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McKinsey on Finance

Perspectives for CFOs and other finance leaders

Clarity

Inside: A better equity story, a different high-growth story, assessing strengths, mapping motivations, and understanding M&A value creation

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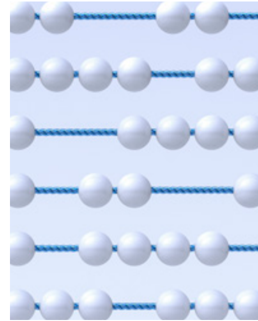

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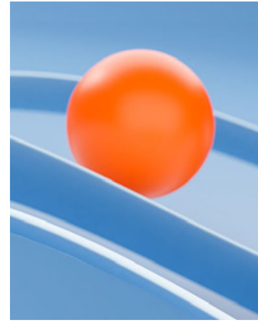

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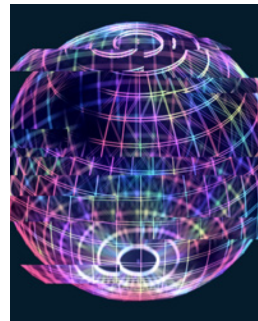

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Item 1: This edition

Charlie Munger once observed that "It's not a competency if you don't know the edge of it." The concept of self-awareness applies just as well to businesses. Every company has its own unique capabilities. But each also has particular challenges and gaps—and it often falls to the CFO to be the organization's leader in taking a clear-eyed view.

In "The equity story you need for the long-term investors you want," our colleagues find that a straightforward presentation of a company's strategic plan and no-nonsense description of its core value drivers are more likely to attract intrinsic investors who afford more time to let company strategy play out, even during bouts of short-term volatility. A recognition of core competencies can also strengthen an organization's own sense of purpose and mission. As Teradata's CFO Claire Bramley shares in this edition's interview, a CFO should strive to consider herself "customer zero" for the company's solutions.

Knowing what a company can and can't yet accomplish is critical to creating more value over the long term. For capital-intensive climate tech companies, the main challenge (though hardly the only one) is obtaining sufficient capital early in a project's long life cycle. Yet there are pragmatic ways to get from here to there, as we present in "A different high-growth story: The unique challenges of climate tech." Moreover, across companies—sustainability driven or otherwise—there are practical ways to capture growth by identifying the ideal adjacent businesses. In "How to reignite growth through adjacencies," a collaborative effort by McKinsey's Strategy & Corporate Finance and Industrials & Electronics Practices, our colleagues share their recommendations. And in "What programmatic acquirers do differently," we identify actionable steps that give sophisticated dealmakers an edge, and analyze how a programmatic approach can translate into value creation.

Senior executives can sometimes disagree profoundly, not least when it comes to how a company should allocate resources to achieve its strategy. In "Motivations under the microscope," the latest in our long-running *Bias Busters* series, we describe how CFOs and other senior leaders can conduct mapping exercises to determine how best to bring employees with different priorities together to achieve common goals.

Finally, a key element of discerning a company's unique value proposition is recognizing how geopolitics and trade could affect its business model. In our closing section, "Looking back," we examine one piece of a very complex puzzle.
As in so many aspects of the role, effective CFOs understand the need for clearer insights to identify the edge of company competencies—including across borders.

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The equity story you need for the long-term investors you want

Sophisticated investors are more likely to afford a company more time to let its strategy play out, even during volatility. But first, they need a clear equity story.

by Hannes Herrmann, Jamie Koenig, Anna Mattsson, and Marc Silberstein

The old adage that you never get a second chance to make a first impression applies precisely to an equity story. Investors will review your company's equity story and make one of two decisions: *yes*, this company deserves our capital, or *no*, it doesn't. Some company leaders—particularly in cases of IPOs or divestitures, when investors are scrutinizing a business for the first time—believe that *maybe* could be a third outcome. But maybe results in sloppy messaging: if we just include language about a trendy noncore business line or sprinkle in the right buzzwords, the thinking goes, maybe we can attract investors' attention or validate a higher stock price.

It won't happen. While it may take several months, a company's market value will eventually reflect the value that the analyst and broader investor community place on it. Moreover, even the strongest companies experience periods of short-term volatility. How patient will your investors be? Large, sophisticated investors—particularly intrinsic investors, the investor segment with the greatest effect on markets—are the most inclined to maintain their positions through short-term volatility compared with other investors. Yet these investors will avoid companies whose equity story lacks clarity; a fuzzy equity story signals that the company itself lacks focus. Indeed, for senior company leaders, the need to distill a complicated business or portfolio of businesses into a clear narrative is a forcing mechanism to prioritize what matters. Intrinsic investors look for management teams that can explain how they realize their strategy. Of course, even if an equity story is flawless, investors can still decide against investing; a company may, for example, be in an industry that the investor is underweighting or avoiding.

Fortunately, three of the most important reasons why intrinsic investors review an equity story and choose *not* to invest result from missteps that are entirely in a company's control: believing there is a "model" equity story that a communications team can simply take care of, muddling the messages with nonessential information, and failing to place an equity story in broader context. By avoiding these mistakes, senior leaders can put their company in the best position to attract investors that support leadership teams through periods of volatility and enable the company to achieve its long-term goals.

Know your audience—know yourself

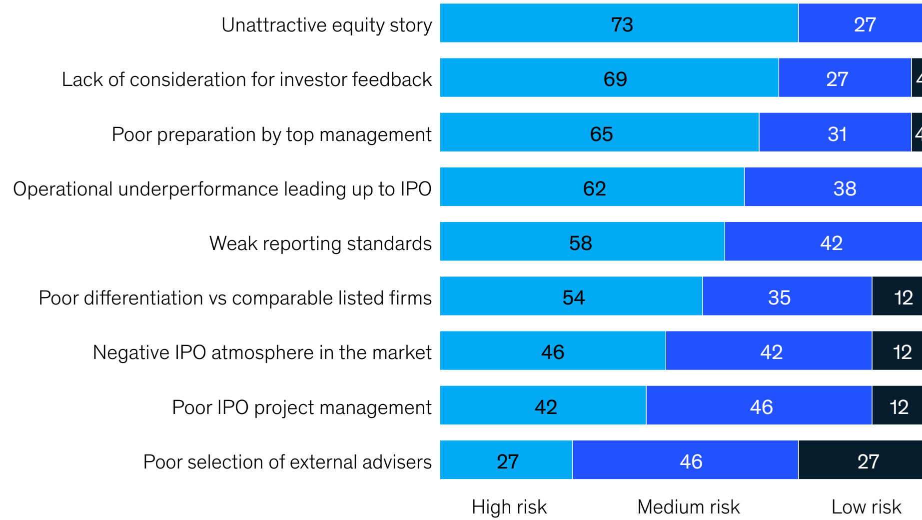
There's no question that delivering a compelling equity story will require the support of your investment communications team. Yet sometimes, companies make the mistake of allowing an equity story to be communications driven. For example, your team may want to make images or photographs a prominent part of your presentation or seek to liven up a road show with imaginative mementos. We've yet to meet any intrinsic investors, however, who don't go first to the financials, or make an investment because of the deal toys. Relying on "the sizzle, not the steak" of an equity story suggests that you're seeking to distract rather than enlighten. Indeed, intrinsic investors view an unattractive equity story as the greatest risk to an IPO (Exhibit 1).

Your target audience is not communications professionals; it is the sophisticated investors who review scores of other equity stories.

Exhibit 1

Intrinsic investors identify an unattractive equity story as the greatest risk to an IPO.

Factors that investors view as a risk to an IPO, % of respondents (n = 26)



Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey survey of global institutional investors

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Your target audience is not communications professionals; it is the sophisticated investors who review scores of other equity stories. While these investors want to see common elements—core value drivers, key trends, and unique capabilities—they don't want a cookie-cutter approach, or to read a model story. Instead, they want to hear your story. The best way to communicate it is to imagine that you are addressing your senior-management team, a seasoned board member, or an experienced analyst. Make clear what the company intends to achieve in the long term, how it is going to meet its objectives, and why it is uniquely positioned to succeed. Provide a clear, fact-based description so investors can make an informed, evidence-driven choice.

Although providing details will be a matter of your own words, you should always make sure to communicate these essential elements:

— *a short description of the company,* ideally made more concrete by providing key milestones in the company's history to demonstrate its positive trajectory

— *competitive framing,* which typically includes key trends and market dynamics, made tangible with clear data (such as the size of the addressable market, historical growth, and reasonable growth assumptions) and a description of the competitive environment

- *competitive position of the company,* such as the company's market share or other rankings, and a description of the differentiating capabilities that demonstrate the company's "best owner" advantage

- *concise strategy,* grounded in the company's strengths and showcasing how the company will benefit from and respond to the market forces at work

- *financial statements,* both historical and with expected long-term targets; these targets should be neither "conservative" nor "aggressive"—instead, they should present the most probable, scenario-tested results that the company will most likely achieve

Precisely because intrinsic investors are so experienced, they're skeptical of canned presentations and short-term market fads. Instead, they want to hear you articulate the company's plan for long-term value creation and the tangible steps it has taken so far.

That's why intrinsic investors are keen to understand your description of KPIs; they know that these metrics will differ from those of other companies, even among industry peers. In our experience, investors pay as much attention to the metrics you choose to prioritize as they do to the KPI numbers themselves. As a rule of thumb, companies should strike a balance between industry-wide essentials (such as margin, ROIC, and growth), industry-specific indicators (such as sales per square foot and same-store sales, in the case of retailers, or average payload or cost per ton, for mining companies), and company-specific KPIs (such as total cardholders or renewal rates, in the case of Costco, or paid net additions and average revenue per membership, in the case of Netflix).

Remember, analysts and investors build their financial models to derive a target valuation. To do so, they need clear links between a company's earnings statement, balance sheet, and statement of cash flows. If your equity story contains metrics that *don't* ultimately link to your financial performance, they shouldn't be included. Moreover, your company should be able to quantify the impact of each metric in a rigorous way. Even something as simple as subscriber growth comes with associated costs; show how more subscribers can lead to more cash (it may not be a simple multiple or a linear trajectory). Or consider forecasts from geographic expansion: one company identified expanding its presence in China as a key growth driver. Yet because it hadn't budgeted sufficiently for associated costs, such as hiring a local sales force, its actions ultimately undermined confidence in its management and strategy.

If you can't anticipate and address basic pushback, your equity story will fail. An equity story, in fact, is more than just a story; it's a forcing mechanism for managers to rigorously think through their strategy and demonstrate discipline to deliver long-term performance. While advisers such as bankers and consultants can help sharpen your story and anticipate questions that may arise, they haven't walked in your shoes and can't deliver the story as well as you. Sophisticated investors quickly realize when a management team is disconnected from what it's presenting. We recommend that management teams spend significant time aligning on key messages, rehearsing their presentation, fielding potential questions, and becoming completely comfortable presenting the story in their own words.

Talk about what matters—and stay away from everything else

How does your company create value? What are its capabilities? Which trends affect it most? And what are the two or three most important factors to maximize and sustain cash flows? If investors can't readily answer these questions, they're almost certain to filter your company out of consideration. It's impossible to have an effective equity story unless you clearly spell out your company's positioning, capabilities, and distinctive sources of value creation.

Company leaders have to pull themselves and their audience away from 'just' a financial model and place the equity story in context.

Start with the basics. Investors won't be able to "follow the plot" when an equity story jumps straight to a niche analysis and fails to explain the contours of the company's industry, where the company is situated in the value chain, or other essential details that management may assume everyone knows (but actually doesn't). Remember, however, that intrinsic investors do have some perspective already, particularly at the industry level. Know your audience: an effective equity story should be neither simplistic nor esoteric. Give your perspective of the market and segment in which the company competes and why it makes for an attractive investment.

For large corporations with several business units, the equity story should identify the few value drivers per business that are most important to performance. That means carefully describing about two to five drivers per business—not ten. Companies with multiple business groups should also clearly explain how their strategy is advanced by owning all the divisions together. It's essential to demonstrate not only that the company is the best owner for each business but also that there are clear ownership advantages that enable the businesses to create value in a portfolio and directly advance strategic priorities in the foreseeable future.

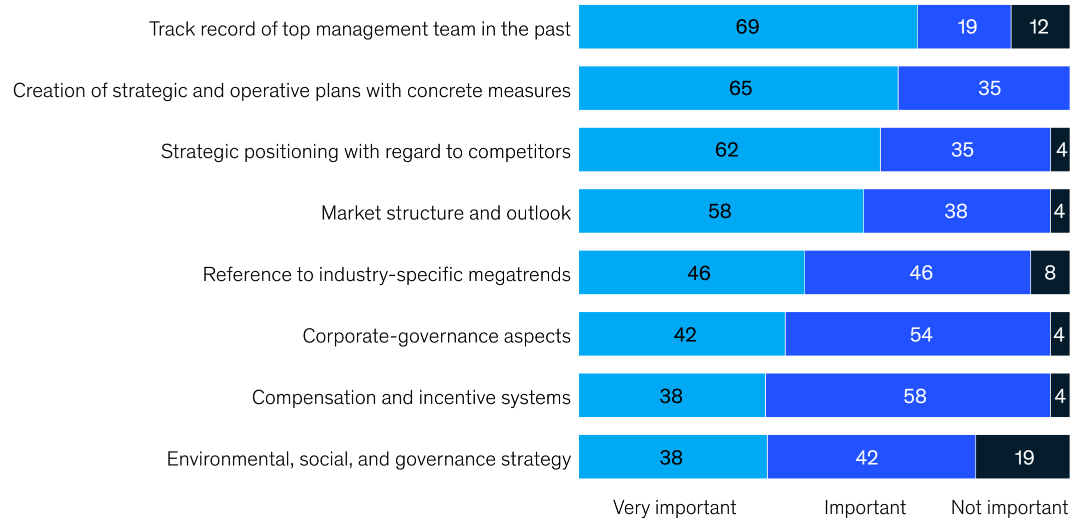
Every moment your equity story spends on businesses or initiatives that aren't clearly connected to your strategy is a wasted moment—and a reason for investors to move on to other opportunities. For example, avoid talking about noncore businesses or small corporate venture capital divisions; there's a time and a place to manage these effectively, but they won't drive a meaningful percentage of your cash flow in the next two to five years. And despite what you may hear about investors seeking the right keywords, don't lard up your story with terms or concepts that might be trendy. Buzzwords are a warning sign that senior leadership is distracted or spouting platitudes. Commonly abstract and overused terms such as "disruption," "holistic," and "exponential" can indicate a lack of strategic rigor.

A compelling equity story, moreover, shows as it tells. It is a tool for management to connect with current and future shareholders who comb through past performance to track the company's record against its strategic aspirations, targets, and plans (Exhibit 2). It's also essential to demonstrate what your choice of wording means. Consider, for example, another commonly used term: ecosystem. Ecosystems can be critical for value creation, as we've highlighted for years. But value is derived from careful strategic thinking and concrete action—not from merely including the word "ecosystem" in the hope that it's on an investor's checklist. One company's value creation strategy, for example, is deeply linked to its ability to continue to innovate. Its equity story—which prominently features ecosystems—resonates because it describes its ecosystem in clear terms and goes into detail about the technology partnerships it has formed with universities, smaller technology companies, and customers within that ecosystem, demonstrating that the company truly is at the center of a fast-

Exhibit 2

Track record and a concrete plan for value creation are key equity story elements.

Importance of the overall equity story elements for an IPO, % of respondents (n = 26)



Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey survey of global institutional investors

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evolving market. The level of detail, in turn, provides investors with confidence that the company will remain well positioned as key technologies within the ecosystem rapidly develop.

In some situations, a company may have a compelling strategy but lack a multiyear track record to back it up. This can be the case, for example, for large corporations that are shifting into new businesses, or companies that have been spun off and suddenly receive much more scrutiny than they had when they were part of a bigger enterprise. One chemical company that faced this challenge made a determined and successful effort to build a clear track record well before it crafted the legal and marketing materials for its intended IPO. Working backward from a potential listing date, it looked at its management plan and defined KPIs at a much more granular level than just the business unit level; senior leaders monitored those KPIs at least monthly to address performance shortfalls as they arose. Investors appreciate both the conviction and the transparency.

Get out of the weeds

As important as it is for company leaders to present an equity story that coherently explains company-specific details, they also have to pull themselves and their audience away from "just" a financial model and place the equity story in context: What are the broader industry trends? Where is *this company* situated in its growth trajectory?

For companies conducting an IPO, an equity story requires more attention to introducing the company

to investors. For companies that are already public, freestanding enterprises, telling an equity story will be iterative, particularly when it comes to key strategic shifts and acquisitions and divestitures (such as why the company has acquired or divested and how integration is progressing). Because competitive dynamics and company performance are always changing, the key points of detail and focus will continue to evolve.

Even well-recognized companies with long track records may find that investors don't grasp their objectives as firmly as the executive team might expect. For example, one industrial company was certain it had developed a compelling growth strategy and had already begun to significantly shift its portfolio of businesses. The executives deeply understood the company's markets, positioning, competitive advantages, and progress toward reaching clearly defined aspirations. Yet the market *didn't* understand the company's strategy. As a result, the company's shares traded down; investors' valuation was in line with the company's traditional, lower-growth sector, rather than with the high-growth markets where the company was increasingly and successfully competing.

That mismatch is the sign of a poor equity story. While the company had committed not only to identifying significant opportunities but also to allocating significant resources to follow through, it failed to go the final mile and explain its strategy to investors in a clear way—and to demonstrate that it was delivering on its growth strategy. To address the disconnect and bring the stock price in line with the company's intrinsic value, the company reset its equity story, using clear KPIs, describing previous portfolio shifts and its track record for building businesses, and detailing its competitive advantages. Critically, the CEO and CFO made sure to present the story in their own words and ensure that analysts and investors understood the company's short- and long-term priorities.

Sometimes, of course, a company may be in resilience mode, recovering from poor performance. Don't sugarcoat: intrinsic investors will see through attempts to turn bad news into happy talk. Instead, be clear about what went wrong and identify the specific actions you are taking to address it, supporting your strategy with metrics and reasonable benchmarks. For example, one consumer goods company misread competitive dynamics and made several acquisitions that wound up destroying value. But it forthrightly identified its mistakes, explained why its thinking was flawed, and described the significant measures it was taking to reset its strategy—in particular, to sell an acquired business and reinvest in a specific core business. Investors welcomed the rigor, and the stock price improved.

Every business is unique, and no company's equity story will resonate with all investors. Moreover, almost all companies will at some point face periods of volatility. When they do, it's far better to have long-term-minded investors in their corner. To attract these sophisticated investors, company leaders need a clear equity story, which they should be able to present in their own words. Patient capital seeks out great strategies—built on comprehensive analyses, demonstrated by meaningful actions, and communicated with clarity.

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Data, analytics, and decisions: An interview with Teradata's CFO

Claire Bramley describes how she's amping up scenario analyses, getting proactive about enterprise risk, and moving her function into white spaces to improve company-wide performance.

Claire Bramley, the CFO of Teradata—a leading, publicly traded multicloud data platform for enterprise analytics companies—is as close to a "digital native" as a certified public accountant and chartered management accountant can be. She joined Teradata in 2021 as its CFO after more than 14 years with HP, where she was responsible for financial controls and compliance, external reporting, and direct coordination with its audit committee. She also led HP's finance strategy and transformation efforts and oversaw its corporate financial planning and analysis. Now, as a senior member of Teradata's executive team, she is responsible for leading finance, IT, analytics, and security. As she recently discussed with McKinsey's CFO, Eric Kutcher, data acumen and financial expertise work hand in hand to inform decision making. An edited version of the conversation follows.

McKinsey: How do you think about your role and what you have to do to make sure your organization is able to navigate unpredictability?

Claire Bramley: We focus on what we need to make the right decisions. That requires us to ask whether the right decision today is going to be the right decision three months from now, six months from now, 12 months from now—and longer. Being able to use data and analytics as we do for our customers helps us look at things from all angles. As we try to be agile, we try to be predictive.

One of the most important things right now for us as CFOs is looking at scenarios. I've never run so many different scenarios: both for my long-range plans and budgets and for my monthly forecast process. That's hard because CFOs have to give external guidance and reassure "the Street." You're trying to predict and anticipate all the different things that can happen over the course of either one quarter, 12 months, or even three years. We're giving long-range plan estimates when there's a lot of change out there. So we come back to data: I try not to use my gut feeling of what's right. You can have a gut feel, but you have to be able to prove it with data and analytics.

You also have to be able to change directions and pivot, sometimes on a dime. Agility requires early indicators: we call them "trip wires." It's the information that allows you to say, "Hang on a minute. This isn't progressing the way we anticipated. Is this a trend, or is it a one-time situation?" We continue to evolve our thinking and decision making based on the new data that we get every day. It's also critically important to surround yourself with the right team. The team around me makes sure that I don't have any blinkers on, that I'm looking at different perspectives, and at different data. There's a lot of information out there, and it's important not only to take it into consideration but to see if it changes, for any reason. Even if you've got the data and the insights, you also need to communicate and collaborate. If you can't communicate externally and back to the business in a way that people understand, act upon, and use to drive different outcomes, then your data and insights are wasted.

McKinsey: One of our beliefs is that the CFO role has changed; it's not an accounting role anymore.

Claire Bramley: Having a finance background and the accounting background is helpful, absolutely. It's good to be able to understand the disclosures and the Qs and the Ks. It's an important part of the role but a smaller part, especially here at Teradata. We're focused on how we can provide support from a finance side and how we can help drive strategy—whether it's in the go-to-market organization, supporting the marketing team, supporting the strategy team, or enabling different functions.

In my team, we're very much involved in all the work that's being done in R&D, for example, to make sure that where we're investing, and why we're investing there, gets us the right returns. It's important for us to understand the business so that the advice that we give as a company and the journey that we are on is in context with what's happening in the external market.

The role of the CFO, I think, is to look for strategic and organizational white spaces—to step up and

‘Agility requires early indicators: we call them “trip wires.” It’s the information that allows you to say, “Hang on a minute. This isn’t progressing the way we anticipated. Is this a trend, or is it a one-time situation?”’

offer to help because we understand operational challenges, we understand the numbers, we understand Teradata’s strategic direction, and we have a very good external perspective about everything that we do.

McKinsey: What have you come to view as most important as you put today’s financial organization together—and what are you doing differently?

Claire Bramley: The team is the core of everything I do. I couldn’t do what I do today without a great team. One thing I would say to CFOs out there: if you don’t think you’ve got the right team, the sooner that you can put in place the best, right team for the moment, the better. And yes, sometimes you have to change players. That’s because of the competition that you’re up against and the transformation that your company is going through, because your company is in a different place at that point in time.

One thing I’ve been doing is bringing in more external–in perspectives. I want to keep those that have really good knowledge of Teradata—the really good insights into where we’ve come from. But it’s also very important to have some external–in perspectives. One of my recent hires, for example, has a lot of customer experience. We’re making sure that we’re putting the customer at the front of everything that we’re doing as we make decisions as a function. And, again, it’s not just about finance. It’s about finance, IT, operations, security—and most important, about the customer. Is this the right outcome for the customer? Is this going to make a difference for the customer?

As the CFO, I’m customer zero for Teradata and use it for closing the books, predictive analytics, analyzing investments, and helping us with our long-range planning. There are many different ways that we can use the different data that we have available to us. But data without insights isn’t helpful. We look at things end to end. I’ve actually set up, and now host, a new team to support the whole company in really focusing on process management improvement. We’re helping to enable some of the biggest strategic initiatives across the company. I brought in a new leader with a few new team members to help teams across the organization on some of our big strategic projects. As we help from a program management standpoint, we also help from a process reengineering standpoint—making sure that we are looking at the downstream impacts and upstream impacts. I don’t think that’s traditionally a role that the CFO would have played. But we don’t have a chief operating officer—a lot of companies our size don’t. It’s really important for the CFO and the team to step up, support, and help out across the organization. Enterprise risk management, for one, is particularly important.

McKinsey: I probably hadn't thought enough about enterprise risk management before I got in the [CFO] role. Now it's something I spend a lot of time on.

Claire Bramley: We take a proactive approach to enterprise risk management: risk or internal audit functions should not be sitting on their own, in isolation. I've changed the culture of how we look at risk management. Now, we see it happening where teams—they could be sales teams, or they could be product teams—are actually pulling in my risk management team to say, "Can you advise? Can you consult? Can you be involved with us at the beginning of this conversation?" That's as opposed to just coming along afterward and doing an audit. It's so important today because everything is volatile: there is a lot of risk out there. Being proactive about risk ensures that when we make decisions, we look at the data and the insights that go into decision making, and we look at our company's risk appetite and the way that we want to manage risk.

McKinsey: Are there other "wow" insights that you could share that would make everyone say, "I wish I had thought of that"?

Claire Bramley: I think one of the things that we've had huge value from as a company is the way we do our forecasting and long-range planning. We do a lot of work with data and analytics to consider potential different outcomes and the different ways we could approach planning depending on what happens with our customers and what they need—for example, depending on what happens in the macro environment.

We got a huge benefit from data analytics in our long-range planning. I feel comfortable now that I have a good way to track how we're doing against our plan and in our outlook estimates. I felt very comfortable reiterating and updating our 2025 goals at the beginning of this year because I know that there's lots of different plans behind that, and that this is the best plan, the most likely plan—the plan that's the right thing for us as a company.

But that doesn't mean I don't have five other plans if something doesn't happen according to what we're expecting, or we have a surprise. We'll know then what we're going to do. We're not going to be scrambling and saying, "Oh, this is different than what we expected, let's re-pivot, and we'll have to make it up on the spot." We are ready to go. We have multiple plans ready depending on the outcome. I think a lot of companies did this at the beginning of the pandemic in terms of how long it was going to last; everyone was trying to predict how long the recovery was going to be. I've taken that kind of approach, and now we do it all the time for our forecasts, our long-range planning.

'We take a proactive approach to enterprise risk management: risk or internal audit functions should not be sitting on their own, in isolation.'

But you can't do that without good data and without good predictive analytics. Now, we track as we move through planning to make sure that there's no reason why we're losing momentum on the current course of action. This means that you can move in a very agile way, and you can make sure that you're ultimately doing the right thing for the shareholders. That helps us, as a leadership team, know what course we're on and know the decisions we're making and why we're making them. We would be able to pivot very quickly to another alternative if need be. We're all up to speed because we've spent a lot of time talking about that as a leadership team. Our long-range planning, scenario planning, and predictive analytics are really important right now in the current environment. They give us confidence that we're on the right path.

McKinsey: How do you see generative AI evolving in terms of what CFOs do, such as predictive forecasting?

Claire Bramley: I'm really excited about the future of generative AI, whether it's how companies can use it in general or how the finance function can use it in particular. There are many great use cases where it's going to add a huge amount of value to us as teams, as functions, and as a company. However, it's a journey. And there's a lot of consideration with regard to ethics and compliance that should not be underestimated. I think it's important that we do it intentionally. I think it's important that we do it thoughtfully.

From a finance standpoint, I think, to your point, predictive forecasting is going to be interesting. I've had companies talking about it with regard to investor relations. I've had people talking about it in terms of operations, credit and collections, and how you can predict people's payment profiles and payroll support. And that's just for the finance function. We can envision many different applications across the company.

Claire Bramley is the CFO of Teradata. **Eric Kutcher** (Eric_Kutcher@McKinsey.com) is the CFO of McKinsey and a senior partner in the Bay Area office.

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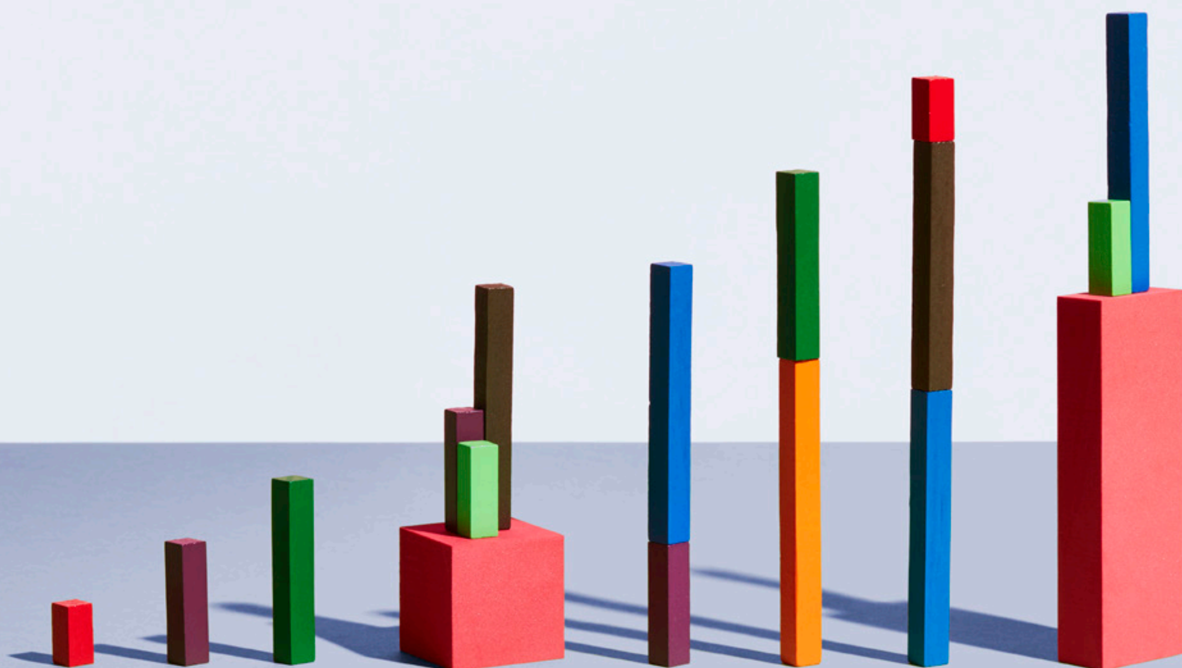
How to reignite growth through adjacencies

Advanced-industries companies that enter adjacent markets with the right approach can outgrow and outperform their peers.

This article is a collaborative effort by Matt Banholzer, Rebecca Doherty, Dorothee Herring, Alex Liu, Erik Sparre, and Tatu Suontausta, representing views from McKinsey's Strategy & Corporate Finance and Industrials & Electronics Practices.



Manufacturers across the advanced-industries spectrum, from electronics and automotive products to industrials, continue to reel from the supply-and-demand shocks caused by economic and geopolitical turbulence. As some of these conditions appear to be here to stay, numerous leadership teams are responding by cutting investments and costs. But while defensive moves matter, long-term resilience starts with growth and the courage to make bold moves to pursue that profitable growth.

In earlier downturns, companies that stayed focused on growing through the cycle—by expanding into adjacencies or new geographies during a recession, then stepping on the gas early in the recovery—emerged stronger than their peers and maintained that edge for years afterward. The current period of volatility is a similar opportunity to chart a new course by seeking growth in adjacent markets as part of activating pathways in a company's holistic growth blueprint. The net-zero transition, in particular, may give advanced-industries companies attractive opportunities in 11 areas of growth.

We define adjacencies as segments beyond a company's core business where it has a "right to win"—a long-term competitive advantage stemming from better abilities to address customers' needs, play across the value chain, deploy a unique capability in a new area, or introduce a disruptive business model or technology. A typical large company generates 20 percent of revenue outside its core business. And our research shows that organizations that expand into natural adjacencies generate, on average, 1.5 percentage points of annual shareholder returns above their industry peers.

Adjacency expansion has not been a common strategy in advanced industries, with only 11 percent of major companies moving into adjacent markets over the past 15 years. To see whether that's a missed opportunity, we analyzed the growth initiatives pursued by the 770 largest companies in the sector between 2004 and 2019 and identified players that had expanded into new industries or segments. We then reviewed annual reports, expert commentaries, and analyst statements to understand whether the new segments were true adjacencies.

A typical large company generates 20 percent of revenue outside its core business. Our research shows that organizations that expand into natural adjacencies generate, on average, 1.5 percentage points of annual shareholder returns above their industry peers.

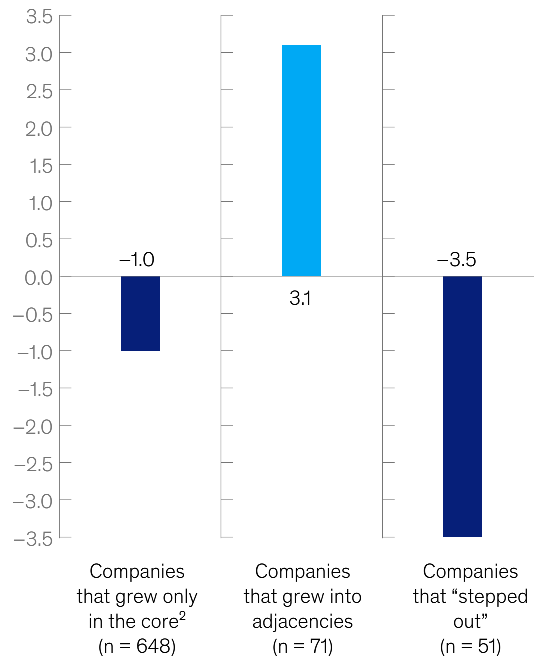
We found that, indeed, moves into adjacencies that build on a competitive advantage deliver significantly more value than purely organic growth or "step-outs" that companies may pursue without a clear right to win. (Note that companies stepping out in hopes of developing breakout businesses can find great success—so long as they have a competitive advantage.) Those that ventured into adjacent segments achieved median TSR that was three percentage points above their closest peers' (Exhibit 1). And these weren't outliers: two-thirds of adjacency growers outperformed their industries.

To help business leaders assess when and how best to expand into adjacent markets, we delved further into the strategies employed by the manufacturers that pursued that growth path. Their approaches can be divided into four categories: those driven by customers, those driven by capability, those based on value chain, and those oriented around a disruptive business model or technology. Each of these adjacency growth strategies delivered between 3 and 4 percent in excess TSR and generated favorable analyst views (Exhibit 2).

Exhibit 1

Growth through adjacencies delivers higher total shareholder returns than growth in the core or 'step-outs.'

Annual excess TSR by company type, median % per annum (for the period from step-out/adjacency entry to 2021[1])



Note: Figures adjusted for outliers by removing minimum and maximum values from the average.
[1]Excluding companies that expanded to adjacencies in 2019, for which financial data was unavailable.
[2]Excess TSR calculated for the period 2004–21.
Source: Study of ~800 largest advanced industries companies in 2004–19

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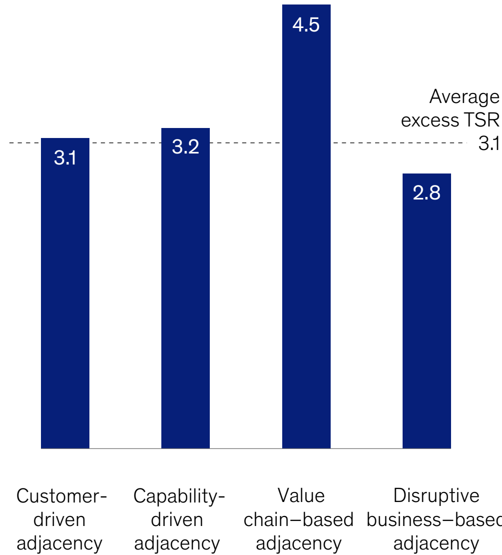
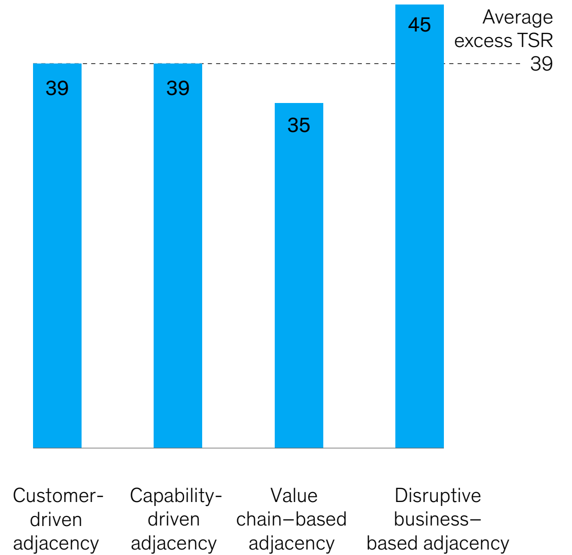
Exhibit 2

All four adjacency approaches drive excess total shareholder returns and positive analyst ratings.

Impact and opinions per value creation approach





[1]Excluding companies that expanded to adjacencies in 2019, for which financial data was unavailable.
[2]Buy recommendations minus sell recommendations as a percentage of all recommendations.
Source: Study of ~800 largest advanced industries companies in 2004–19

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Four approaches to growth in adjacencies

While the four categories have distinct characteristics, customer-propelled, capability-propelled, and value chain–based adjacencies can each require business model shifts to be effective. No matter which value creation logic advanced-industries companies pursued, those that succeeded in adjacencies applied some common practices in how they chose the approach, secured their foothold, and ramped up growth.

Customer-driven adjacency

Adding offerings that meet existing customers' needs that you don't already address, such as complementing hardware offerings with software or services, is a tried-and-true path to growth. This strategy was the most common of the four approaches, with six in ten players in our sample pursuing it alone or in conjunction with other adjacency moves. The reason is simple: companies can often find numerous cross-selling opportunities by analyzing what their current customers buy.

When a networking hardware manufacturer, for example, found its customers shifting their spending to enterprise software, it turned the threat into an opportunity by acquiring several software providers. It then used its extensive existing sales channels to deliver this broader portfolio of enterprise technology to both current and new customers. In just over a decade, the company was generating more than half its revenue from software sales, with much stronger margins.

Our experience has shown us, however, the importance of involving sales leaders and customers in identifying the best adjacencies for customer-driven growth. One global mining equipment manufacturer, for example, significantly benefited from bringing its key customers into its growth strategy discussions. Based partly on their feedback, the company started developing mining fleet optimization software in close collaboration with core clients—a move that significantly contributed to its outperforming its closest competitor in TSR by 18 percentage points since 2018.

Capability-driven adjacency
Transferring capabilities that were honed in the core business to an adjacent industry is a growth strategy that was pursued by a quarter of the companies in our sample. In advanced industries, these capabilities tend to fall into three categories: product development, operational, and commercial (see sidebar, "Three capability archetypes").

A producer of electronics testing equipment that was facing flat growth, for instance, scanned for opportunities in adjacencies and identified robotics as a fast-growing segment wherein it could leverage its operational capabilities. The company acquired a robotics business and applied its expertise in automation to galvanize the target's growth, then expanded further into industrial automation with additional acquisitions. The move was a triumph, contributing 13 percentage points to the top line within three years of expansion.

Value chain–based adjacency
Potential upstream and downstream moves within your own or your customers' value chains are among the easiest growth opportunities to identify and evaluate given their proximity to your existing business. Gaining greater control of the industry value chain can also increase a company's resilience to supply shocks, a particularly important benefit amid today's widespread supply chain disruptions. In addition, value chain moves can give companies a stronger ability to customize offerings to client needs—for example, tailoring raw material specifications to refinement processes—and secure a higher share of industry revenue and profit pools.

A mining equipment manufacturer, for example, used a merger to move into metal-refining machinery, which enabled it to integrate crushing and grinding with refining and thus help its customers to reduce waste. The move is expected to yield €150 million in annual revenue synergies and €100 million in yearly cost savings.

Disruptive business model–based adjacency
Companies with strong innovation capabilities can create adjacencies by launching entirely new businesses and revenue streams. In advanced industries, such innovation often takes the form of a disruptive business model or technology.
A case in point is an air compression equipment manufacturer's introduction of a pay-by-use service, a disruptive move made possible by technology the company developed that significantly lowered maintenance costs. Customers embraced the service because the equipment cost no longer required a major up-front outlay; rather, it was tied to their revenue streams.

Three capability archetypes

Capabilities that can enable companies to successfully enter an adjacent segment fall into three main categories:

— *Product development* capabilities include innovation assets such as patents and trade secrets, as well as engineering, R&D, and design competencies.

— *Operational* capabilities cover manufacturing and logistics, as well as technological areas: data science, software, and AI. Tech talent is particularly critical to scaling this capability archetype.

— *Commercial* capabilities include branding, business or market intelligence, revenue management, distribution, and aftermarket services.

Let's be clear: growth through disruptive innovation is rare. Fewer than a tenth of our adjacency expansion sample used this value creation logic. However, when pursued successfully, it can generate strong top-line gains.

Making the most of the right opportunity

As with all growth strategies, companies seeking to expand into adjacent industries or markets should first establish an aspirational culture and mindset. Then they should identify the right pathways and follow through with strong execution. The following outlines how to put adjacency strategy into action.

Apply a broad lens to identify opportunities
Successful adjacency growers first look at how they can better serve their existing customers—60 percent of adjacency growth comes from that client base. What add-on services or complementary products could you offer to increase your share of your customers' spending?

Recognize, however, that adjacent opportunities can emerge in unexpected segments. To find them, first assess the impact of macroeconomic and sector trends on your industry profit pools and identify entry prospects based on the above four paths to adjacency growth. Complementing that analysis with AI-assisted searches can reveal options you might not otherwise consider—by, for example, uncovering overlaps with other industries and markets within your product development, operational, or commercial capabilities.

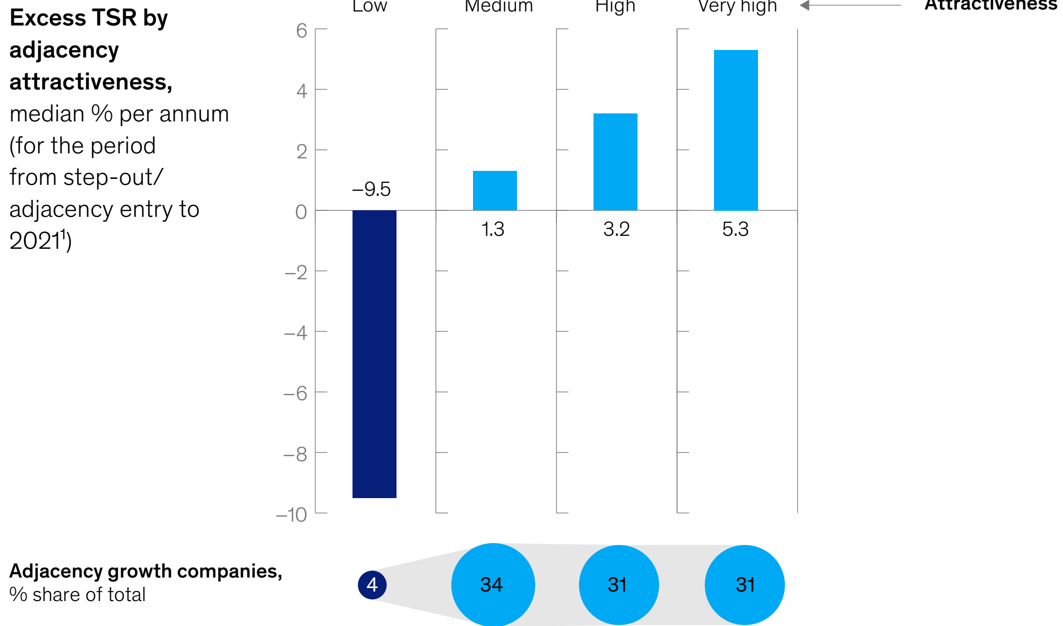
Next, map out opportunities along the value chain. Could you improve your offering by gaining more control upstream or serve your customers better by adding more downstream capabilities, such as a dealer network? Finally, consider ways to innovate your business model. How could you improve your connection with customers and become a true partner in boosting their productivity?

Prioritize the opportunities systematically
Having generated a list of potential adjacencies, you can prioritize them based not only on the best customer, value chain, and capability fit but also on the market's attractiveness according to its size, growth, margins, and the overall profit pool trajectory. While the importance of inherent segment attractiveness may seem obvious, executives often make the mistake of putting a company's suitability for operating in a market ahead of that market's prospects. Yet expanding into adjacencies that are above average in profitability and growth can deliver about 15 percentage points more in excess TSR than can venturing into markets in the bottom quartile of growth and profits (Exhibit 3).

Leaders should be clear about the capabilities their companies will need to succeed in the new segment and the implications the adjacency strategy may have for the existing organization.

Exhibit 3

Segment attractiveness is a key factor in adjacency growth success.



Note: Figures adjusted for outliers by removing minimum and maximum values from the average.
[1]Excluding companies that expanded to adjacencies in 2019, due to financial data unavailability. Excess TSR calculated for the period 2004–21.
Source: Study of ~800 largest advanced industries companies in 2004–19

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Next, ensure that the adjacency is aligned with your overall strategy from the perspective of balance sheet requirements, the level of customization needed, or technology complexity. You might choose, for instance, to enter only asset-light segments regardless of your financial restrictions. Finally, use feasibility metrics to assess market entry options, whether through M&A or partnerships (what size of target or type of joint venture could you pursue, for example?) or through the investment needed for organic entry.

Execute with focus and conviction

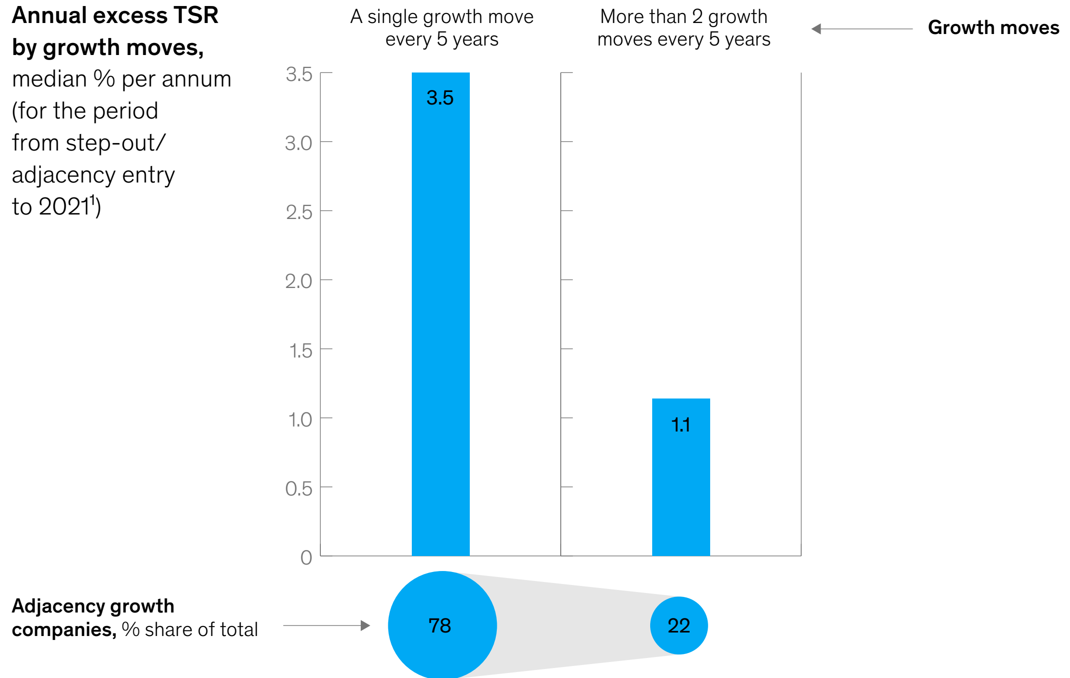
While companies outperforming in growth pursue all directions of growth over a ten-year period, these bold moves, including those into adjacencies, should be thoughtfully sequenced and undertaken with a focused approach. Our research shows that companies that pursued one adjacency move over a five-year period outperformed those that pursued two or more by three percentage points (Exhibit 4).

Leaders should be clear about the capabilities their companies will need to succeed in the new segment and the implications the adjacency strategy may have for the existing organization—for example, when shifting from hardware to software or services. To fill those capability gaps, the best performers use M&A, acquiring established businesses to gain footholds in their chosen markets. They then grow from those bases through programmatic, "bolt-on" acquisitions to strengthen their positions.

Finally, stay true to your strategy over time, understanding that adjacency growth is a long journey.

Exhibit 4

Outperformers favor a focused approach to adjacency expansion.



Note: Figures adjusted for outliers by removing minimum and maximum values from the average.
[1]Excluding companies that expanded to adjacencies in 2019, for which financial data was unavailable. Excess TSR calculated for the period 2004–21.
Source: Study of ~800 largest advanced industries companies in 2004–19

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It can also require tough choices—including divestments and significant up-front investments to gain initial traction.

A time of uncertainty rewards ambidextrous companies: those careful about managing the downside while aggressively pursuing the upside. As supply shocks and changing value pools open new opportunities in adjacent markets, advanced-industries companies can significantly boost both their growth prospects and shareholder returns by moving beyond their core businesses, provided their expansion is based on a clear value creation logic.

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A different high-growth story: The unique challenges of climate tech

Capital-intensive, sustainable businesses offer growth on a scale achieved by technology juggernauts of recent decades. But they face a different set of challenges. Here’s how they can overcome them.

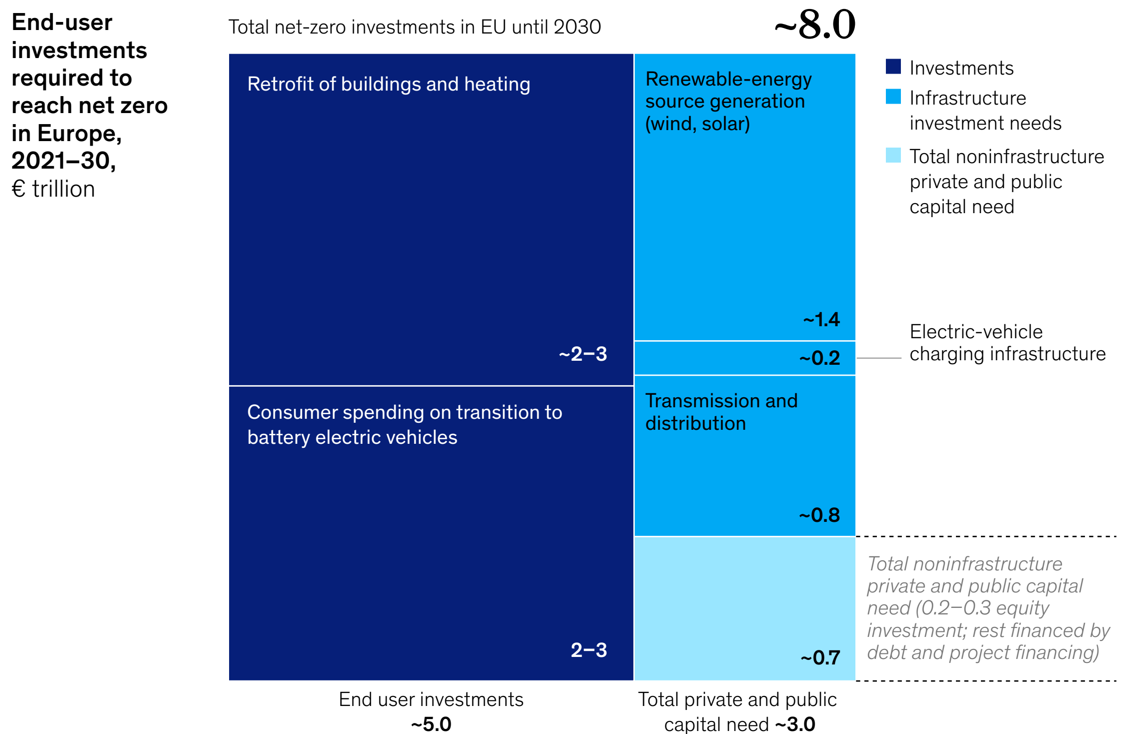
by Michael Birshan, Lisa Leinert, Tomas Nauclér, and Werner Rehm

Precisely because sustainability offers such a massive opportunity, it evokes the success achieved by technology companies over the past three decades. Yet while software may have eaten the world, its appetite for capital wasn't voracious. Asset-heavy climate tech solutions—such as green steel, the removal of carbon from the atmosphere, and new ways to produce and store renewable energy—are different. Unlike software or other asset-light businesses, these climate tech ventures require substantial capital at early stages in their life cycle and need more time to break even and scale up. And in contrast to existing solar and wind energy farms, they face greater commercial uncertainty, including the development and adoption decisions of other players across the value chain. Put another way, capital-intense climate tech ventures aren't quite a fit for traditional venture capital (VC) (their businesses offer the promise of extraordinary growth and don't yet have positive cash flow, but need more capital, sooner than VC firms typically provide), aren't quite a match for private equity (PE) (which tends to invest in businesses that are already cash flow positive), and would appear to be too early in their business building to receive significant bank financing. Like other new ventures across sectors and over time, some will surely fail.

Yet encouragingly, several are beginning to access life-giving capital, and some have achieved remarkable, profitable performance. Although the challenges for scaling asset-heavy sustainability solutions businesses are daunting, there are solutions that already work, or can work as a matter of engineering and physics. Climate tech also benefits from favorable regulatory tailwinds—themselves a response to urgent climate change. Private capital, too, can play a critical role in the green transition (Exhibit 1). In this article, we explore the unique challenges and opportunities of asset-heavy climate

Exhibit 1

Private capital will play an important role in the green transition.



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tech businesses—and how climate tech can realize its immense potential.

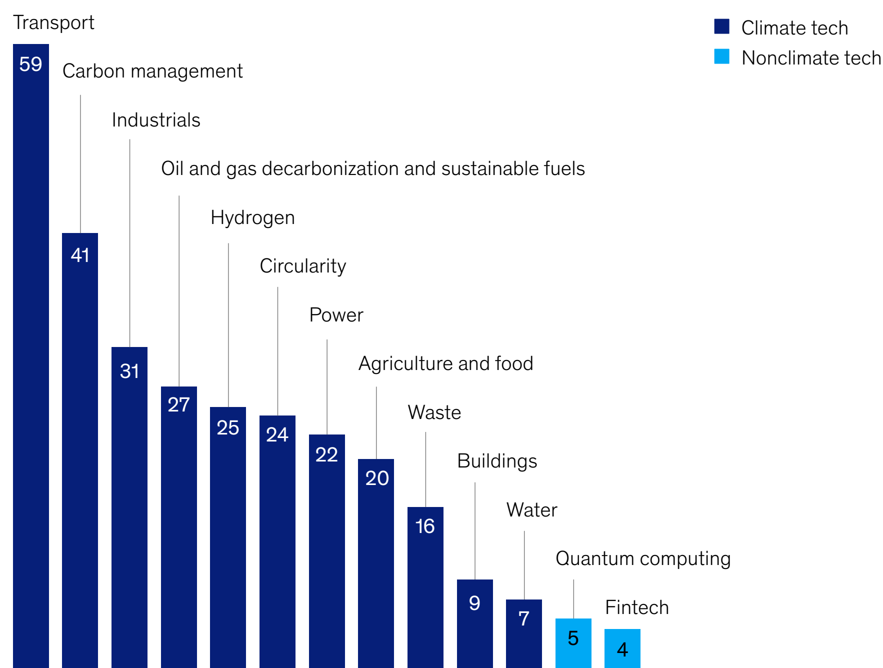
Recognizing the challenge

The first step to overcoming a challenge is to recognize it, in all of its complexity. Make no mistake: the challenges that climate tech businesses face are different—and frankly, harder—than the ones faced by high-tech companies over decades past.[1] That starts with capital intensity. The ticket size of major climate technologies in early-stage VC are five to six times higher than, for example, fintech or quantum computing. In particular, high-demand solutions for sustainable fuels, hydrogen, green power, and circularity have high capital needs well before production (Exhibit 2). Climate tech sectors such as carbon capture, use, and storage (CCUS) and electrification of transport have ticket sizes of more than $25 million at early VC stages.[2]

Exhibit 2

Climate tech sectors have significantly larger ticket sizes in later-stage venture capital than other high-growth, high-tech sectors.

Average ticket size in later-stage venture capital, $ million



Source: PitchBook; McKinsey analysis

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[1] For broader context on the multiple and sometimes competing challenges of the net-zero transition, see "What would it take to scale critical climate technologies," McKinsey, December 1, 2023; "An affordable, reliable, competitive path to net zero," McKinsey, November 30, 2023; and "Solving the net-zero equation: Nine requirements for a more orderly transition," McKinsey, October 27, 2021.
[2] McKinsey analysis based on PitchBook data.

It is currently estimated that up to 90 percent of 2050 baseline man-made emissions could be abated with existing climate technologies. Ten percent of abatement potential comes from climate technologies that are already commercially mature; however, approximately 45 percent of required abatements will come from emerging technologies that have not yet been deployed at scale (such as floating wind turbines and e-fuels).[3] For example, sustainable airline fuels represent the only viable way to decarbonize emissions from airlines until at least 2050.[4] While the general process knowledge of producing sustainable fuels has existed for decades, McKinsey analysis shows that production is not expected to be deployed at scale until at least 2025, and it remains to be seen whether a price premium will be sustainable. Traditional project investors—accustomed to debt levels of about 80 percent—can shy away from these longer-term investments, given that projects such as solar and wind power already offer a steady income stream.

Even more critically, some capital-intensive climate technologies lack proven commercial models. Often, the physical product would be similar to or the same as the nondecarbonized product, apart from its net carbon emissions (for example, green steel and net-zero chemicals). The investment thesis, therefore, often comes down to relying upon a green premium to generate high returns. But the existence of a *sustainable* green premium *in the future* is not a given. In parallel, construction and operating costs must come down, even at higher price levels, to enable a sustainable commercial model.

Moreover, the break-even point is not immediately in view, which can create tension in financing discussions. Capital-intensive climate businesses usually require significantly more time to scale up physical assets in comparison to asset-light high-tech companies. For example, the average time from Series A to Series D for digital marketplaces is three years; climate technologies based on today's knowledge will take about seven years to achieve scale.[5]

Solving the conundrum

While the challenges are formidable, the promise of capital-intensive climate tech, as a fundamental matter of finance and economics, offers grounds for optimism. Investors naturally seek out attractive risk-adjusted returns, just as businesses ineluctably strive to meet emerging demand. What's more, substantial governmental assistance provides a powerful tailwind. A path forward will require capital-intensive climate tech to derisk the business case, get creative about financing (often by taking advantage of public incentives), and scale up operations more quickly.

Derisk the business case

Capital-intensive solutions are actual solutions—not theoretical ones; most technologies needed for net zero are already mature. There are some technology risks, of course, but making these challenges transparent is actually a positive step toward allaying investor concerns. Businesses can start by explaining that key risks are a matter of engineering, not physics; many net-zero solutions combine technologies where most or even all the individual steps have been proved in other applications. For example, a circular chemical company combined five different steps where all but one were proved at scale—and the new production step was already being demonstrated at one plant. Laying out the solution in clear steps rather than presenting it as a "black box" proved enormously helpful to investors.

Climate tech leaders can also show that new production processes are well founded and based on engineering certification studies. Often, one or more of the new process steps can be assessed by impartial, respected third-party engineering firms and synthesized into a "bankability study" that addresses, for example, technology maturity,

[3] "What would it take to scale critical climate change technologies," December 1, 2023.
[4] Laurence Delina and Kristiana Santos, "Soaring sustainably: Promoting the uptake of sustainable aviation fuels during and post-pandemic," *Energy Research & Social Science*, July 2021, Volume 77.
[5] McKinsey analysis based on Crunchbase data.

process robustness, cost, and required capital expenditures. These studies are especially effective with project debt financiers in the early-launch phases.

Of course, merely demystifying how solutions would work does not, by itself, equate to derisking; the business needs to bring the solutions to life. But we find that many new businesses can take operational steps quickly. This starts with securing a supply chain: new businesses need to line up suppliers of raw materials and other key components early and creatively. We've seen recent examples of companies that establish partnerships with key suppliers to secure a stable future supply chain—and share the risk. For example, one early-stage green-ammonia project developer negotiated a long-term baseload purchase price allocation from a renewable-power source; the agreement included guarantees of origin for each project site.

Offtake agreements or similar arrangements are particularly important for derisking and to buttress the commercial model. Negotiations typically go through several steps, culminating in a bankable agreement, which includes timeline, product specifications, warranties, and final-pricing arrangements. Critically for financing, we've seen companies achieve offtake agreements well before a technology was market tested. For example, a green-materials company started discussing offtakes with leading automotive CEOs early in the business planning phase, well before the first detailed design of the initial plant financing. Management presented latent demand in a transparent way, demonstrating that by 2030, for 30 percent of automotive OEMs, decarbonization would require the use of its specific product—which was less expensive and involved lower technology risk than alternative solutions. In addition, the company clearly laid out demand-and-supply growth on a competitor-by-competitor level, an exercise that highlighted the risk of a shortage between the 2025 to 2035 time period—bolstering the case for long-term contracts. In fact, the company was able to establish win–win offtake agreements well before the design of its first projects and delivery four years thereafter.

Beyond offtake agreements, new businesses can get moving early on a clear strategic plan beyond the typical, longer-term horizon. Consider, for example, the success that some players in the automotive industry scored in driving down the cost for electric vehicles (EVs) by moving from "luxury only" to "below average car cost" for some models. Players in both the battery space and energy sectors, for their part, have entered into joint venture agreements with customers to share equity risk and eliminate most—and even all—demand risk. These arrangements aren't new: in 2012, for example, Intel took an equity ownership in Dutch semiconductor equipment manufacturer ASML to strengthen the company's largest company relationships.[6]

Effective companies across capital-intensive climate tech also secure relationships with equipment providers; suppliers of materials and components; and engineering, procurement, and construction firms as soon as possible. For example, one automotive player is collaborating with Eastern European companies to ensure a supply of low-carbon metal parts. Understandably, investors and partners want to see demonstrable progress on timelines and recoil from delays and cost overruns. Because the stakes are high, even a bit of slippage could result in financial distress given the size of the required plans.

Yet boldness is essential. Success requires capital-intensive companies to set and meet large, stretch-the-possible aspirations. A true disruptor lays out a clear ambition to build an industry-leading platform with multiple plants, products, and scaling. For example, Ørsted set an ambition in 2010 to shift its portfolio from 85 percent fossil fuels and 15 percent renewable energy to 99 percent power generation from renewable sources by 2025. Its comprehensive plan was to shift from being an integrated energy provider to a world leader in wind energy—and it worked. The company's net income

[6] "Intel takes 15% stake in ASML, part of EUV, 450mm development push," *Semiconductor Digest*, July 10, 2012.

Boldness is essential. A true disruptor lays out a clear ambition to build an industry-leading platform with multiple plants, products, and scaling.

has flipped from negative to positive—ranging from approximately $1 billion to $3 billion from 2016 to 2022, even in the face of recent supply chain strains and rising interest rates—all while decreasing its emissions by about 90 percent.

Get creative with financing

While climate tech now faces steeper challenges than high tech—particularly the amounts of capital needed and the longer horizon to achieve scale—it also enjoys a unique tailwind: the tremendous regulatory push for sustainability. That can be a difference maker in accessing large amounts of capital.

As part of the 2022 US Inflation Reduction Act (IRA), more than $500 billion will be invested in climate technologies (not including significant additional regulatory support for EVs).[7] But IRA initiatives are not the only source of public support: the residential solar company Sunnova Energy International, for example, tapped US government partial loan guarantees of up to $3 billion to back financing for its rooftop solar systems.[8] In the European Union, more than $2 trillion in equity investments, grant money, and policy support has been budgeted through funds dedicated to achieving the European Green Deal.[9] Players such as Solarcentury (acquired by Statkraft), Encavis, and the joint venture of Enbridge and EDF Renewables have allocated significant funds to design, build, and maintain asset-heavy solutions.[10] The European Investment Bank, for its part, supports battery maker Northvolt's gigafactory for lithium-ion battery cells in Skellefteå, Sweden, with backing from the Investment Plan for Europe.[11]

Corporate debt can start as early as the Series A round. New climate tech companies typically access debt through syndicated loans, where commercial and public lenders come together to enable successful debt financing and successful scaling of business. Public institutions are often first movers when lending to climate tech companies. Some commercial institutions are adjusting their lending profile to be more creative, as well. For example, European commercial banks issued conditional commitment letters for €3.3 billion senior debt for an investment in green steel.[12] Nor are banks the only provider of debt financing: growth-lending facilities for venture and scale-up, alternative asset managers, and direct-lender specialists are providing debt financing for the net-zero transition. Given current challenges in equity capital markets, debt will likely remain an important source of capital over the coming one to two years as well as the long term.

[7] "How a half-trillion dollars is transforming climate technology," *MIT Technology Review*, August 16, 2023.
[8] "US commits to $3 billion loan guarantee for Sunnova to expand solar access," Reuters, April 20, 2023.
[9] EU long-term budget (2021–2027), European Council–Council of the European Union, accessed January 2024.
[10] "Enbridge's joint venture, and EDF Renewables, selected to develop France's largest offshore wind farm," PR Newswire, March 27, 2023.
[11] "European backing for Northvolt's battery gigafactory in Sweden," EU Monitor, May 15, 2019.
[12] "Leading European financial institutions support H2 Green Steel's €3.5 billion debt financing," PR Newswire, October 24, 2022.

In addition to accessing debt at the corporate level, we see companies use project financing as early as the Series B stage to fund projected cash flows. This type of financing—already standard for wind and solar energy generation—helps to protect the parent's balance sheet, even when debt is consolidated on an accounting basis. While renewable energy still constitutes the largest share of transition project financing, project financing for other climate technologies—such as battery production, EV manufacturing plants, and hydrogen plants—has seen growth rates around 15 to 30 percent over the past years and now constitutes about 25 percent of total project financing volume.[13]

Several banks are rapidly ramping up their capabilities to fund climate projects in creative ways. In the case of one leading green-hydrogen production plant, for example, the project financing vehicle was made bankable through a large, indirect governmental shareholding in one of its holding companies and through a 30-year offtake agreement signed by a global hydrogen production company.

Climate tech businesses can also reduce capital costs in a meaningful way through credit guarantees, export credit guarantees, or government guarantees once orders are achieved or within reach. One of the world's largest credit guarantee programs for climate technologies is run by the US Department of Energy; its Title XVII Innovative Energy Loan Guarantee Program has provided more than $25 billion in loan guarantees for largely renewable-energy facilities.[14] In Europe, where agencies such as EKN, the Swedish export credit agency, help make projects bankable by moving early to assume risk, one green-steel manufacturer received export agency credit guarantees for 10 to 15 percent of its €4.5 billion financing—which helped it, in turn, receive senior loans committed from a consortium led by project financing banks. In another example, the Swedish national debt office provided an 80 percent credit guarantee for a €300 million loan to a European oil refinery to increase the supply of renewable fuels. And at COP28, the UAE announced the launch of Alterra, a $30 billion initiative to help fund climate solutions through which $25 billion will be applied to scale climate investments and $5 billion for risk mitigation. The investment vehicle has already committed $6.5 billion for global investments, including in the Global South.[15]

Scale up faster

There's no getting around it: scaling up capital-intensive plants, production pathways, and other asset-heavy operations takes time. But even marathons can be run quickly—and being fast comes with clear advantages. Suppliers that can provide certified working solutions to their industrial and consumer customers, for example, are more likely to become the industry standard or provide the must-have solution or product that other businesses come to rely upon.

Novel approaches can enable companies to scale capital expenditure–intensive businesses much faster than before. For example, Northvolt was able to significantly cut costs through increased equipment productivity and lower energy requirements and material costs. The automotive industry's drive toward affordable batteries for EVs is a demonstrable example of achieving cost improvements. The price of lithium-ion batteries decreased by more than 85 percent over the past decade, largely through megafactories that employed modular scale. Similar investments in hydrogen production have been forecasted to decrease the price of

[13] McKinsey analysis based on data from Dealogic, Crunchbase, and PitchBook.
[14] The program provides that the US government will guarantee repayment of 100 percent of the principal and interest on private loans for up to 80 percent of construction costs. Guaranteed loans can have terms up to 30 years. Importantly, the US Department of Energy (DOE) acknowledges the inherent risk and accepts that some loans will fail, meaning that the guaranteed amount will have to be refunded to the guaranteed commercial bank. As of the end of 2022, only 3 percent of loans guaranteed by the DOE have run into repayment issues, and only a fraction of those have defaulted in full. See "Public credit guarantees: Unlocking private investments for climate technologies," Tech for Net Zero Allianz, July 13, 2023.
[15] See "What is Alterra, the UAE's $30 billion green investment fund?," Climate Home News, December 12, 2023; and "Explained: what is Alterra, the $30 billion fund launched at COP28," Energy Connects, December 1, 2023.

green hydrogen substantially by 2030, further driving the green transition.[16]

In addition, modular plant design allows nearly identical operating units to be built in parallel as companies rapidly scale up their business.[17] Companies are moving faster by taking an iterative approach, with releases of updated plants, modules, operational instructions, and training that can be refreshed across all facilities at the same time. By focusing on the minimum requirements to prioritize speed to market, rather than designing for every possible customer need, companies can move more rapidly.[18] For example, an industrial gas player minimized costs while maximizing speed to market through a standardized design of its hydrogen equipment and operation of its facilities. Standardizing hydrogen plants envisions them as modules or "trains" that can be easily connected to increase capacity or deployed to customers as individual units. As demand rises, an additional train is added easily. Because the design is standardized across all units, the process does not require significant engineering, design, or other cost outlays. To further ensure operational simplicity, all engineering work is completed in one location.

Capital-intensive projects don't require that one stage be completed before another can start; design and scaling can work in parallel.[19] In fact, optimizing for each step can be the exact wrong approach. Instead, effective climate tech businesses often take a "plant as product" approach and work backward from what is possible. This can mean skipping the pilot and going straight to the smallest commercial scale. As they do so, they engage with partners, especially suppliers, that share the objective of a long-term relationship. Tesla is perhaps the most prominent example of leveraging its engineering, procurement, and construction approach to scale rapidly. But it is hardly unique. Vargas companies such as H2 Green Steel have a similar record of aggressive construction and scaling, and are becoming serial builders of new projects. While not all players can or want to launch multiple plants, it's far more likely that "more and bigger" will be a differentiator. Unlike writing better code, it's hard to be a fast follower in an asset-heavy business.

While the growth potential of climate tech is reminiscent of the spectacular rise of high tech over the past three decades, the key challenges to realizing that growth are vastly different. Getting enough capital, and enough time to build scale, will be particularly hard. But these challenges are solvable. In another decade, some companies will be capital-intensive climate tech leaders. Why not yours?

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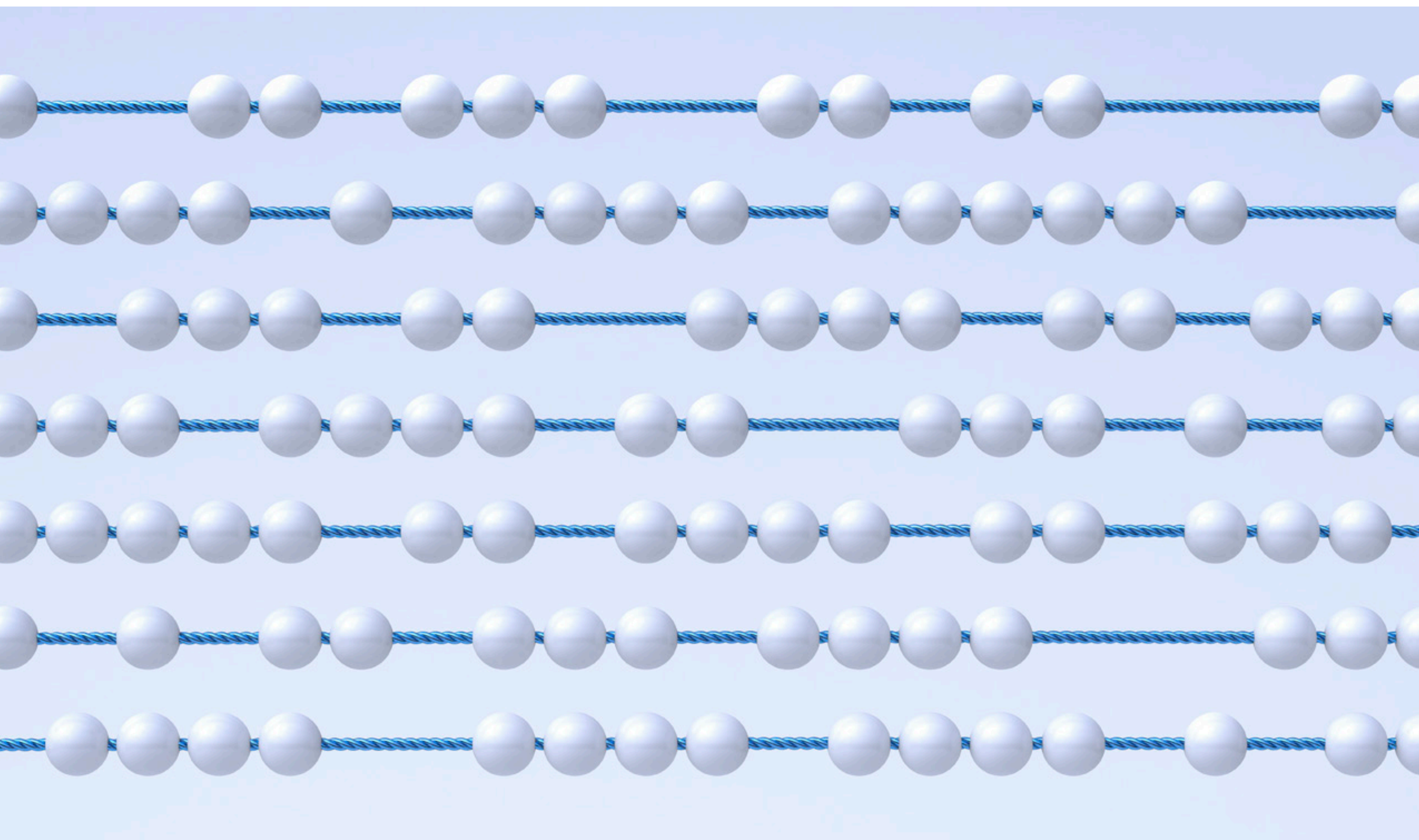
[16] See "Global Energy Perspective 2023: Hydrogen outlook," McKinsey, January 10, 2024; "The clean hydrogen opportunity for hydrocarbon-rich countries," McKinsey, November 23, 2022; and Bernd Heid, Christopher Martens, and Anna Orthofer, "How hydrogen combustion engines can contribute to zero emissions," McKinsey, June 25, 2021.
[17] See "Modular construction: From projects to products," McKinsey, June 18, 2019; "How smart platforms can crack the complexity challenge in project industries," McKinsey, October 10, 2019; and Jeff Hart, Niels Phaf, and Koen Vermeltfoort, "Saving time and money on major projects," McKinsey, December 1, 2013.
[18] See Sanjiv Ratan, William Baade, and David Wolfson, "The large hydrogen plant challenge," *Hydrocarbon Engineering*, July 2005.
[19] Mark Bakker and Zak Cutler, "The plant as a product: Hyperscaling green capex," McKinsey, September 7, 2023.

What programmatic acquirers do differently

Our latest findings bolster the case for programmatic M&A. But beyond doing more deals, what gives programmatic acquirers an edge—and how does their dealmaking translate to value creation?

by Tobias Lundberg, Jeff Rudnicki, Frederyk Schroeder, and Mieke Van Oostende



The evidence is growing stronger: companies that practice programmatic M&A are likely to outperform competitors. Our colleagues have been tracking the data for years, measuring not only the market performance but also the remarkable habits of successful dealmakers.[1] Now, we've taken an additional lens to the evidence, including findings from McKinsey's most recent Global 2,000 study,[2] to better understand what drives shareholder returns. We have identified key actions that programmatic acquirers take and the relationship that those actions have to outperformance. We also disaggregated the levers of excess TSR and zeroed in on how programmatic M&A flows into value creation.

Taking a programmatic approach doesn't ensure that a company will necessarily create more value than it would by taking a different approach to deals (including choosing to grow organically). However, in the aggregate, companies that take a programmatic approach have a greater likelihood of outperforming. In this article, we'll look at some of the important actions that they take, the math of outperformance, and the implications for large companies around the world.

Four key actions that programmatic acquirers take

Creating value through M&A takes commitment; the most effective dealmakers build and refine their expertise by doing multiple deals over time. Yet deal counts are the outcome—not the determinant—of having an effective strategy. Programmatic acquirers take four crucial strategic actions to outperform their peers.

1. Move beyond the core

In previous research, our colleagues found that companies were more likely to outperform when they moved beyond, but not too far beyond, their primary businesses.[3] Our most recent analysis bolsters that position.

We have found that the most effective acquirers make a larger share of their acquisitions outside of their core businesses in adjacencies (different sectors within the same industry) and "step-outs" (sectors beyond their core industry) than their peers do. Programmatic acquirers anticipate a natural decline of growth in core markets and move aggressively to where the growth is. As a result, they grow faster.

Programmatic acquirers anticipate a natural decline of growth in core markets and move aggressively to where the growth is. As a result, they grow faster.

[1] Paul Daume, Tobias Lundberg, Anika Montag, and Jeff Rudnicki, "The flip side of large M&A deals," McKinsey, March 25, 2022; "How one approach to M&A is more likely to create value than all others," *McKinsey Quarterly*, October 13, 2021; Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 12, 2019.
[2] McKinsey analyzed 11,746 M&A transactions from 2013 to 2022 in a data set of 2,000 global companies using Global Industry Classification Standard data.
[3] Sandra Andersen, Chris Bradley, Sri Swaminathan, and Andy West, "Why you've got to put your portfolio on the move," *McKinsey Quarterly*, July 22, 2020.

2. Recognize the strategic rationale

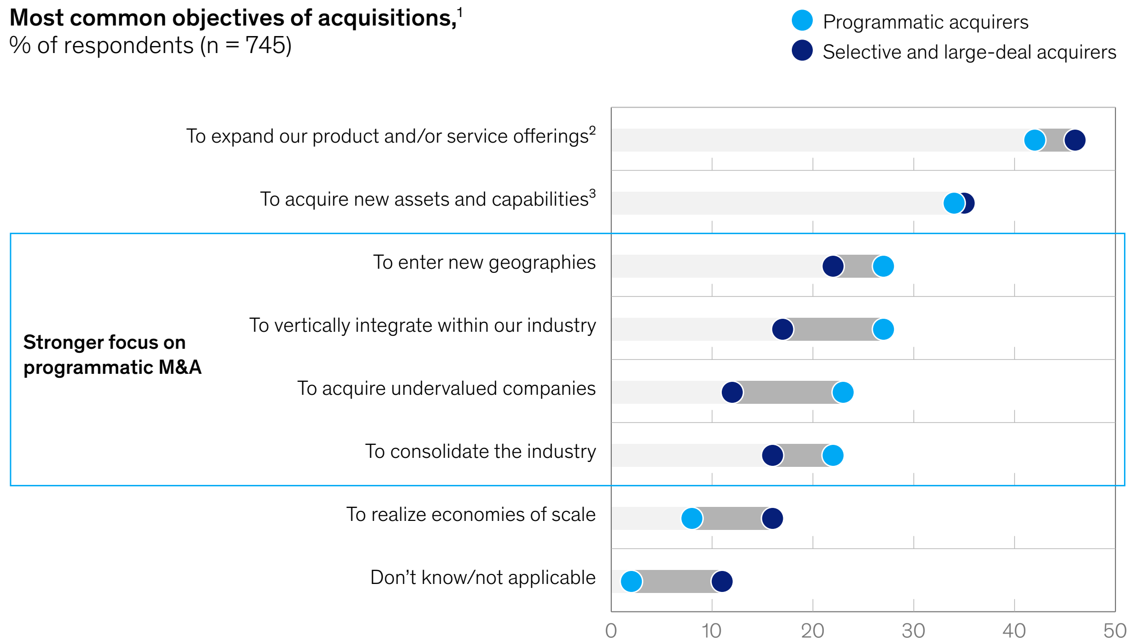
Nonprogrammatic acquirers offer traditional reasons for their transactions, such as expanding their product lines or service offerings and scaling core businesses. For instance, they cite better procurement and improved SG&A. At the same time, one in ten nonprogrammatic acquirers struggles to articulate a clear strategy for all their deals. By contrast, programmatic acquirers are relentlessly mindful of their guiding strategies and have broader sets of value-creation rationales (Exhibit 1).

Similarly to nonprogrammatic acquirers, programmatic acquirers may identify traditional business rationales. But they do so to a competitive end. For example, they'll pursue scale because they recognize that an industry is undergoing rapid consolidation. Or they might seek to improve their margins because they recognize new opportunities from vertical integration.

Some, having built their dealmaking muscles, may even develop and demonstrate a rationale whereby they can recognize, acquire, and rapidly integrate undervalued companies. One European programmatic acquirer has created significant shareholder value from its experience in strengthening target companies' businesses, even when challenges give other potential acquirers pause. Financial acquirers, such as private equity funds, might deploy a holistic view on value-creation levers. They often focus on improving operating models (for example, implementing commercial excellence through more informed pricing and

Exhibit 1

Programmatic acquirers pursue a broader set of value-creation rationales.



[1]Question: Which of the following best describes the most common objectives of the acquisitions your company pursued in the past 2 years and the acquisitions it plans to pursue in the next 2 years (select up to 2)?
[2]For example, new digital-based products.
[3]For example, intellectual property, new go-to-market approaches, and know-how.
Source: McKinsey Global M&A Capability Survey 2023

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better account management). As our colleagues have shown, successful public companies can also put private equity best practices to work.[4]

3. Prioritize value creation over price

Good businesses—particularly growing businesses—usually cost more than others do. Programmatic acquirers are distinct in doing the right deal, even at a higher price, so long as the value created by the deal exceeds the cost of the deal, including the cost of realizing synergies. We have found that these dealmakers are more willing than their peers to acquire higher-valued companies, both in absolute price and relative to their own valuation. The target's price, in fact, is often a clear indication of its future growth expectations, attracting rather than filtering out sophisticated acquirers. By being willing to pay higher acquisition multiples, programmatic acquirers show a great conviction about their strategies and their ability to create value.

4. Actively divest

Some companies succumb to the temptation of empire building instead of value creation. Being bigger isn't necessarily more value creating, however. Our colleagues have shown that dynamically reallocating capital to acquire and divest businesses isn't only highly prized by investors but also a distinguishing feature of companies that adopt programmatic M&A.[5] In fact, programmatic acquirers divest twice as often as acquirers that follow a selective or large-deal approach do. They also divest the most over the long term by deal size, as measured by their share of divested market capitalization versus their share of acquired market capitalization. By complementing programmatic purchases with active divestments of less attractive businesses, these companies free up additional capital for acquisitions. This methodical pruning-while-growing method pays off: our Global 2,000 research shows that programmatic divestments generate more than 1 percent median excess TSR, with lower excess standard deviation.

Programmatic acquirers are more willing than their peers to acquire higher-valued companies, both in absolute price and relative to their own valuation.

[4] Ankur Agrawal, Kevin Carmody, Matthew Maloney, and Ishaan Seth, "Five insights for public company CFOs from private equity," McKinsey, November 15, 2022; Andreas Beroutsos, Andrew Freeman, and Conor F. Kehoe, "What public companies can learn from private equity," McKinsey, January 1, 2007.

[5] Jay Gelb, Rob McCarthy, Werner Rehm, and Andrey Voronin, "The investors that matter still want you to focus on the long term," McKinsey, April 10, 2023.

Value creation in action

The effects of best practices in programmatic M&A are particularly stark when one disaggregates excess TSR into its individual components—revenue, margin, valuation multiples, and dividend payout (Exhibit 2). We found that, among programmatic acquirers, about 1.5 percentage points of excess TSR were driven by valuation multiples, which serve as an indicator for investors' valuation of the businesses' prospects for future growth. Even as programmatic acquirers divested more businesses (and the revenue generated by those businesses), they kept pace in revenue growth with those that took a different approach, except for large-deal acquirers that acquired top-line growth in a gulp.

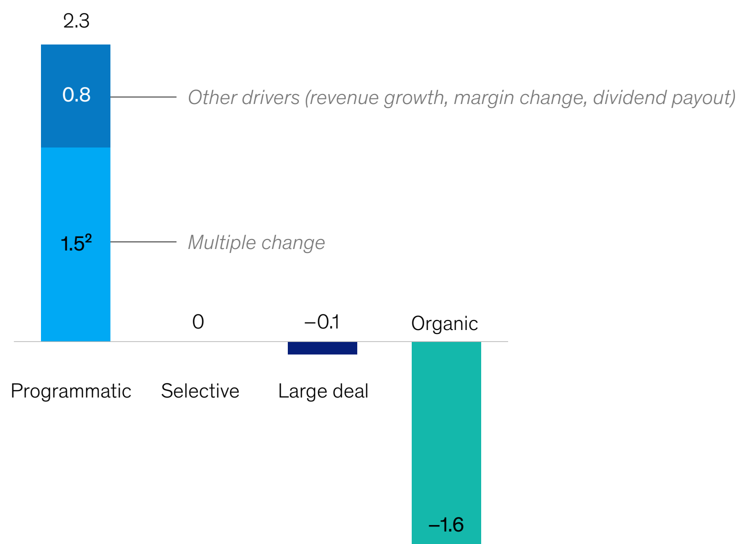
Programmatic acquirers create positive excess TSR by continually repositioning their business portfolios for growth via M&A. However, large-deal acquirers tend to follow a different value-creation rationale: they seek to turn their newly bolstered top line into excess TSR, supported by positive margin improvements from scale synergies. With only a 50-50 chance of outperforming industry peers, though, many find themselves with lower valuations and declining changes, and many fail to generate excess TSR.

Superior TSR performance not only provides insight into the performance drivers of M&A but also ties back to what programmatic acquirers do differently.

Exhibit 2

The business portfolios of programmatic acquirers dramatically outperform those of their peers.

Global 2,000 median excess TSR, by M&A program type, Jan 2013–Dec 2022,[1] %



[1]Companies that were among the top 2,000 companies by market capitalizations (>$2.5 billion) on Dec 31, 2012, and were still trading as of Dec 31, 2022; excludes companies headquartered in Africa and Latin America.
[2]Standard deviation of 9.9% for programmatic acquirers (10.8% for full Global 2,000).
Source: S&P Capital IQ; Corporate Performance Analytics by McKinsey; McKinsey Global 2,000 Survey, 2022

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They're bolder on making out-of-core acquisitions to sustain growth, even as their core businesses mature. They align their companies' M&A rationales with broader strategic imperatives, have the confidence in their M&A expertise not to view price as an automatic disqualifier, and make sure that they divest nonstrategic businesses while keeping up the acquisition pace. They're also more likely to be rewarded with higher multiples (Exhibit 3). While positive organic growth remains the main driver for positive TSR across deal types, programmatic acquirers tend to deliver a multiples increase and achieve neutral TSR relative to industry peers, even in the face of growth headwinds.[6]

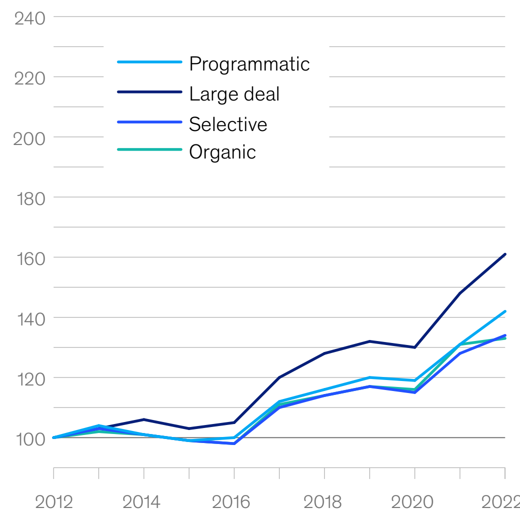
For instance, consider one European company whose core business was developing and publishing printed materials, mostly for a targeted professional audience, as the internet was wreaking profound changes for the publishing industry. Over the course of a decade, the company acquired about $1.5 billion worth of companies that slotted into a digitally focused strategy, allowing the company to overcome challenging trends. During the same period, the company also divested about $1 billion of low-potential assets.

In another example, an Asia-based conglomerate whose core businesses are in the industrial and energy sectors was, in 2014, the largest company by revenue in its home country. Adopting a program-matic approach, the company began to expand into higher-growth sectors and markets. As a result, it was able not only to position itself to take advantage of growth tailwinds but also to increase its return on capital employed (ROCE). Between 2018 and 2019,

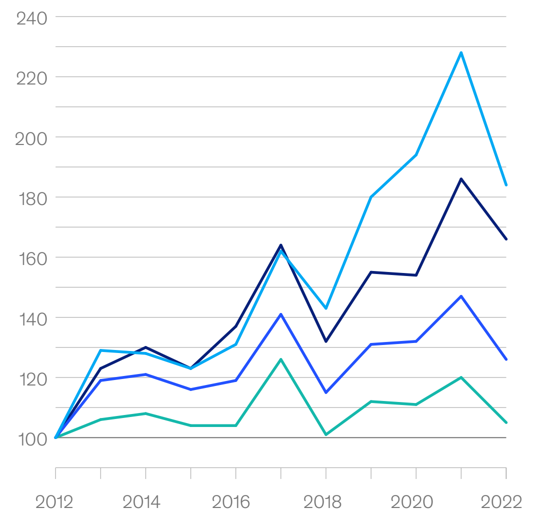
Exhibit 3

Programmatic acquirers' growth and market value tend to outperform those of their peers over the long term.

Median cumulative revenue growth, by acquirer type, index (2012 = 100)



Median cumulative market cap growth, by acquirer type, index (2012 = 100)



Source: S&P Capital IQ; McKinsey analysis

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[6] Our analysis of the 2,000 largest companies found that programmatic acquirers with negative (excess) revenue growth (sample median of –4.2 percentage points TSR per annum [–3.0 percentage points excess TSR]) experienced an almost neutral total TSR of –0.6 percentage points per annum (0.4 percentage points excess TSR).

the company made three significant acquisitions in earlier-stage global technology companies, and by 2019 it had closed on nearly 50 deals, most of which targeted technology-oriented companies with higher enterprise value to EBITDA multiples. Programmatic M&A enabled the company to increase its consolidated ROCE by more than a percentage point while also strengthening its position in areas with much greater likelihood for growth.

Putting it all together: Implications for acquirers

Every company is unique, and the appropriate approaches toward M&A should always be bespoke and follow a clearly articulated business strategy. Nor does every company create value in every deal. The weight of the evidence in the aggregate, however, points to three clear takeaways for acquirers.

First, acquirers tend to fare best when they embed programmatic M&A into their strategies and persistently seek to acquire profitable growth. That means not only doing deals in their core sectors but also moving to adjacencies, typically by strengthening a high-growth, secondary business unit where the company already competes—and, sometimes, by going even further beyond their core. These sophisticated acquirers continually pursue growth, so long as they have (or can acquire) the capabilities to be the best owner of the acquired business.

Second, effective acquirers recognize that M&A is a capability, not an event. They build and continually refine their M&A operating models *and* mindsets. As a result, they relentlessly reallocate capital, not just to do more acquisitions than their peers but to divest more frequently and at greater deal volumes. Their commitment to value creation attracts committed, long-term capital and powers a virtuous cycle. Despite the common wisdom that the market frowns on dealmaking, our research finds that intrinsic investors—the active, long-equity funds that are the most likely to move the market—identify dynamic capital reallocation as the most desired behavior from CEOs.

Finally and fundamentally, the most successful dealmakers commit to long-term value creation not just in words but in action. For example, while these sophisticated acquirers don't ignore target price, they aren't cowed by it, either. In our experience, programmatic acquirers develop an experience-based perspective on what a fair price is. This steels their resolve to execute an "expensive" deal when the price plus the value of the synergies is value accretive. In fact, our findings show that programmatic acquirers tend to buy at higher multiples—and then proceed to overcome nonprogrammatic acquirers in excess TSR. They're much more ambitious than others in setting—and effective in capturing—higher synergy targets. They also pull a more expansive array of levers to realize meaningful operating improvements. Private equity acquirers, which dig into target operations root and branch, show what's possible for public company strategic acquirers, so long as those acquirers have the commitment to prioritize long-term, outsize value creation over solving for quarterly earnings targets.

Programmatic M&A has consistently proved, in the aggregate, to be the most effective approach to dealmaking. By analyzing key actions that programmatic acquirers take, we can better understand why these acquirers tend to outperform their peers. And by disaggregating excess TSR, we can identify how a programmatic approach creates more value over the long term.

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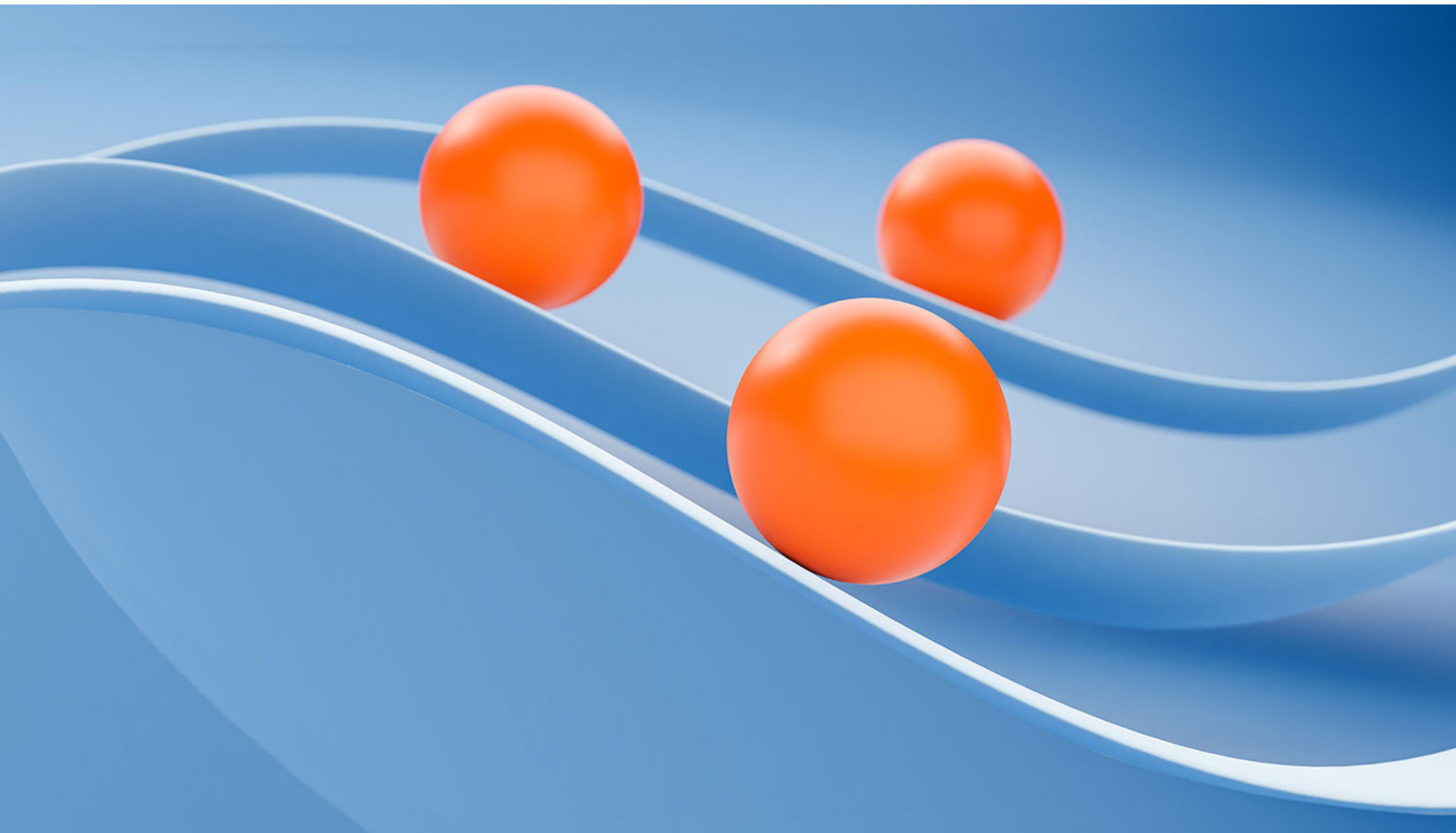
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

Motivations under the microscope

by Eileen Kelly Rinaudo, Tim Koller, and Derek Schatz



The dilemma

The CFO at a chemicals company is launching a new resource allocation process. Under it, the finance and strategy teams would no longer review requests business unit by business unit. Instead, they would consider proposals in the aggregate, rank them, and funnel resources to the most promising opportunities. It's a nimbler way to manage resources, the CFO tells senior management—"and, really, the only way we can continue to keep up with the market."

Leaders in the life sciences and advanced-materials businesses are on board with the plan. They can easily point to strong sales growth and recent product innovations to support their resource requests. But other leaders are balking. The head of petrochemicals tells the CFO, "We're not growing as fast or as much as everyone else, but the revenue from our polymers keeps the lights on around here. Under this new plan, our proposals are never going to get a fair shot."

They and some of the other business unit leaders have already started appealing to the finance and strategy teams for process exceptions, which would essentially defeat the purpose of the new approach.

How can the CFO make the new resource allocation plan work for everyone?

The research

The CFO needs to recognize the dynamic at play here, which is a form of the collective action problem—a bias that has vexed business, social science, and political leaders since the dawn of organizations.[1] It reflects situations in which individuals or teams would be better off in the long term by cooperating with others but fail to do so because of conflicting interests, prompting tensions to rise. The dynamic has also been described as the principal–agent problem, where an agent (an individual or group) acts on behalf of a principal (another individual or group), and if their motivations aren't in sync, outcomes for both may be suboptimal.[2]

In the case of the chemicals company, business unit leaders are being asked to cooperate with a new process that would have them "compete" with colleagues for access to limited corporate resources.

The motivation here is for the different teams to act in their own best interests, which may lead to decreased growth and value to shareholders over time.

Individuals or teams would be better off in the long term by cooperating with others but fail to do so because of conflicting interests.

[1] Todd Sandler, "Collective action: Fifty years later," *Public Choice*, September 2015, Volume 164, Number 3/4.

[2] Michael C. Jensen and William H. Meckling, "Theory of the firm: Managerial behavior, agency costs and ownership structure," *Journal of Financial Economics*, October 1976, Volume 3, Number 4.

The remedy

One way to counter the collective action problem is for the CFO and executive-leadership team to draw what we call a motivation map. The map could be a literal outline, captured in a spreadsheet or slideshow, or a one-time discussion. Either way, it's a tool that the CFO and executive-leadership team can use to better understand how business unit leaders would be affected by the new allocation process. Through the mapping exercise, they would first take inventory of each leader's primary motivations and priorities, looking at factors such as financial incentives, personal goals, and professional status. They could then consider how the status quo supports those motivations and priorities and plan for how to appeal to business unit leaders in a way that would help shift their thinking in a different direction.

In the case of the chemicals company, such an exercise could be particularly useful for bringing the head of petrochemicals into the fold. For instance, the CFO and team could ask, "Is this leader's compensation tied to the size of the business unit's P&L? Are they currently in a position of influence within the organization—and looking for more?" Based on the answers, the CFO and team could tailor their messaging on the process change accordingly. For instance, if loss of status is a concern, they might offer the petrochemicals head an advisory role on the new resource allocation board. If compensation is the issue, the CFO and team can help redefine financial incentives to reflect the change in the company's approach to resource management. A formalized mapping exercise can give the CFO and team more information than surface-level statements might.

It can be hard to convince individuals and teams to let go of long-established processes, rituals, and rewards. A motivation map can help senior management determine how best to bring together leaders with different priorities and perspectives, align their incentives, and ultimately move everyone toward a better, more productive place.

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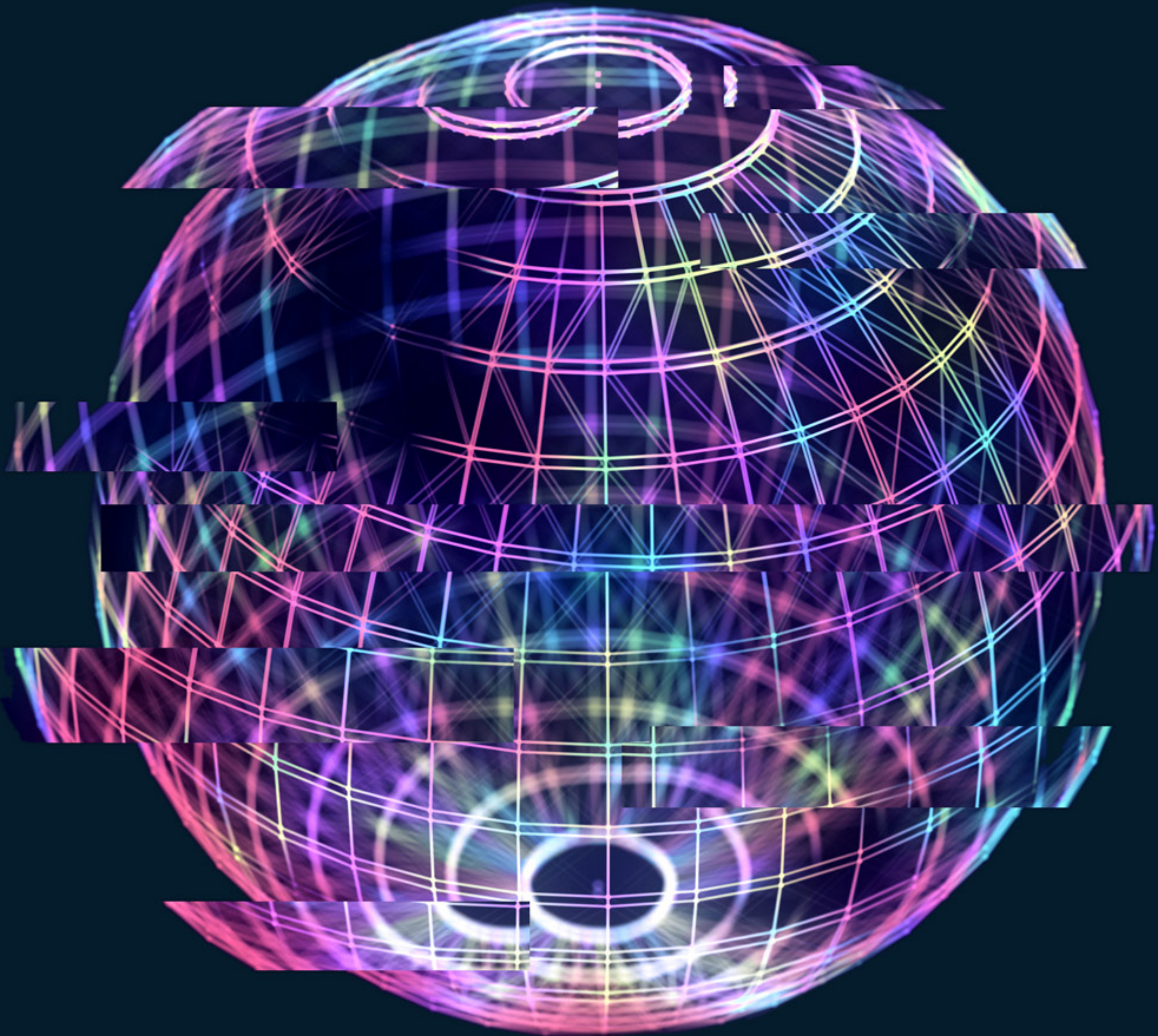
Looking back

How shockproof is your supply chain, really?

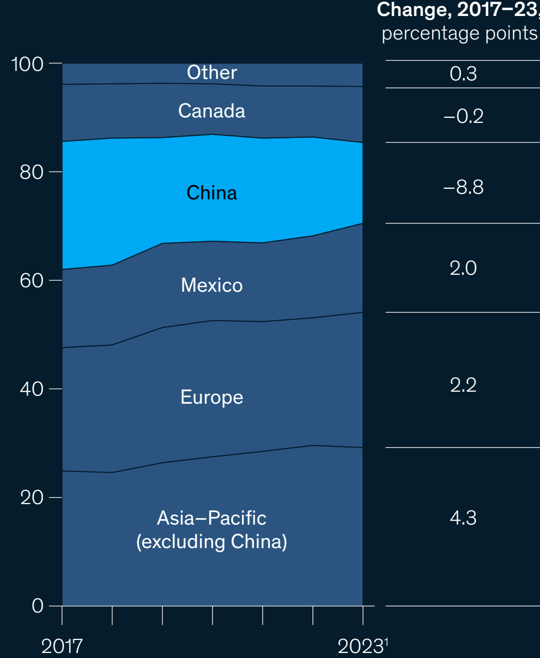


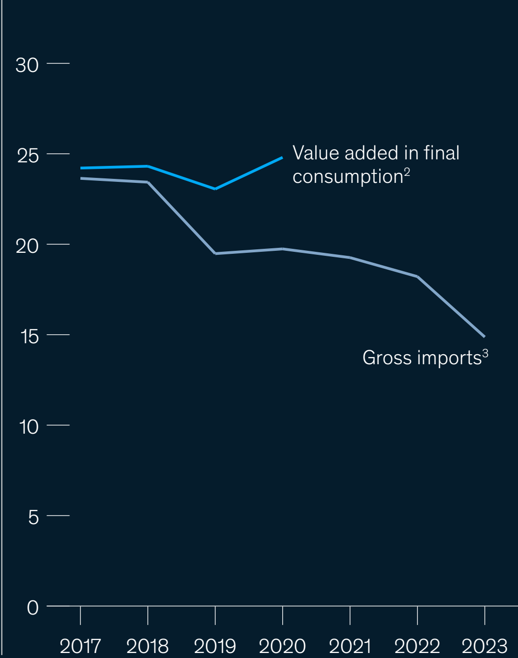
While global trade has risen dramatically since the 1990s and has continued to improve the lives of millions of people, geopolitical concerns have lately been rising, too. Terms such as "reshoring" and "friendshoring" have seen increased use in corporate presentations by more than 20-fold in the past few years.[1]

For example, in recent years China's share of US imported manufactured goods fell from 24 to 15 percent. The latest value-added data extends only through 2020, since it takes time for official sources to conduct and finalize their analyses. For now, the trajectory of the most recent years, as well as the *future* of value-added versus gross exports, remains unknown. Yet it's clear that a company does not ensure that it has a geographically diverse supply chain if it merely shifts from suppliers that assemble and ship from one country to suppliers that assemble and ship from another country. In fact, even as the share of US imports of manufactured goods from China declined, the share of value added in final consumption remained steady (exhibit). Goods that had been supplied directly from China

Exhibit

Although the share of US imports of manufactured goods from China declined, the share of imported value added stayed steady.





[1]Through Sept 2023.
[2]China's share of value added in US final consumption of manufactured goods. This includes value added originating in China that is imported by the US from another economy. Data available only through 2020.
[3]China's share of total imports of manufactured goods into the US.
Source: Trade in Value Added Database, 2022, OECD, accessed November 2022; US Census Bureau; McKinsey Global Institute analysis

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[1] Shekhar Aiyar et al., *Geoeconomic fragmentation and the future of multilateralism*, International Monetary Fund, January 2023.

are still being largely produced in China, but they are also being rerouted through other countries that add incrementally to the final value. The result can be that a supply chain is not significantly more geopolitically diversified—and is now also longer and potentially more opaque.

For CFOs—who in many organizations function as the de facto chief risk officer on the top team and, in every case, should be asking and encouraging hard questions—it's essential to dig deeper: How well do we understand our own supply chain? What is our company's exposure if different geopolitical scenarios play out? In one recent survey of senior global supply chain executives, only about half reported that they understood the location and essential risks of their tier-one suppliers—and only 2 percent had visibility beyond the second tier. Yet our research finds, too, that in times of uncertainty, the best leaders hone three types of competitive edge: insights, commitment, and execution. As uncertainty ramps up, CFOs will need much clearer insights across borders.

For more about the reconfiguration of global trade patterns and the potential trade-offs ahead, see Geopolitics and the geometry of global trade*, McKinsey Global Institute, January 17, 2024.*

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