired—or simply cease to exist.

Moreover, even the boldest decisions on capital allocation should not be “one and done.” Instead, the CEO can ensure that key strategic initiatives are followed through in regular reviews. Funding can also be timed to—and conditioned on—achieving necessary benchmarks and conditions, such as proof of concept and receiving regulatory approvals. Ideally, capital allocation anticipates a range of different outcomes; projects will almost certainly need more or less funding than initially determined. But likely scenarios can be reasonably planned for and bounded.

Assembling and leading an effective committee

Subject only to guidance and approval from the company’s board of directors, the CEO should be the ultimate decision maker on capital allocation. Even so, informed decisions can’t be made by fiat. Companies that are most effective at capital allocation vet their decisions through a committee, sometimes referred to as the “investment committee”—though a more accurate designation would be the “strategic resource allocation committee.” Most companies don’t use that longer title, and many don’t use investment committee either. By any name, however, this is the forum where strategically critical capital allocation decisions are made.

The process of making decisions does not mean that all committee members are afforded a vote on capital allocation or that the majority vote wins. Voting, especially by secret ballot, is a helpful means to gauge what members really believe, but the final call should belong to the CEO alone. Committee members serve as recommenders, advisers, and sounding boards to the CEO. But their role is not to insulate hard decisions in consensus. Capital allocation decisions should be decisive, transparent, and stark.

It’s the CEO’s role, as well, to select the members, lead the committee, and establish core principles on committee size, meeting frequency, and membership. The latter should be limited solely to the company’s most senior leaders, who have a holistic, enterprise-wide perspective. The most effective strategic resource-allocation committees are small—ideally with three to five voting members, and fewer than ten persons (including any nonvoting members) in total. The CFO should always be among the voting members; additional voting members should similarly have organization-wide authority.

While official titles differ, particularly by industry, examples of additional voting members could be a COO, chief strategy officer, chief technology officer, or head of R&D. Not every company has these roles. A nonvoting member must, in all cases, be a knowledgeable senior executive who is at the ready to provide more information and perspective for a more informed decision—someone whose contribution is additive but should not be decisive. The most important point is that committee membership is a *decision-shaping* role; these are the principals who, when the door is closed and hard choices have to be made, have the authority to weigh in by vote—with the CEO always having the final say.

One principle that can trip up even outstanding leaders is the distinction between decisions and debate. *Decisions* are the province of the voting members, with the CEO always making the final call. *Debate*, on the other hand, helps inform those decisions, and a robust, meaningful debate often encompasses a wider and well-informed circle.[1] Indeed, our research shows that while successful big-bet decisions are marked (as one would expect) by meaningful analyses of robust data, what matters even more is the quality of team dynamics, in particular the diversity of people and perspectives needed to encourage pushback and avoid groupthink.

Healthy debate about capital allocation enables decision makers to understand different implications of an investment and ensures that committee members fully comprehend the "for" and "against" arguments. The mark of a good debate is that participants understand both sides of the decision of whether to allocate—presenting the strongest form of each position, ideally to the point where one can articulate the opposing argument as well as or even better than those who hold a contrary view. If the debate starts to sound perfunctory—or, worse, like an echo chamber—CEOs should actively seek out individuals with a different view. Business managers and outside experts with demonstrated operational, technology, risk, or country- or demographic-specific knowledge can offer valuable perspectives, especially when uncertainty is high.

One question we often encounter is whether division heads should have a voting say—or, for that matter, be a nonvoting participant. In our experience working with large corporations, division heads typically wield enormous power. That makes sense; these talented individuals are charged with delivering division performance, and they likely reached their role because they achieve distinctive results. Yet for all of their insight, division heads often lack the holistic perspective needed to make optimal capital allocation decisions on an organization-wide basis. Moreover, they are typically incentivized based on the results that their own businesses deliver during their tenure—which doesn't necessarily match the long-term performance of the enterprise.

Those misalignments can doubly affect their opinions: more capital for their division, and more resources for operating results right now. If their division contributes an outsize share of revenues, it makes sense to have them in the room, and perhaps even grant them a vote. They'll pound the table for more capital. Let them pound and listen carefully to what they say, but don't cede decision making for company-wide capital allocation. Most important, don't settle for a compromise allocation that gives every business an equal or proportional amount based on historical revenues. By definition, that's precisely the wrong way to place outsize bets. To be effective, capital allocation needs to be *unfair*—low-growth, nonstrategic businesses should receive fewer resources than the company's future growth engines.

Shifting the mission from gatekeeper to growth champion

CEOs and their supporting team should strive relentlessly to invest for growth. Yet all too often, those who are most involved in capital allocation

[1] One helpful framework is DARE, which stands for deciders, advisers, recommenders, and execution stakeholders. See *McKinsey People and Organization Blog*, "The limits of RACI—and a better way to make decisions," blog entry by Aaron De Smet, Caitlin Hewes, and Mengwei Luo, July 25, 2022.

find themselves adopting the role of gatekeeper. It's their duty, as these leaders see it, to protect and safeguard the company's scarce resources. This is a growth-destroying approach, and it's up to the CEO to shake leaders free from that model and shift the mindset from gatekeepers who steward capital to growth champions who relentlessly seek out opportunities for value creation. Nor does the role of growth champion stop with writing a check. Effective resource allocation means ensuring, consistently and proactively, that strategically important businesses receive and *keep receiving* the capital, talent, and management attention they need—so long as the growth thesis remains robust.

Achieving the proper cadence of capital allocation decisions to keep up with current developments and get ahead of new ones will differ across industries. A fast-growing tech company with many rapidly advancing initiatives may need to hold meetings more frequently than a mature industrial company. But even in the most capital-intensive sectors, the committee shouldn't wait too long between formal meetings. The CEO of one leading retailer, for example, supplements committee sessions with weekly meetings among the CFO and the head of financial planning and analysis (FP&A) to ensure that the company is consistently meeting its goals of identifying, analyzing, and funding its long-term, high-growth strategic priorities.

Getting clear—and granular—about resource allocation

To make sure that the right businesses are receiving sufficient resources, the CEO-led committee should be very clear about the company's strategic priorities. This means understanding the divisions' businesses at the appropriate level of granularity, which is definitely not a "30,000-foot view."

Getting to good decisions requires committees to rank the ten to 30 most important initiatives across the corporation. These are the initiatives that simply must have the resources they need. Practically, it's impossible for investment committees to rank more than about 30 top initiatives: doing so can not only present a false sense of specificity but also demoralize business unit heads by limiting their discretion to fund their individual business lines.

Second, the committee should make sure that it has insight into, and funding authority over, capital allocation at a level of about 20 to 50 business cells, regardless of the formal organizational structure. In large corporations, the major divisions likely comprise businesses and individual product lines that can have very different economics and potential. Sometimes, the highest-potential initiatives, particularly for innovative products or services, may be housed (rightly) outside a formal line; these "skunkworks" can mature into

To make sure that the right businesses are receiving sufficient resources, the CEO-led committee should be very clear about the company's strategic priorities.

major breakthroughs—or, conversely, shrivel away if they fail to receive sufficient capital and management attention. Transparency is therefore essential. Of course, micromanagement is neither realistic nor without consequences, chiefly information overload for the decision makers and demotivation for the talented executives below the C-suite. But often, the most compelling cells within a division can get lost when they are aggregated into broader groups. When committees are presented with too few businesses or initiatives per division, they lose the opportunity to make decisions at a meaningful level of granularity.

For an example of what *not* to do, consider one of the world's largest corporations, organized into three divisions; each division has about 20 product lines. For years, the corporation has allocated a lump sum of R&D and sales and marketing funding to each of the three divisions, letting the division leaders decide how to allocate that capital among their managed businesses. Privately, the CEO admits that he is essentially allocating division leaders the capital and praying that they do the right thing. Those prayers often go unanswered. Too frequently, the division heads spend the money in ways that perpetuate historical results but don't align with strategic, forward-looking corporate priorities. Their decisions can also be affected by the division heads' short-term compensation incentives, based on meeting their short-term numbers. Even worse, when one of the division businesses is suffering, division heads may ask the other business managers under their charge to reduce the funding of longer-term investments and direct the "saved" capital toward shoring up the underperforming, less strategically important businesses.

Empowering a capable, influential support team

A strong support team is essential to effective governance. Just as the CEO requires a senior capital allocation committee, so too do committee members need a seasoned, fact-based, and influential support team to help set the decision agenda, keep the decisions on track, and get the decision makers the most insightful, nonbiased, and actionable information.

Any employee with a strong analytical background can crunch numbers, and an effective support team can crunch with the best of them. But number-crunching for the sake of complex analyses isn't the objective. The goal, instead, is to enable decision making. A strong support team should always include a leader with major influence inside the company, as well as team members with extensive experience beyond just financial modeling. That means members with CEO backing and demonstrated capabilities—managing upward and downward in the organization—to present the committee with the matters it needs to decide on, and the detailed supporting information its members will draw from.

While the support team doesn't do the deciding, its members shouldn't be gofers or wallflowers. On the contrary, they must do the rigorous prework of digging into capital allocation requests, pushing for higher-quality data, and presenting the information in a usable way. Committee time is precious; every meeting should be action-oriented. The ideal is that every committee meeting will end with a decision, rather than "deciding to decide"—that is, only figuring out what's missing or promising to circle back later.

Often, this support team is the company's FP&A function; sometimes it takes the form of the corporate-strategy team. Some organizations have both functions, and some have neither. The company's capital allocation committee, though, requires critical support: senior staff need to work and set agendas, working closely with those in financial planning and analysis. Despite FP&A's importance, it is, ironically, too often among the first functions to have its resources cut in times of broader, company-wide cost reductions. While no corporate group should be immune from scrutiny, scaling back on FP&A is usually pound-foolish; the function must have the personnel and tools it needs to deliver actionable insight, and the senior heft to speak up when committees start to

meander or become perfunctory. Without quality FP&A support, challenges to business unit plans are typically left to the CEO or CFO, who often lack detail beyond consolidated reports and incomplete observations.

One automobile manufacturer is instructive. Its FP&A team is composed of 15 highly experienced leaders with diverse capabilities, including finance, procurement, marketing, and country management. The team sets strategic targets for each country and product area; business units are then responsible for achieving these targets. In another example, a leading industrial company expanded the authority of its FP&A group, giving it the remit to have blunt discussions with business unit leaders as well as executive-level management. This helps to keep the enterprise aligned throughout the resource allocation process.

Dynamic resource allocation is a choice; governance comes down to *who* is deciding. The CEO—the company's most important decision maker—should take the lead. Making effective decisions requires a serious time investment, a relentless commitment to profitable growth, a capital allocation investment committee with an enterprise-wide perspective and a granular level of scrutiny, a commitment to understand the "why" and "why not" bases for investment decisions, and the experience of a seasoned, influential support team.

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The authors wish to thank Zev Mayer for his contribution to this article.

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Merck's Ken Frazier

The former CEO and executive chairman of the pharmaceutical company offers candid reflections on consequential decisions and value creation.

by Vik Malhotra and Steve Van Kuiken

This article is adapted from "Voices of CEO excellence: Merck's Ken Frazier," McKinsey, June 12, 2023.

As CEO of Merck, Ken Frazier gained the respect of his employees, shareholders, and the broader community through not only the company's performance during his 11-year tenure but also his handling of several tests of his leadership. Now Merck's former executive chairman, he recently discussed some of his most consequential decisions with Vik Malhotra, former chairman of McKinsey's Americas region and coauthor of last year's bestseller *CEO Excellence*,[1] and Steve Van Kuiken, former leader in McKinsey's Life Sciences Practice and former global leader of McKinsey Technology.

Vik Malhotra: You often talk about your humble roots in Philadelphia. What lessons did you take away that informed your future leadership?

Ken Frazier: Most of us are products of our background; that's certainly true of my life. I was raised in the inner city of Philadelphia during the Civil Rights Movement. My younger sister and I came along at a time when Philadelphia's social engineers were engaged in what they called school desegregation, an attempt to bus some Black children from the inner city to schools in White areas. That was one of the most important developments in my life, because the quality of the education I received was significantly higher than the standard in the local schools. It drove how I thought about myself and my role in the world. Our society has a big challenge to provide opportunities to everyone.

I went to college and law school, then came back to Philadelphia to practice law in a large firm. I became a partner but spent a lot of my time doing civil rights work—death penalty cases, voting rights. I also taught law school in South Africa during apartheid. Those experiences also shaped my views of what makes our society and values unique.

Vik Malhotra: How did these values translate into your work at Merck?

Ken Frazier: Before I joined Merck, I never thought about working for a company. I loved being a lawyer and the commitment to social justice. But I had represented Merck for years and found its mission was similar: I was focusing on legal justice; they were focusing on alleviating human suffering. I saw a parallel in terms of the values.

I came to Merck in the early 1990s. The CEO at that time, Roy Vagelos, is an icon, and I worked directly for him running public affairs. A big part of my role was to put into writing his views of Merck's salient purpose in the world. I couldn't imagine better preparation for one day becoming CEO.

Vik Malhotra: In your early days as CEO, what was your vision for Merck?

Ken Frazier: In the lead-up, reporters and analysts would ask me what my vision for Merck was, and I would respond, "The last thing Merck needs is Ken Frazier's vision for Merck." Merck had been around for 125 years and had a clear mission and purpose. In fact, in the early 1950s, the company's former president, George W. Merck, was on the cover of *Time* because he gave a speech at a medical school in which he said, "Medicine is for the people, not for the profits." Every Merck employee knows and believes in that quote. When I became CEO, I felt that my job was to be the guardian of the company's longstanding values around scientific excellence and translating that cutting-edge science into medically important therapeutics and vaccines. My job wasn't to establish the purpose—it was to reaffirm the purpose.

Steve Van Kuiken: How did you approach the decision to focus on the science? At the time, Wall Street had negative views of pharmaceutical companies' R&D investments.

Ken Frazier: You're right. I still have a report from an influential Wall Street analyst headlined, "In order to create value, pharmaceutical CEOs should stop investing in R&D and invest in nonpharma assets." That was a common view at the time. When I

[1] Carolyn Dewar, Scott Keller, and Vikram Malhotra, *CEO Excellence: The Six Mindsets That Distinguish the Best Leaders from the Rest*, New York, NY: Scribner, 2022.

‘What matters is whether you invest with a long-term view or do what’s more acceptable to investors in the short term. We withdrew guidance, and the stock got hit hard, but it was necessary to confirm that we were an R&D-based company.’

became CEO, Merck was in year two of five-year earnings guidance, and the Street expected me to cut R&D. In fact, if I was to stay on that earnings road map, I would have had to cut R&D.

I think I was 25 days into the job when I told the board that I intended to withdraw the remaining three years of the guidance. As you can imagine, that was not a popular idea, but I felt strongly that if Merck was going to be an R&D-focused company, this was our moment of truth. Saying “we are a science-based company” has enormous rhetorical appeal, but what matters is whether you invest in the science with a long-term view or do what’s more acceptable to investors in the short term. We withdrew the guidance, and the stock got hit hard, but it was necessary in order to confirm that we were an R&D-based company. It turned out that the people who bought the stock during the sell-off were investors who believed in that strategy, so without planning it, Merck ended up with the right investor base.

Now, I understand why analysts had the view that they did. Merck and the whole industry had gone through a fallow period in terms of R&D productivity. The challenge in this industry is that transformational medicines and vaccines don’t happen on a regular cadence, so if you look at a ten-year or a five-year period, you may not see the progress.

Vik Malhotra: Given that in your first year you had committed to R&D but also faced productivity issues, how did you approach resource allocation?

Ken Frazier: Someone once told me, “The long run is composed of a series of short runs.” We had to manage to those short runs. In my first five years, revenue declined, so we needed to significantly reduce our expense base. That was probably the hardest thing I ever did as CEO because that implied laying off more than 10,000 loyal, committed people who deserved better. But we needed to do that in order to invest in R&D and to convince investors to continue giving us the necessary capital. We ended up with a very successful cancer drug called Keytruda. Had we not freed up that capital, we would not have been able to invest as strongly in Keytruda.

Vik Malhotra: How did you work with the organization to develop and put in place your strategy? Did you have to make choices that went against your colleagues’ views?

Ken Frazier: I believe there were only five decisions I made during my 11 years as CEO that might not have been what my team or the board would have done or what shareholders wanted. I always believed in consulting my team, but in those five instances, it was a question of whether we

were committed to the long-term pursuit of the company's mission, and that might mean doing something that wouldn't be popular. If you tell your colleagues, "We're going to be about R&D," and then you cut the R&D budget significantly, you lose credibility.

One of the most important decisions I made was to bring in Roger Perlmutter, the former head of R&D at Amgen who had retired. He told me, "If you had not made the fundamental commitment to R&D, why would I come and recruit people to do an R&D turnaround?"

Steve Van Kuiken: When you made these five consequential decisions, where did you seek counsel?

Ken Frazier: The first one was about withdrawing the earnings guidance, and I didn't need to make consultations, because it was about whether I would stay committed to my own mission. Another was about committing to Keytruda. We were far behind a competitor, and our investors thought it wasn't worthwhile because we would never catch up. In that case, I consulted with our R&D organization.

Leadership at Merck is a team sport. When a company is successful, the CEO gets a lot of credit for what I call the big moments, but leadership is in the many small, quiet moments with the team. You have to assemble the right talent and figure out how to work together, making sure the company has the right intensity, operational cadence, and accountability. It's great to have a mission, but we have to deliver what we say we will deliver.

Vik Malhotra: One CEO I spoke with said, "It's not about a team of stars. It's about a star team." It sounds like that's what you assembled.

Ken Frazier: Not at the beginning. A bunch of talented people working together will not necessarily like each other. By the time people get to a certain

'CEOs should not be telling people, including their own employees, what to think about political issues. At the same time, I strongly believe that in order for businesses to succeed, we need a climate conducive both to people and to commerce.'

career stage, they are set in their ways. One of the biggest challenges for a CEO is to assemble a team of talented individuals and then create an environment in which they work together effectively. They have to work together for the common good, for the enterprise. The question I asked was, "Is the person behaving in a way that puts Merck first rather than themselves or their area of responsibility? Is that person doing what is in the best interests of patients?"

Vik Malhotra: Did you put in place processes that reinforced those behaviors?

Ken Frazier: I thought the operating grid was too complicated, so we shrank it down to three things: top line, bottom line, and pipeline. We also stopped rewarding people for how their individual divisions performed. In my first year as CEO, I remember saying when people submitted their divisional scorecards, "Isn't this interesting? The divisions all did better than Merck." People realized the point—that we should all live and die with the enterprise. We also changed the operational cadence so that we were meeting monthly to go through the most important operational elements.

Steve Van Kuiken: You have been a role model to many people who had no direct involvement with Merck. Did that influence how you thought about your role?

Ken Frazier: During my CEO tenure, there were at most five African American CEOs in the Fortune 500, and that did have an impact on me. People in the African American community expected me to speak to certain issues, such as voting rights when states were passing laws that could have affected people's ability to cast votes. I was watching the NCAA tournament when I got a call from a leader in the African American community who said, "Someone needs to urge the business community to speak up on this." So together with [former American Express CEO] Ken Chenault and a few others, we set up a group of African American senior leaders and another with 700 senior leaders across all industries. We got the business community to say, "We stand for certain principles."

There is a debate today about whether businesses should get involved in social issues. ESG [environmental, social, and governance] has become a political football, and leaders fear being called a "woke CEO." I fully subscribe to the view that CEOs should not be telling people, including their own employees, what to think about political issues, and businesses should not get involved in political issues unless absolutely necessary. At the same time, I strongly believe that in order for businesses to succeed, we need a climate conducive both to people and to commerce. The climate that makes American business successful is based on fundamental principles such as democracy, equal opportunity, respect for private property, and peaceful transfer of power. When government officials either abandon or fail to support those principles, it's the responsibility of citizens to act—and CEOs are among the most influential citizens. Just because somebody says an issue is political because they want to politicize a principle doesn't mean the principle is inherently political.

Vik Malhotra: And the principles are universal. Your board supported you when you chose to speak out on a matter of principle.

Ken Frazier: Yes. [The Charlottesville Unite the Right rally] happened early in President Trump's presidency, and when a CEO chooses to speak out on something like that, you have to consider the impact on the company. I felt strongly about speaking out as a matter of conscience. I told my board, "I'm going to step off the president's business council. My question for you is not whether I should or not, because I will, but whether the statement about it should be on my behalf or on behalf of Merck." I'm very proud that the board unanimously said, "We want you to speak to the company's values." But that was not an easy moment.

I believe that our employees also wanted the company to speak up, but they may not share political views, and one of the challenges for CEOs today is leading a polarized workforce. Shortly after the Charlottesville controversy, I remember speaking at a manufacturing plant in North Carolina. I said, "I respect your views. I hope you will respect mine." When I initially looked across this cafeteria filled with manufacturing workers, most people had their arms crossed. After I said that, they uncrossed their arms. That is an important aspect of leadership: showing employees that you are listening, and you respect them. If you don't have influence on people, you cannot lead.

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The times for multiples: Why value creation always comes first

Beware of solving for enterprise multiples instead of value creation.

by Marc Goedhart, Vartika Gupta, Peeyush Karnani, and Werner Rehm

It's your call: Which internal businesses or projects merit company capital? Managers frequently employ enterprise value multiples as a key yardstick. However, when evaluating potential strategies more comprehensively, it's essential not to rely on multiples alone or even primarily. The goal of strategy is maximizing long-term value, not optimizing multiples. Multiples are the result of good outcomes, but they are not the primary objective. Sometimes companies miss this essential point.

In particular, there are three instances when an overreliance on multiples can contribute to poor strategic decisions in capital allocation: (1) prioritizing multiples when investments at a lower multiple could generate more value; (2) ignoring the interplay between multiples, returns on capital, and cost of capital when allocating capital to a noncore business; and (3) extrapolating from a start-up's results when determining a conglomerate's potential for value creation.

The 'higher multiple' trap

A higher multiple is a head turner. Imagine you are the CEO of a company with an enterprise value (EV), excluding excess cash, of $1.5 billion. The current core business generates net operating profit after taxes (NOPAT) of $100 million; the EV-to-NOPAT multiple is therefore 15. For purposes of this example, the company also has $300 million of excess cash, and $9 million of posttax earnings, which leads to an observed market multiple of 16.5. You understand that the company should invest for growth; a board member suggests more share repurchases in order to "stabilize the price."

You are faced with the choices in Exhibit 1.

Your team is excited about scenario 1, which involves an investment of $100 million to grow a new, high-multiple business, which requires less capital, leaving $200 million to buy back shares.[1] Executing on scenario 1 would expand your company's EV/NOPAT multiple of core operations (that is, the multiple, adjusted for cash holdings, observed today by investors) to 16.4. That's awfully tempting: scenario 1 generates value, produces a higher multiple, and enables buybacks. It looks like a win–win–win.

A junior colleague, however, proposes scenario 2: deploy all the excess cash into a lower-multiple business. Doing so shrinks the multiple, but it also creates more absolute shareholder value. This option has a higher return on capital (measured as earnings divided by the investment needed) than

Multiples are the result of good outcomes, but they are not the primary objective. Sometimes companies miss this essential point.

[1] We assume, for purposes of this example, that all assets and companies are fairly valued. Therefore, the stock buyback has no impact on the value of the core business, and the fair value of the growth businesses reflects all future growth opportunities.

Exhibit 1

A higher multiple isn't always the most value-creating choice.

Scenario comparison

Current business in 5 years

Core business	
Enterprise value (EV), $ million	1,500
NOPAT,[1] $ million	100
EV/NOPAT, multiple	15×

Excess cash	
Enterprise value (EV), $ million	300
Posttax earnings, $ million	9
EV/posttax earnings, multiple	33.3×

Combined	
Value, $ million	1,800
NOPAT, $ million	109
EV/posttax earnings, multiple	16.5×

New business / **Combined business**

New business	New business: Scenario 1	New business: Scenario 2	Combined business: Scenario 1	Combined business: Scenario 2
Net fair value post investment, $ million	300	700	1,800	2,200
NOPAT, $ million	10	63.6	110	163.6
EV/NOPAT, multiple	30×	11×	16.4×	13.4×
Investment needed, $ million	100	300		
Cost of stock buyback, $ million	200			
Net present value, $ million	200	400		
Earnings/investment, %	10	21		

[1]Net operating profit after tax.

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scenario 1 and maximizes long-term value, which, from a shareholders' perspective, is paramount.

To be sure, this is a simplistic model. Yet something like it occurs quite often. For instance, a software company or other asset-light business with a relatively high multiple can hesitate to invest in strategically important assets that have a lower multiple (for example, a leasing business or data centers), even if doing so would create positive net present value (NPV).

To avoid this trap, you should always identify the total value created, as well as the underlying growth and return on capital that drive value. This will enable a robust discussion on achieving greater value creation as opposed to splashier, higher-multiple headlines.

The challenge of investing outside the core

In the next strategic cycle, the board asks you to investigate value creation by expanding the core business. Again, your team has come up with two proposals for investing the next $100 million.

Both potential expansions grow at around 2 percent. However, business 1 seems to have potential for a higher multiple. Intrigued, you ask for more details. Could that potential be driven by fundamental differences in ROIC? At the same growth, a business with higher ROIC should have a higher multiple (Exhibit 2).

The details surprise you: at the same growth and the same investment, business 2 has a higher ROIC but a *lower* multiple. What's going on?

Exhibit 2

The interaction between growth, return on capital, and cost of capital can affect value creation.

Comparison of investments in two hypothetical businesses

	ROIC,[1] %	**Growth,** %	**WACC,**[2] %	**ROIC–WACC spread,** %	**Implied multiple**[3]	**Investment,** $ million	**NOPAT,**[4] $ million	**EV,**[5] $ million
Business 1	8	2	6	2	18.8×	100	8	150
Business 2	20	2	8	12	15.0×	100	20	300

[1]Return on invested capital.
[2]Weighted average cost of capital.
[3]Enterprise value/net operating profit after tax.
[4]Net operating profit after tax.
[5]Enterprise value.

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It turns out that this counterintuitive outcome results from a subtle interplay between growth, return on capital, and cost of capital. Investing in business 2, at the same cost of capital, would indeed lead to a higher multiple. However, the difference in the cost of capital drives the multiple for investing in business 2 below that of investing in business 1.

Once again, to arrive at the solution, focus on value creation: Why does the team believe that the cost of capital is higher for investing in business 2? With a 5 percent risk premium and similar leverage, the 2 percent difference in weighted average cost of capital (WACC) comes from a 0.4 difference in (levered) beta, which is relatively large. While the disparity in cost of capital is possible because of differences in the underlying risks of business 2—for example, a regulated utility company entering into a new business outside its core could face much greater risks, a different beta, and, therefore, a higher cost of capital—the difference could also be due to the fact that the numbers reflect a less robust analysis. Sometimes, a team will arbitrarily apply a risk premium rather than conduct a more robust valuation using time-tested methodologies.

Consider a company that simply adds a 3 percent risk premium to any investment that is not in its core business, regardless of the underlying economics and cost of capital. That's an easier analysis, to be sure, but it's also a worse one. Assessments of risk are imprecise, outputs are opaque, and the lack of rigor can lead managers to systematically disregard opportunities they could have explored if they had dug deeper. As we've shown in multiple contexts (such as investing in emerging markets or in speculative R&D projects), the best, most transparent way to assess potential value is to reflect risks other than the cost of capital in cash flow projections and probability-weighted scenarios.

Conglomerates and small businesses

A third, common instance in which relying on multiples can lead to misunderstandings is when conglomerates assume that investors assess value creation by extrapolating the multiple from one (typically the largest) business in the portfolio. For example, managers of conglomerates often believe that investors will apply the multiple of one conglomerate business to its other businesses,

as long as the higher-multiple business is larger than that of the rest of the conglomerate. We have seen this time and again as an argument for value creation in M&A.

Sophisticated investors don't make this mistake; they understand that there is no magic "multiple expansion." Instead, they value businesses by the sum of their visible parts.

A related and often more challenging issue arises when conglomerates assess the effect that investing in high-multiple new businesses will have on the conglomerate's own multiple. Consider a traditional industrial company without a product that addresses the energy transition. For purposes of this example, assume that the industrial company currently trades at a multiple of five times EBITDA, due to its shrinking volume and lack of growth prospects. Start-ups with dedicated products in energy transition, by contrast, see high growth and enjoy multiples of 30 times EBITDA.

Next, assume that the company in our example identifies an opportunity to invest $1 billion into a new business expected to create $200 million in earnings in five years. It's very tempting to justify this investment by assuming it will increase the acquirer's own multiple considerably; after all, the energy transition business trades at a multiple of 30.

But that logic is flawed, for several reasons. First, earnings multiples will likely not remain at 30 in five years; as a start-up's growth slows, its multiple declines. Second, the core business is likely to shrink and therefore produce lower earnings than it does today. Finally, once the core business stops shrinking—assuming that some demand for its products remains—that core multiple will *increase*, because a no-growth business has a higher multiple than a shrinking one. Taken together, the most likely effect is that even as the new business grows, the conglomerate's overall multiple will stay about the same. This doesn't mean it's a bad investment; in fact, it might be critical for the company's survival. But time and again, we've seen that the promise of a higher overall multiple does not materialize.

Like other methodologies at a CFO's disposal, multiples have their uses, including decisions on capital allocation. But an overreliance on multiples can lead to suboptimal outcomes. Greater value, not higher multiples, should always be the objective.

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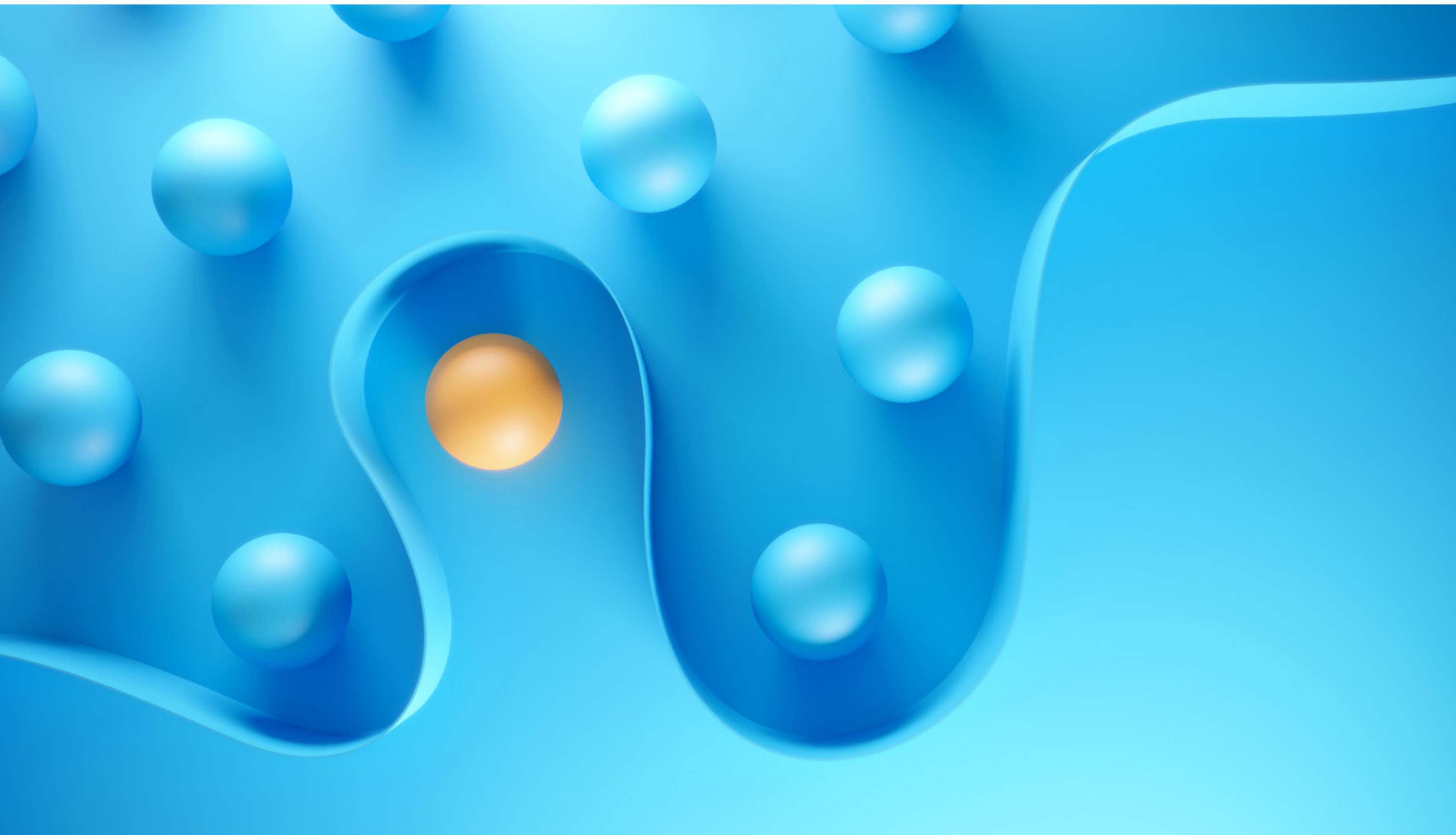
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

The perils of executive typecasting

by Eileen Kelly Rinaudo, Tim Koller, and Derek Schatz



The dilemma

The new CFO at a medical-device company has heard nothing but positive things about a line of products, now in their third generation, from the company's consumer health division. According to her detailed review of the company's entire portfolio, however, this product line has been underperforming compared with others, and the numbers are continuing to slide. On a team call with the operating and business unit heads of consumer health, the CFO hints that it might be a good time to divest. "Classic CFO: always looking for ways to cut costs," the division executives observe as they trade instant messages among themselves. On the call, they wage a loud campaign against divestiture, noting the financial and reputational risks of doing so. When the meeting ends, the CFO thinks twice about bringing up the idea of divestiture with the CEO and other members of the executive-leadership team (ELT). There is strong institutional support for this product line, clearly. Given the response she just received, would the ELT even welcome her contrarian viewpoint?

The research

A common obstacle to good decision making is executives' adherence to role theory, a concept in sociology and psychology that suggests that most people categorize themselves and others according to socially defined roles—as a parent, a manager, or a teacher, for instance. They adopt norms associated with designated roles, behave accordingly, and, in a form of groupthink, expect others to do the same.[1] At the medical-device company, all that the operating and business unit heads could see was a relatively new CFO making an overly conservative proposal in line with her role. "Playing it safe is just what CFOs are supposed to do," they felt. This role-based perspective allowed them to discount the CFO's idea out of hand without fairly evaluating its merits. It also raised doubts for the very early tenured CFO about the best way to present new ideas to this group and the ELT.

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[1] Michael A. Hogg, "Social identity and social comparison," in Jerry Suls and Ladd Wheeler, editors, *Handbook of Social Comparison: Theory and Research*, New York, NY: Kluwer Academic/Plenum Publishers, 2000.

The remedy

Organizations must actively encourage dissent and make it safe for individuals at all levels, regardless of role, to share contrarian ideas. In this case, if the CFO could separate her idea to divest from her status in the organization, she might get a fairer shake from everyone involved.

One way to do that would be to engage individuals and teams in a “what you have to believe” assessment, highlighting the discrepancies between the product line’s current performance and the resources needed to bring it back to premier status. Such an assessment could put more facts into and structure around strategy discussions.

Alternatively, the CFO could engage colleagues with a range of perspectives (outside of the usual suspects in finance and the C-suite) to help make objective cases for both investing in the asset and divestiture. Bringing in someone from the commercial side—such as a product manager who could speak to the current and historical performance of the devices in question, or a sales representative who could do the same—could provide a reality check against prevailing perspectives. The CFO could then lead a group discussion on the most likely outcomes.

With those other voices in the room, it might be easier for business unit and operating executives to stop making assumptions about the CFO’s motivations and consider the clear facts about the business situation at hand. And having gone through this impartial assessment and collected all the necessary data, the CFO would be better prepared to share with the ELT her perspective on the potential risks and benefits of divestiture—as a strategy for growth and definitely not just a controller’s attempts to control.

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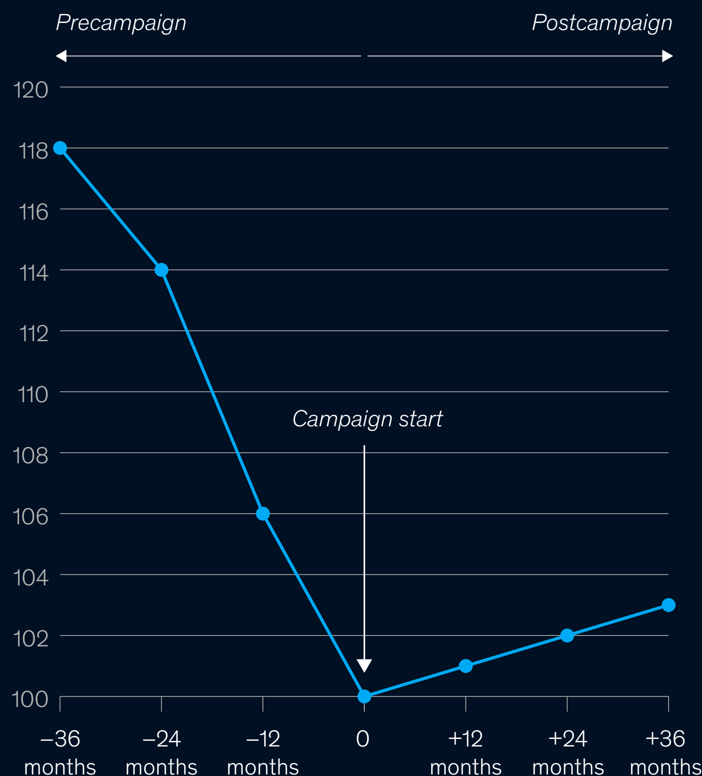
Looking back

When activist investors knock at the door, companies can do themselves a favor and let them in.

Exhibit

Activist campaigns tend to generate a sustained increase in shareholder returns.

Excess TSR performance of activist campaigns,[1] index (100 = day of campaign announcement)



[1]Includes US companies with successful activist campaigns and market cap and revenues >$1 billion during 2010–20 time frame. Chart shows median performance of companies in sample (n = 146). Excess TSR measured based on S&P 500 benchmark.
Source: Investor Activism Data, S&P Capital IQ

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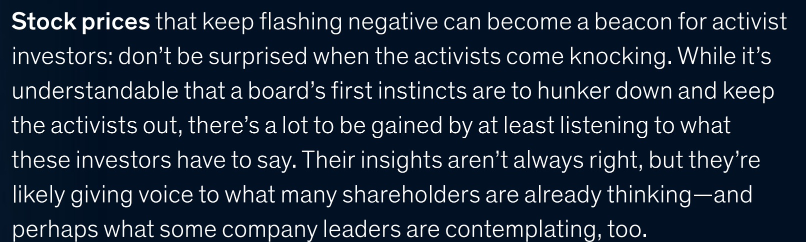

Stock prices that keep flashing negative can become a beacon for activist investors: don't be surprised when the activists come knocking. While it's understandable that a board's first instincts are to hunker down and keep the activists out, there's a lot to be gained by at least listening to what these investors have to say. Their insights aren't always right, but they're likely giving voice to what many shareholders are already thinking—and perhaps what some company leaders are contemplating, too.

A prepared board should already be a step ahead, learning to think like an activist investor and taking an unvarnished look at its company's performance, just as an outsider would do. That doesn't mean reflexively adopting an activist's standard action items (including major cost reductions and divestitures), but boards should encourage managers to scrutinize company strategy, priorities, and operations to identify opportunities for significant improvement.

Still, activists almost invariably arrive before a company is fully prepared. What does that bode for company performance? In most cases, good news: activist announcements correlate with value creation (exhibit).

While excess TSR created by activist campaigns isn't massive, it's more than just a short-term blip. Activist campaigns tend to stop a long downward trajectory in company performance and then correspond with excess returns that persist for at least 36 months. Whether that pattern will hold in what's predicted to be turbulent times ahead remains to be seen. But the historical results are consistent: activists, in their way, can be an impetus for value creation.

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The authors wish to thank Ravi Kant for his contributions to this article.

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