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Highlights include:

Interviews with:

Investment insights on:

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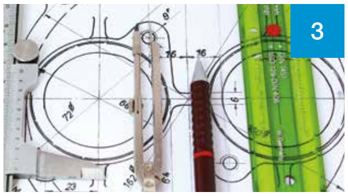
Table of contents



Sector insights

Introduction

Welcome to the second volume of *McKinsey on Investing*, developed to share the best of our recent research and thinking on the business of investing. Colleagues from offices around the world and across many disciplines—including asset management, institutional investing, private equity, and beyond—collaborated to develop these insights. We were also privileged to speak on the record with four industry leaders: Michael Sabia of CDPQ, Erik Hirsch of Hamilton Lane, Rob Leary of TIAA-CREF, and Jim Coulter of TPG, in the second part of our 2014 interview with him. We hope this combination of perspectives will help provoke reflection, dialogue, and change.

This volume includes 15 articles, loosely bound by the idea of uncovering value. We start with two pieces about management techniques that are particularly suited to private owners of companies and then continue with two articles that discuss the challenges of investing in infrastructure and family businesses, respectively. Another pair of articles looks at pensions, which are very much in focus on both sides of the Atlantic. We are pleased to offer new ideas on solving the funding gap among US state pensions and to take a look at the massive changes reshaping the UK retirement market.

New for this volume is a set of sector insights, which distills for investors the implications of McKinsey's ongoing industry research. We are delighted to share with you pertinent research on oil and gas, education, agriculture, healthcare, and the automotive aftermarket.

We hope you enjoy these articles and find in them ideas worthy of your consideration. Let us know what you think at Investing@McKinsey.com. You can also view these articles, earlier articles on investing, and many others on mckinsey.com and on our app for Android and iOS.

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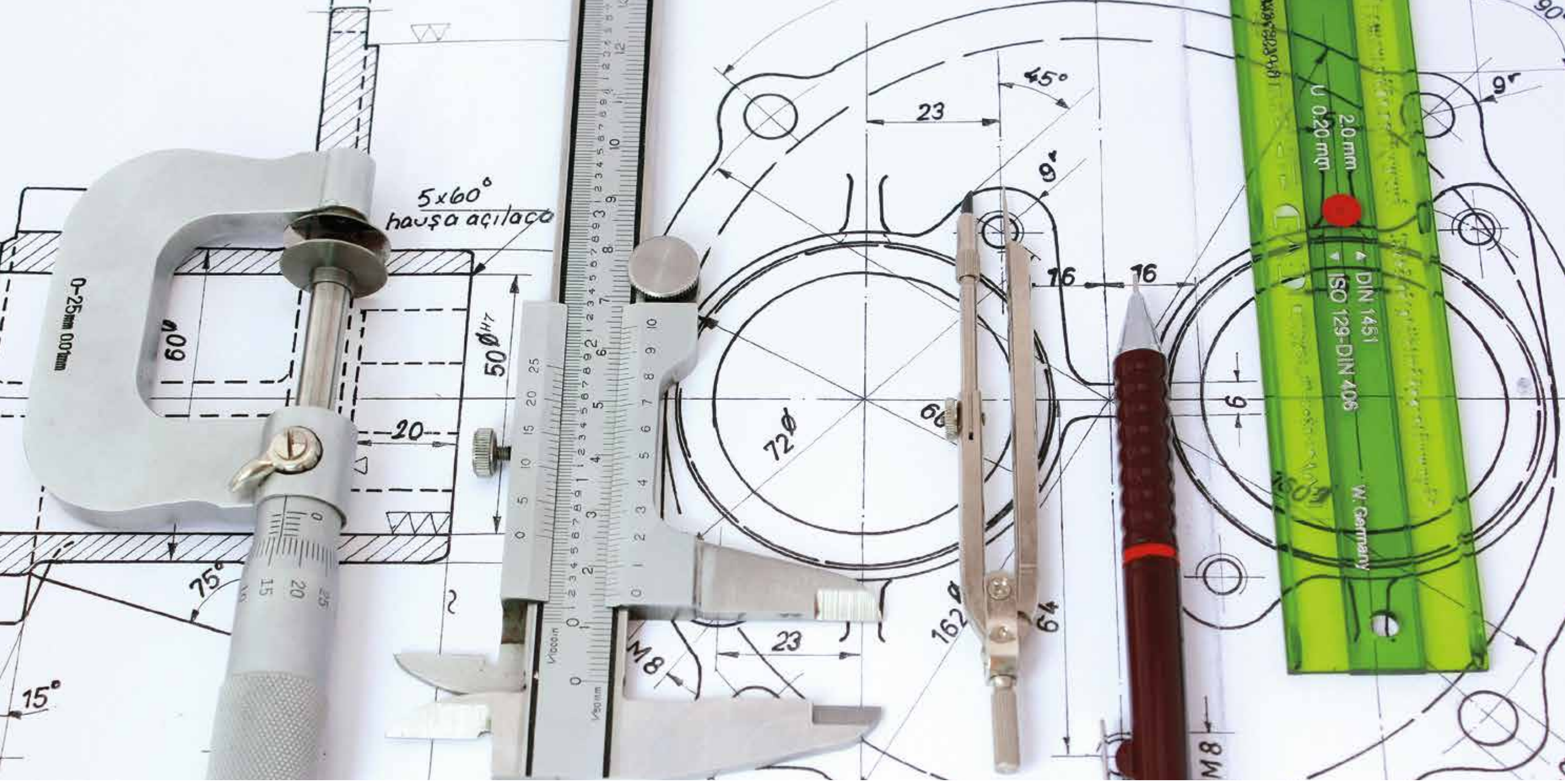

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Back to basics: Creating value through superior products

Revitalizing product development is an unexplored lever for most private-equity firms.

Michael Gordon, Chris Musso, and Patrick Zeitouni

Some analysts argue that private equity has run out of steam.[1] It's true that some of the traditional ways that firms have created value—notably buying undermanaged companies and modifying capital structures—are getting harder to accomplish. There are fewer companies available that are susceptible to these kinds of improvements. That's not news, though. Private-equity firms have recognized this and learned new techniques, such as improving operations, optimizing pricing, and making sales forces more productive. Many firms believe there is still plenty of value to be tapped through these and other approaches.

At the same time, however, the frontier of value creation is shifting, in ways that not every private-equity firm recognizes. All of the traditional techniques aim to improve the denominator of the multiple—that is, the intrinsic value of the company. Today, some farsighted firms are moving in a different direction, seeking to expand the numerator and achieve a higher multiple for their portfolio companies. Strategic buyers are willing to pay a higher multiple for faster-growing companies with products that excite customers. Private owners are responding by retooling their product-creation skills.

It's an idea whose time has come, as product development is a basic lever of value creation. Every privately owned company has cut costs, both in direct operations and in selling, general, and administrative expenses. Product development has only been addressed in blunt ways, when R&D budgets have been slashed for short-term cash flow.

Today, new tools can be applied to address the accumulated inefficiencies in operating companies. Portfolios of new-product ideas are rarely well managed and are often clogged with expensive, low-value projects. When these ideas do come to market, they saddle the company with the problems of managing too many SKUs. And few companies can say, hand on heart, that they have the insights needed to create new blockbuster products.

These problems can crop up anywhere but are most often found in smaller established companies, businesses that have been run for cash, and businesses that have become "unstrategic" and have been neglected—exactly the companies that are most likely to fall under private-equity ownership.

In this article, we will examine four ways that private owners can increase efficiency and accelerate revenue growth through creative changes to product development. Firms that embrace these techniques may approach their next auction with more confidence than their rivals and go on to extract more value than others could. In our experience, companies can free up to 30 percent of their product-development capacity. They can then spend the savings in various ways: some of it can be used immediately to lift margins, and the rest can go to reinvigorate the product-development process—and the company's fortunes.

Conduct rapid portfolio review

To begin, companies should review the R&D portfolio. Typically, about a quarter of all projects can be cut without sacrificing any value. Review criteria should include financial strength, alignment with product platforms, and the ability to meet or exceed customer features and needs. Mitsubishi Fuso Truck and Bus Corporation, the Japanese maker of trucks and buses, set up a cross-functional team (R&D, sales, product planning, and finance) to analyze the product portfolio. Top management set high thresholds for the review, looking in particular for projects that had been overtaken by market developments and those that an influential executive had kept afloat. As a result, the company stopped development of two major product lines, which represented nearly 350 potential SKUs. In another case, a diversified specialty-chemicals manufacturer systematically evaluated its R&D projects; it pruned the projects that had fundamental economic issues—a stunning 70 percent of the portfolio. In both cases, the teams on the canceled projects were reassigned to other projects, with the aim of accelerating commercialization.

Redesign products for value

Another important use of liberated resources is to improve margins on current products. The design-to-value (DTV) approach uses market insights, competitive intelligence, analytics, and engineering know-how to challenge a company's design paradigms. By breaking through these norms, DTV changes products in ways that are sometimes large (such as eliminating unused functionality) and sometimes small (such as spec optimizations). Redesigned products command higher margins, in our experience—between 5 and 30 percent higher, depending on the industry and the original design. And companies nearly always go on to greater market share, as redesigned products provide opportunities for pricing and promotion actions. A medical-device company deployed DTV to improve margins across its portfolio of products, from electrotherapy machines to ultrasound equipment. The company started by interviewing customers and sales teams, to understand how products were used and the parts of the experience that worked well (or not). It compared features with competitors' products, putting the top four products through "teardowns" to understand their engineering. It scoured supply markets to arrive at the "should cost" price for the most expensive components (circuit boards, displays, and so on). All this information was used to fuel a two-day workshop to generate ideas with a cross-functional team. The team suggested adding some new features and dropping others, to better align products with customers' unmet needs. A touch screen was added to one product and laser therapy to others. After DTV, one product cost 23 percent less to make, even as the company was able to price it effectively 5 percent higher.

DTV is a vital element of the broader transformation, not only for these effects but also because of its speed: it generates immediate and lasting cash-flow improvements that can fund the effort to develop new products. In fact, we have seen that DTV can make the whole program EBITDA neutral within a year—and EBITDA positive after that.

Streamline new-product development

As mentioned, companies can also put redeployed R&D teams on the product-development process, looking for efficiencies that can get the company's best ideas to market faster. In our experience, companies can trim both cost and development time by 15 to 30 percent through a disciplined lean approach to their product-development work. This means making a concerted attack on process steps that do not add value, improved resource planning, redesigned performance management and incentive systems, and a rejuvenated focus on project governance. Mitsubishi Fuso did this, and found that 40 percent of engineers' time was spent on e-mails, calls, meetings, reporting, and so on. By cutting down on these administrative activities, the company liberated 170,000 hours of engineering time in one year. The freed capacity was spread across the R&D function; but by reallocating resources, the company was able to launch many products faster and start new ones sooner.

Other companies have had similar results. Within 18 months, as this discipline becomes embedded, the product pipeline becomes markedly stronger, and companies have a more credible value proposition for new products. Streamlining product development contributes heavily to higher valuation multiples.

Create an environment where breakthroughs can happen

Few things are as compelling to investors as a track record of breakthrough products. That's largely because these skills are so rare: not many companies would argue against having more capabilities to see unique market insights and translate them into exciting new products. But these skills are within reach. New approaches to so-called design thinking are starting to bear fruit. And any company can learn the principles of unconventional market research, advanced analytics, rapid prototyping/revision, and strategic launch planning and develop a steady stream of breakthrough products.

As an example, General Mills used ethnographic techniques to gain insights for creating the first-ever yogurt in a tube. It studied families and saw that many parents had trouble getting sleepy kids to eat before rushing out the door in the morning. Insight generated: families needed an on-the-go breakfast option that could be consumed in the car or before lunch at school. Instead of trying to make the product better, General Mills developed dramatically different packaging that made consumption easier for young people on the move. Go-Gurt reached first-year sales of $37 million, rejuvenating the yogurt category and helping General Mills capture market leadership from competitors.

Smaller, privately held companies often do not devote adequate resources or energy to new-product development. To innovate properly, several things need to happen. To begin, boards and management need to encourage different behaviors. The relentless focus on short-term profits is not conducive to innovation. Management must create slack in some core processes to allow R&D innovators some creative space. At the same time, innovation must be strictly tied to corporate strategy. The concept of allowing engineers time to pursue individual projects is expensive and its benefits are uncertain. Companies must have a clear understanding of the businesses and geographies in which they plan to be active, and develop products for those opportunities.

With new products to talk about, the sales force is reinvigorated. New products create opportunities to revisit accounts, explore adjacent markets, and enter completely new ones. Our experience shows that growth is maximized when product-line transformations are accompanied by sales-force-effectiveness efforts.

■ ■ ■

When companies take all these steps, good things happen. Margins on current products jump by 15 to 30 percent. About 30 percent more products get launched, after the dogs of the portfolio are culled. One or two breakthrough products create a halo effect for the rest of the pipeline, which is itself much strengthened. And it is not uncommon to see growth accelerate by three to eight percentage points. That can boost the exit multiple one or two times—and provide an answer to those who doubt that private equity can continue to thrive. ■

[1] See, for example, Andy Kessler, "The glory days of private equity are over," *Wall Street Journal*, March 29, 2015, wsj.com.

The authors wish to thank Christine Decker Miller for her contributions to this article.

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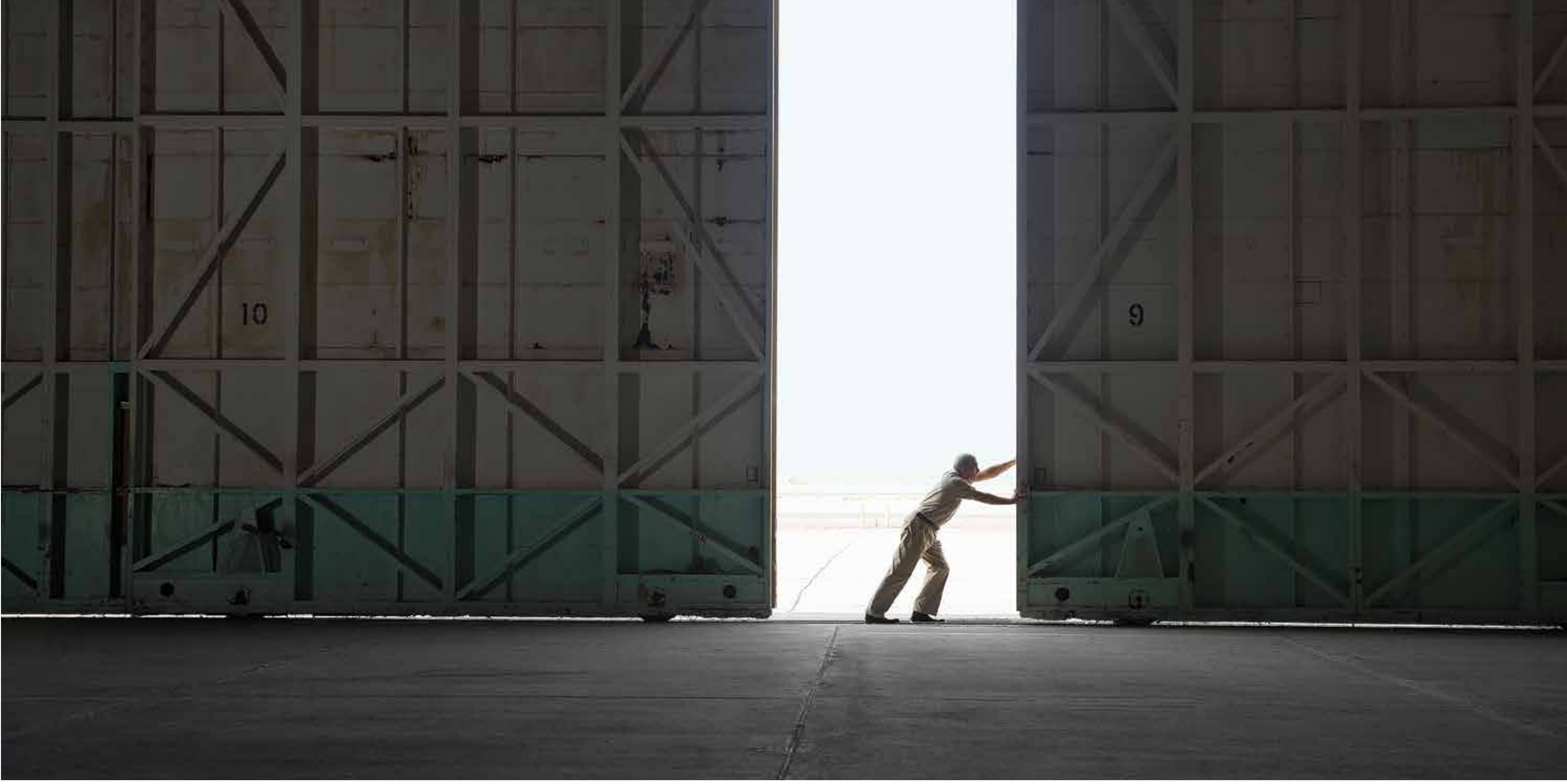


The return of zero-base budgeting

The venerable technique has vaulted back into the consciousness of corporate leaders—for good reason. But getting it right is not easy and depends on five key elements.

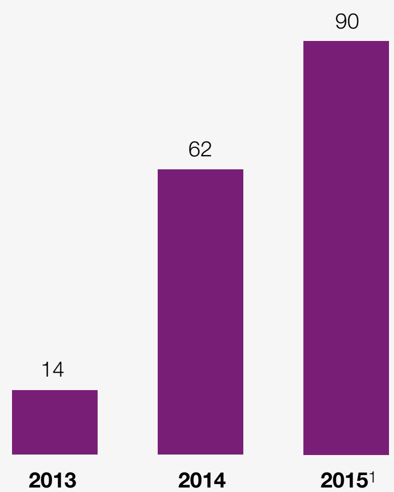
Matt Fitzpatrick and Kyle Hawke

"Zero-base budgeting" (ZBB) was first introduced to the public in a 1970 article by Peter A. Pyhrr in the *Harvard Business Review*[1] and soon gained a following. However, over the last half century, the tool became dogged by misperceptions and faded into obscurity.[2] Today, it is enjoying a renaissance. The number of companies publicly referring to zero-base budgeting has exploded over the past few years, including such disparate companies as Alcoa, Boston Scientific, Jarden Corporation, and Quiksilver (exhibit). It's not only big companies that have taken to ZBB; businesses of all sizes are taking the leap. For example, B&G Foods—a US-based multibrand company with $850 million in annual sales and less than $100 million in sales, general, and administrative (SG&A) expenses—has recently adopted ZBB. It's becoming clear that ZBB can be effective across industries, in companies big and small, and under both public and private ownership.

ZBB of the 1970s was fundamentally about ascribing each company activity to a decision "package," evaluating and ranking these packages for their costs and benefits, and allocating resources accordingly.[3] Today's ZBB is much more than that—it's a repeatable process to rigorously review every dollar in the annual budget, manage monthly financial performance, and build a culture of cost management. What makes ZBB unique is not the budgeting methodology; it is the mind-set shift that upends managers' default assumptions. Rather than compare this year's spending to last year's, Exhibit

Zero-base budgeting is back.

Number of companies mentioning zero-base budgeting on quarterly earnings calls



[1] Projected based on year-to-date mentions.
Source: Seeking Alpha; McKinsey analysis

ZBB looks instead for the most efficient return on spending, from the bottom up. As one executive who recently made the transition to ZBB told us, "It was more effective to talk about every dollar spent in terms of efficiency, and ask if it was really necessary, rather than to compare it to last year. It resets the discussion."

ZBB is especially useful for private-equity firms. It aligns well with the return-on-capital approach that the industry favors. It can eliminate unproductive costs (often as much as 10 to 25 percent of SG&A in six months), allowing owners to reallocate capital to growth, through marketing, sales, and M&A. And ZBB is a standardized and replicable playbook that can be rolled out across a portfolio of companies, ensuring aligned processes, controls, cadences, and incentives. For private-equity operating groups seeking standardization (with a helpful degree of flexibility), ZBB is the perfect fit.

Five factors of success

Some executives ask us whether zero-base budgeting is the "secret sauce" for cost reduction. It is an important tool, but just as important are the organizational elements that must support it, such as management buy-in, the organization's willingness to challenge current thinking, and its tolerance of the risks that arise when making changes to reduce costs. In our experience, the following five factors are required to build the culture of cost management that distinguishes superior ZBB from mediocre efforts:

- *Deeper visibility into cost drivers.* Companies need a granular understanding of the drivers of costs so that managers can make better and quicker decisions on how to control them. Tactically, that means grouping costs into a matrix with two dimensions—the type of expense and the owner—to make the drivers clearer. Without this visibility, it's too easy to explain away the way things are and why they cannot change.

- *Dual-ownership governance model.* Two people, the P&L owner and a leader from a functional cost center (such as IT), should focus on driving down the expenses in a given package. The addition of a second owner takes away autonomy from the P&L owner and results in an ongoing and healthy dialogue on cost management. This governance model helps spread best practices across business units and geographies. It also ensures that windfalls in one area do not get subconsciously reallocated somewhere else. That's the problem at the root of something we often hear CFOs say: "I don't understand—on paper we saved $100 million, but my EBIT is flat."

- *Rigorous processes for planning and monitoring.* Budgeting from zero is just one part of the planning process. Others include the setting of aggressive top-down targets by the C-suite (supported by detailed bottom-up analysis) and

> Zero-base budgeting is an effective tool, but it is also a thorough process that takes time to execute.

structured budget negotiations across the company, with a common fact base and analogous cost comparisons across operating units. Monthly checkups on these plans ensure that savings don't slip away and unfavorable variances are quickly addressed by both cost owners.

- *Aligned incentives.* Adding an explicit metric to measure cost performance (in addition to growth and profit) aligns compensation to cost-management objectives. Metrics should consider only what is under each manager's control, to avoid penalizing managers in the field when, say, intercompany charges and allocations from the corporate center rise.

- *Mind-set.* Perhaps the most critical change is in managers' mind-set. ZBB is most successful when managers stop trying to prove why something is the way it is and start thinking actively about ways to make it better, the same way they do at home when the money is coming out of their own wallet. This includes a shift to "arguing things in" rather than "arguing things out" and the realization that no spending is too small to be reviewed. One hundred small changes that save $100,000 apiece still add up to $10 million.

A tool for all seasons

ZBB is an effective tool, but it is also a thorough process that takes time to execute and requires management buy-in. Before budgeting begins, management needs to build a highly detailed fact base, develop visibility into cost drivers, and put in the effort needed to support aggressive top-down targets with detailed bottom-up analysis. Given the high degree of change required—the new financial-planning process, modified incentives, as well as the execution of significant cost reductions—ZBB is most effective at companies with willing and able management (often newly installed) and a small and aligned investor group that has control of the company. ZBB is less successful in growth-capital investments.

More companies are taking up ZBB every month, in every kind of circumstance. In our experience, the following situations present an ideal time to begin the transition in a portfolio company:

- at the start of the first annual budget cycle under private-equity ownership

- at a change in management, with the opportunity it presents to reset the company's behaviors and practices

- when a company is underperforming and the need to exit is rising

- when a company's performance culture resists continuous improvement

- when a company needs funding for growth initiatives

In a 2014 McKinsey survey of private-equity operating groups,[4] firms agreed that a standardized playbook across their companies is highly desirable. While some firms have made some headway in several core processes, budgeting is often more ad hoc and company specific. ZBB gives private owners the standard but flexible approach they want for perhaps the most essential corporate process: the allocation of capital.

It is thus no surprise that, 45 years after its creation, ZBB is making a comeback. Private-equity firms and others are finding it a useful framework to reset a company's default mode of operating and drive sustainable cost efficiency. This time around, ZBB seems likely to stick: the new incarnation is more likely to become a widespread norm than to fade into the ether. For ZBB 2.0, this may be just the beginning. ■

[1] Peter A. Pyhrr, "Zero-base budgeting," *Harvard Business Review*, November/December 1970, Volume 48, Number 6, pp. 111–21.
[2] See Shaun Callaghan, Kyle Hawke, and Carey Mignerey, "Five myths (and realities) about zero-based budgeting," October 2014, mckinsey.com.
[3] Pyhrr, "Zero-base budgeting."
[4] Andrew Mullin and Alex Panas, "Private-equity operations: Inside the black box," *McKinsey on Investing*, Winter 2014/15, mckinsey.com.

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Erik Hirsch on private equity

The chief investment officer of a big fund of funds explains why top-quartile performance is no longer enough.

Aly Jeddy and Bryce Klempner

Erik Hirsch is the chief investment officer of Hamilton Lane, a US-based provider of investment-management services to investors in private markets. The firm manages more than $33 billion and advises on an additional $191 billion. He spoke with McKinsey's Aly Jeddy and Bryce Klempner in April 2015.

McKinsey on Investing: *Given Hamilton Lane's size and breadth, you see as much or more of what's happening in private equity than perhaps any other limited partner (LP). Let's start with your view on the most significant changes taking place in private equity.*

Erik Hirsch: To me, the most interesting evolution is in the expansion of private-market strategies. In the past ten years, we have rapidly evolved from an industry that was simply vanilla or chocolate to one that now is Baskin-Robbins, with 31 flavors. It wasn't long ago that LPs could choose either venture capital or buyout, the chocolate or vanilla options. Sure, there were fringe strategies—growth equity, mezzanine—but the world was largely made up of only two flavors. Today, there are many more, and they continue to evolve.

One obvious implication for LPs is that it's much easier to pick funds when you only have two flavors. This year, I would estimate that Hamilton Lane will review 650 to 700 institutionally sized funds. To source and review that volume, institutional investors need substantial resources. Participating in this asset class successfully with small teams and single offices is very challenging.

Another implication is much greater flexibility in portfolio construction. General partners [GPs] and LPs can now have a real discussion about how to use the private markets to achieve objectives for returns, risk, duration, exposure, and getting the balance right in a way that they couldn't ten years ago.

McKinsey on Investing: *So the LPs' selection risk has increased. Does this mean that the GPs' track records have become less relevant?*

Erik Hirsch: It does and it doesn't. Comparing track records is easier when you're evaluating vanilla and chocolate. The comparison is much clearer. But as the world has evolved and become more complicated, not every GP fits in a neat bucket. And let's be honest—GPs often don't want to fit in a neat bucket; they want comparisons to be hard to make. And so calculating track records and truly understanding peer groups is harder today. The good news is that we have more data on this asset class, and it is increasingly accessible, though we have a long way to go.

McKinsey on Investing: *At Hamilton Lane, you see a lot of that data.*

Erik Hirsch: Yes. But data is still a great challenge for the industry. If you consider that the returns of private versus public markets are well documented and that private markets have outperformed public ones through multiple cycles, you would expect that allocations would be rising rapidly. They are not—they're rising only slightly. So you have to ask, why does the average LP allocate less than 10 percent of its portfolio to private equity [PE]? One reason is that PE has been very data constrained. That makes ranking, benchmarking, and decision making difficult for investors.

McKinsey on Investing: *Do you see that changing?*

Erik Hirsch: Yes, but not quickly. One reason is that in some cases, we've created the problem. Many people like the fact that data is private. Lots of people don't want to live in a perfectly efficient world, because lots of people make a living from inefficiencies. Some GPs have reveled in the lack of

Erik Hirsch

Vital statistics
Born September, 1972, in Charlottesville, VA

Married to Margaret McAllister

Education
Holds a bachelor's degree from University of Virginia

Career highlights
Hamilton Lane
(1999–present)
Chief investment officer and board member

Previously an investment banker with Brown Brothers Harriman

Fast facts
Regular lecturer at University of Pennsylvania's Wharton School

Frequent guest on CNBC, Fox Business, and Bloomberg TV

Engaged in a variety of charitable endeavors, including Main Line Animal Rescue and the City of Philadelphia Mural Arts Program transparency, and some LPs have too. Someone's managing those fourth-quartile funds, and someone's investing in them. Not everyone wants to see all of that brought into the light of day.

There are also some practical challenges in evaluation methods and knowing how to compare strategies. Other asset classes have managed to figure that out in far less time than PE, however, so I think the change is inevitable.

McKinsey on Investing: *What other challenges are holding back LPs?*

Erik Hirsch: One has to do with duration. PE is known to be a fairly long-term asset class, but the data suggests that it's even longer than people think. The life of most funds is not 10 years, as we expected; on average, today it's 12 to 14 years. That's a meaningful difference and certainly gives some LPs pause about locking up capital for that period of time.

Another issue is liquidity. The secondary market continues to grow, and LPs are using it for liquidity and, increasingly, for portfolio management. But this is an inefficient system that by nature produces a discount in net asset value. Add the friction costs associated with completing a transaction, and these are real stall points for a lot of LPs.

McKinsey on Investing: *You noted that private markets have outperformed public markets over the long haul. Do you see that performance continuing or changing?*

Erik Hirsch: I see it continuing. The asset class has some real advantages over the public markets—control, tight alignment of interests between GP and management, operational toolboxes that can be brought to bear. The outperformance isn't random or erratic. It is significant and it is consistent over long time frames.

McKinsey on Investing: *So is there ultimately a trade-off between the scale and the returns of this asset class?*

Erik Hirsch: The issue is really more the supply of transactions. Deal volume is shrinking. Deals come from just a few channels—the classic private owner selling to a private-equity firm, PE firms selling to other PE firms, public companies or divisions going private. "Take privates" have historically been a meaningful part of deal volume but today represent virtually none. Private-equity practitioners view the public markets as very fully priced. Even in this leverage environment, and even with the tool kit to improve businesses, practitioners are still not doing these deals. So while purchase prices in private markets are going up, most GPs would tell you they still think that private-market multiples look more attractive than public-market multiples.

So to me, the question around scale is really more about supply, not whether more capital makes the industry efficient and thereby automatically lowers performance. When you look at the classic channels—US and European buyout funds—we are at a supply–demand imbalance today, so more capital makes that worse, not better. When you look at why the industry has been growing so much, it has not been buyouts. Back to our ice-cream analogy, it's really been the arrival of all the new flavors of asset classes, plus new geographies. That's where you're seeing a lot of the growth. You're not seeing it in just another US midmarket buyout firm. That market is relatively flat, and some firms are disappearing.

McKinsey on Investing: *If developed markets are flat, what is your prognosis for emerging markets?*

Most LPs we speak to think that while these look exciting and dynamic, historically the returns have not justified the risk. How do you see that evolving?

Erik Hirsch: No question, that's what this has been historically. You can certainly find numerous exceptions, but as an asset class, emerging-market PE returns have been disappointing. You have not been rewarded for the risk, and in some cases you have not been rewarded, period. Emerging-market funds have underperformed relative to funds in the US or in Europe, and when you factor in currency volatility, geopolitical risk, et cetera, it's even worse.

Will that change? A lot of LPs flock to emerging markets believing that as public markets go, so go the private markets. The data suggests that's not true. The factors that create good public markets are often very macro, and that's not at all true in private markets. Good GDP growth, rising employment rates, a maturing demographic, or the expansion of the middle class may cause positive public-market reactions, but they may not alter the fundamental behavior or nature of an individual business.

For that performance to turn around, you need a few things to happen. One, you need to grow the talent base as managers continue to mature and expand. That's a very positive thing and will certainly help returns. Second, culturally, you're beginning to see more openness to control buyouts in emerging markets. Deal volume has largely been a growth-equity story to date, and as an asset class, that's never been our strong suit. Private equity often does best when playing a much more hands-on, active role in managing businesses, using all of the tools in its toolbox. But a lot of emerging markets have not been as receptive to that for cultural, structural, and tax reasons, among others. That is beginning to change, which will also help. The third piece is that currency hedging as a tool is more commonplace. It's more cost efficient, and GPs are becoming more adept at using it. That will help take out some of the currency risk.

All of those are good factors. You're also starting to see fund-raising decrease in a lot of those markets. Ironically, one of the things that help returns go up in our asset class is when fund-raising drops. Over the past ten years, performance in emerging markets has been relatively disappointing, so fund-raising has decreased, which I think is going to prove, over the next cycle, to be a very good thing.

McKinsey on Investing: *You have mentioned the GP tool kit a couple of times. Do you believe that active ownership can produce real, differential value for LPs? And if you see financial engineering and operational improvements as the first sets of tools, what do you think is next?*

Erik Hirsch: I do think active ownership is real when it's done well. As an industry, though, it would be grossly unfair to say that everyone does it well and that everyone has the resources; they don't. There is a huge gap in the level of resources that each firm has and how firms actually utilize them. People have prognosticated that the dispersion of returns would shrink as our asset classes grew, to which we at Hamilton Lane loudly say: That's not going to happen. Too much of the value creation is about what you do with the business after you buy it, not what you paid for it or how you sourced it. The data suggests that is still the case.

So then the question arises of what comes next. I think the tool that's beginning to come on—and it's ironic that it's coming on now and didn't sooner—is portfolio-construction techniques. A lot of GPs were investors first and portfolio constructors second, if at all. It was "find good deal, do good deal; find good deal, do good deal."

> "Elite firms are thinking about being portfolio managers, not just investors. Portfolio construction is becoming another tool for general partners to further enhance and differentiate performance."

Today, among the elite firms, I'm seeing a lot more time and attention spent on managing the internal rate of return (IRR). They're thinking more about the timing of cash flows, how assets get assembled, using tools like lines of credit as funding mechanisms—thinking about being a portfolio manager, not just an investor. That's becoming another tool for GPs to further enhance and differentiate performance.

McKinsey on Investing: *Not all IRRs are created equal—some GPs take on more risk to achieve the same result. To what extent are LPs differentiating among returns by level or type of risk?*

Erik Hirsch: It varies by LP. A surprising number don't have the tools or the resources to think through that, because the data required to do so effectively is pretty significant, and not every GP is racing to provide it. But the theory is absolutely right. It's one of the reasons a firm like ours can add real value: we have the tools, the data, and the resources to go and figure all that out. So for us, that is a key criterion, and we spend a lot of time tracing every dollar of gain to understand where it came from. It could come from multiple expansion, from earnings growth, from leverage, or from some combination. Tracing that gain is a key part of our due diligence. Then you can begin tracing the gain in portfolio decisions—how much came from timing, from sector weighting, from IRR-enhancement tools. You begin to draw the full picture by tracing back each of those underlying pieces.

But as an industry, frankly, I think we've done a pretty lackluster job at either rewarding or punishing risk and risk management. There has just been a fairly exclusive focus on returns and not enough focus on the broader picture.

McKinsey on Investing: *Continuing with that line of thought, what are some of the greatest misconceptions LPs have about private equity, and what do you see as GPs' greatest misconceptions about LPs?*

Erik Hirsch: It's probably easier to start with the latter. Most GPs are not particularly good students of their own asset class. For their portfolio companies, they know chapter and verse about the competitive environment, but they tend to know very little about other GPs. This is somewhat understandable as data is hard to come by, and good data even harder. But very few GPs seem to think about the world that way. They have grown up believing that if they do a good job and generate a top-quartile return, they should and will be funded by LPs.

GPs forget that we're in a world of a few thousand fund managers, so even the top quartile is still a really big pool. A typical Hamilton Lane client invests in six to ten funds a year. Last year alone, screening out all the noise, we saw 630 fund managers that could work for an institution, raising funds of at least $100 million. So if you allocate to six to ten funds, you're investing in 1 to 2 percent of the total asset class. If a GP's sole pitch is that it's in the top quartile, that isn't exactly compelling.

McKinsey on Investing: *So does that mean the top decile is the new top quartile? Or that being in the top quartile is now just table stakes?*

Erik Hirsch: I think it means some of both. It also means that LPs are becoming more sophisticated about portfolio construction. The LPs' portfolio-construction approach used to be "find GPs I like, back them, keep backing them, keep finding new GPs that I like, and back them too." Those LPs then woke up after several years and realized they had 200 funds, many with duplicative strategies, similar returns, and similar risk profiles. So now they've diversified for the sake of diversity.

The other reality is that the asset class is becoming more expensive to manage. LPs' legal bills are all going up because they're dealing with more amendments, more fund extensions, and so on. We all want more data, but getting, tracking, and storing more data is also expensive. The more funds you do due diligence on, the more it costs.

So LPs are thinking about how to limit the number of GPs. They are doing new things, like secondaries. Ten years ago, an LP selling a big part of its private-equity portfolio meant that something bad was happening in its organization. Today, secondaries are becoming much more of a portfolio-construction tool. Some LPs today will do a secondary sale if the returns look right, then turn around and redeploy that money elsewhere. Portfolio management is changing.

Most LPs today are not making the decision to invest simply because of the returns number or the benchmark. Top quartile is a start, but the LP is then going to have to move quickly to questions like what this is going to do for the portfolio and the bigger and better questions: "Do I need this? What is adding that next GP doing for us? Is it providing diversification that we have lacked? A different type of cash-flow stream? A different type of risk or return profile?" If the answer is none of the above, the LP is just adding costs to its portfolio management and getting little in return.

This is one reason you're seeing relationships between some GPs and LPs expand. It's better for the LPs to have fewer partners that can do more for them. And some of the GPs are taking advantage of that—through bigger strategic partnerships and separate accounts.

McKinsey on Investing: *What services do LPs value most today?*

Erik Hirsch: Mainly, it's having one GP that invests across multiple strategies. With such a partner, LPs are diversifying strategy and returns, but doing so with less friction cost because there's only one partner to manage.

McKinsey on Investing: *To what extent do you see LPs beginning to insource capabilities? Is there a tension in expanding GP relationships while bringing capabilities in-house?*

Erik Hirsch: Bringing capabilities in-house is more spoken about than actually done. Very few LPs are truly equipped to execute as a GP would using in-house resources. For most, cost remains a real challenge; it is tough for them to attract and retain the right talent. Add all the other resources required—multiple offices, operating partners—and this is a difficult model to replicate well. Some will, that's inevitable, but this will be the exception, not the rule. The resource gap is growing wider. GPs are adding more resources every day. So the challenges of replicating that model are increasing.

If there's a tension, it's closer to "What have you done for me lately?" The LPs' expectations of the biggest bang for the buck continue to rise. There are more demands being put on LPs by constituents and boards, and they in turn relay those pressures back to the GP. Transparency is chief among those pressures. Ask GPs which costs have risen fastest in the past few years, and they'll tell you that it's back-office and investor-relations personnel.

McKinsey on Investing: *This falls under the broader rubric of GPs becoming institutionalized. Where do you see them making progress and where are they struggling?*

Erik Hirsch: The dispersion in the level of professionalization and institutionalization is vast and will stay vast for a long time. GPs have to make a real choice whether to professionalize or not—not all GPs believe they need to do this. Overall, the trend is a good one because while people chafe at increased regulation, it does bring increased professionalization, and LPs benefit from transparency, disclosure, and better access to information.

The flip side, though, is that this adds a lot of costs for LPs, who need to build out their infrastructure. You can't track your private-markets portfolio today in all of its detailed glory using Excel and some notebooks. You need to invest in real technology and in the personnel for managing it or to outsource it to a provider. Either way, that's a real cost. I think the outcome is going to be better, but it's not free.

McKinsey on Investing: *What new kinds of LPs are entering the private-equity asset class?*

Erik Hirsch: We see new LPs every day. A surprising number just hadn't gotten around to investing in the private markets earlier. Sometimes, they were not investing because of misperceptions, and they entered as those misperceptions were cleared up. Some in the media still say you could replicate the return stream by simply levering the public markets—which is completely false. Others say the only way to make money is by slashing jobs and slashing costs. That too is simply not true.

New pockets of capital are also arriving from different geographies. The question of how to package this asset class effectively for the high-net-worth or retail channel has not yet been solved but inevitably will be. That will be good for new capital flowing in, but it does make us ask whether the asset class can absorb all the capital. Institutional investors need to think about whether they will be seen by GPs as an attractive source of capital in the future if GPs have unfettered access to the retail market.

McKinsey on Investing: *As that plays out, how do you see the power dynamic shifting between GPs and LPs?*

Erik Hirsch: You can imagine a world in which the retail code is cracked and funds are packaged and sold freely so GPs have essentially unlimited access to capital. Retail investors have historically been less demanding because they're fragmented, with no lead voice demanding transparency or meetings. That market has been very cost insensitive relative to the institutional channel. As a GP, this world probably looks much more attractive to you than the institutional world.

But this retail world is also prone to class-action lawsuits. It opens you up to public scrutiny that perhaps you don't have today, and distributing and managing the capital base is expensive. What emerges is likely not going to be either extreme, but today it's not clear what that reality will look like. The institutional investors need to understand that although to date public pension funds and sovereigns have been the loudest and most important voices in the room, things may not stay that way forever.

McKinsey on Investing: *Let's talk about the ecosystem surrounding GPs and LPs. What is the outlook for funds of funds and investment consultants over the next five to ten years?*

Erik Hirsch: It's very fluid. There's a real difference between a service provider like ourselves and a simple fund of funds. To me, the fund of funds–only world is challenged because institutions want high levels of customization. Funds of funds, by their very nature, are more one size fits all. If the retail market thrives, that will probably be good for funds of funds. For the small-market investor or for the retail investor, this may be the only option.

The environment for broader service providers like us is different. Adding another layer of cost is never seen as a good thing, so we have to prove our value. Again, back to our ice-cream analogy, it is more complicated than ever before to navigate through all the flavors and to choose wisely and to assemble them in the proper way. And the resources needed to do so are higher than ever before.

Then there are all the other supporting pieces. You want to be active in the secondary markets because they are a good portfolio-management tool; you need resources to do that. You want to do coinvestments; you need resources. You want to track and analyze the massive amount of data that we're demanding and expecting; you need resources. We have those resources, but the clients' expectations go up every day. We try to stay one step ahead. ■

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New horizons for infrastructure investing

Investors are having trouble finding attractive deals. They might be looking in the wrong places.

Tyler Duvall, Alastair Green, and Mike Kerlin

The world needs new infrastructure—$57 trillion worth over the next 15 years, according to the McKinsey Global Institute. That's an enormous sum, but as investors well know, there is no shortage of capital. Institutional investors are jumping in with both feet; indeed, infrastructure is now seen as an asset class in its own right. Limited partners and giant sovereign-wealth funds are putting money into play. Multilateral and development-finance institutions also are stepping up their efforts. Across all investor groups, we estimate that more than $5 trillion a year is available to build airports, roads, ports, and so on.

If capital is not the problem, then what is? Investors are having trouble finding attractive projects. At a recent Global Infrastructure Initiative Roundtable held in New York, a senior member of a leading global infrastructure investor pointed out that his challenge is to clarify risk and policy uncertainties associated with potential deals, rather than find the capital to pursue them.

It seems that, in some ways, investors have not yet turned over all the necessary rocks. New winning deals can be found if investors shift gears and try new approaches. Here are three principles that can guide the search.

Consider emerging markets and greenfield assets

Investors need to deal with each emerging market individually and harness local knowledge on the way. That may sound obvious, but it needs to be said. The fact is, many investors (or their limited partners) restrict themselves to Organisation for Economic Co-operation and Development (OECD) members or other investment-grade countries. Others will not take on "greenfield assets"—new-build infrastructure projects where investors must take on the risk of development and construction. Instead, they prefer to focus on already-built brownfield assets. As another infrastructure investor recently told us, one reason is that emerging markets' greenfield assets present more severe information asymmetries to foreign investors.

As more money flows into brownfield OECD markets (industry-data provider Preqin has estimated that the number of institutional investors in the sector more than doubled between 2011 and 2014), heightened competition is placing pressure on returns. Although measuring precise changes in such investments is difficult, many institutional investors with long track records are looking beyond brownfield OECD infrastructure assets in response to rising prices.

Investors who want to consider these types of opportunities should be aware that doing so could mean taking calculated risks in emerging markets; adopting a country-by-country approach to risk assessment is important. But identifying appropriate returns for each market is not easy, in part because of the scarcity of reliable information regarding typical returns from infrastructure projects by asset class, region, and stage of investment. The rewards of emerging-market deals can be significant (for instance, power-plant deals can often generate project-level returns 5 to 10 percent higher than for a comparable OECD project, although they typically entail greater currency, political, or counterparty risk).

In addition, investors might want to ensure that limited-partner agreements allow them the flexibility to invest in what may be considered riskier countries, as long as these markets meet certain criteria. For instance, if investors consider a country like Croatia, they would find that though the three major rating agencies rate the country as sub-investment-grade, Croatia has an attractive regime of public–private partnerships (PPPs). The Economist Intelligence Unit rates it well ahead of its peers in southern Europe in many ways, and it has a more favorable legal and regulatory profile than a number of countries that do better at attracting capital. Infrastructure projects in countries like Croatia that fall just outside investment grade (rated BB+ through BB– by Standard & Poor's) account for $4 trillion of infrastructure needs over the next five years.

Smart investors will deploy a variety of tactics—not least assessing the sometimes considerable risk profiles of potential investments and partnering with local sponsors and development-finance institutions—in order to pursue high-growth projects where fewer players are at the bidding table.

Bid for overlooked public assets

Many governments, particularly in developing markets, are sitting on a stock of cash-generating assets. The world's infrastructure stock is valued at an estimated $48 trillion. Some of these assets are already profitable, while others could turn a profit if operations improved. There are examples at hand. Greece's government recently agreed to sell a network of 14 regional airports to a consortium, and in 2013, the Brazilian government sold for nearly $800 million a 30-year concession to operate Confins Airport in the state of Minas Gerais.

Reforming or privatizing state-owned infrastructure presents challenges, of course. An asset may operate at a loss, have a difficult labor situation, or need to be untangled from other businesses unsuitable for privatization. Despite these complexities, purchasing these assets can yield greater returns from selling assets or turning money-losing assets into profitable ones. For example, Jordan's Queen Alia Airport once required a government subsidy to operate; a private-sector operator not only has invested in its expansion but also makes enough money that it can now pay fees to the government and remain profitable.

Deepen partnerships with infrastructure providers

The infrastructure-finance market is plagued by a lack of information. Governments and businesses aren't in the habit of sharing best practices or benchmarks with one another, much less the details of what went wrong (or even right). Governments, investors, developers, and operators alike would benefit from sharing more information, in more structured ways. Many governments recognize that developers can be a valuable source of ideas—for example, about which projects would have the best economic returns or how to attract private investment. Early evaluation of project plans can help prospective bidders warn governments if the project looks unviable.

One way to contribute ideas and expertise is to submit unsolicited proposals for infrastructure projects to governments that allow such proposals. Brazil and Colombia, two of the busiest and most promising infrastructure markets in South America, accept them. Other entities are seeking to open new channels of communication. For example, the Port Authority of New York and New Jersey has invited private investors and developers to share their perspectives on how to develop the region's infrastructure. Tanzania's government uses "delivery labs" of public-, private-, and social-sector experts to set infrastructure-investment plans. And Chile has developed a way of evaluating PPP projects that rewards developers for proposing low-cost solutions to national-infrastructure problems. These are just a few of the governments showing a growing interest in investors' views.

■ ■ ■

It's common today to hear that too much capital is chasing too few infrastructure assets. But the problem is not a lack of worthy projects; it's a lack of expertise and, perhaps, daring. Finding attractively priced assets with solid economics is not easy—it requires a change to traditional ways of working. But the deals investors uncover can repay the effort. ■

This article was adapted from "Making the most of a wealth of infrastructure finance," *Rethinking Infrastructure*, May 2015, mckinsey.com.

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Joining the family business: An emerging opportunity for investors

Family-owned businesses are a large and growing force, especially in emerging markets. Those who would invest in these companies must first understand them.

Åsa Björnberg, Heinz-Peter Elstrodt, and Vivek Pandit

Almost all of today's biggest companies came into being through the work of a founder and family. Over time, in developed markets, ownership tends to become dispersed. Less than one-third of the companies in the S&P 500, for example, are still controlled by founding families. The picture is quite different in emerging economies. Approximately 60 percent of their private-sector companies with revenues of $1 billion or more were owned by their founders or families in 2010. And there are good reasons to suspect that proportion will only increase. As brisk growth propels emerging regions and their family-owned businesses forward, our analysis suggests that an additional 4,000 of them could hit $1 billion in sales in the years from 2010 to 2025 (Exhibit 1). If that's how things shake out, such companies will represent nearly 40 percent of the world's large enterprises in 2025, up from roughly 15 percent in 2010. Developing an understanding of them, therefore, is fast becoming a crucial long-term priority for would-be investors. What follows is a brief guide to their attractions—and some complicating factors.

Why past may not be prologue

The starting point for many family-controlled local companies is a demonstrable, even dominant, "home field" advantage; they have a deep understanding of their countries and industries, as well as considerable influence on regulators and domestic policy. They derive this from years of personal relationships with stakeholders across the value chain. Many have proved resilient through times of economic crisis.[1]

The very fact that they are family businesses may be advantageous in emerging economies. Where the conventions of commercial law and corporate identity are less developed, doing business on behalf of a family can signal greater accountability—the family's reputation is at stake—and a stronger commitment to a "through-cycle view" of their businesses. Indeed, we have observed circumstances where a personal commitment from the owner of a family business was as powerful as a signed contract.

They can also work fast. As one executive at such a company told us, "All the world is trying to make managers think like owners. If we put in one of the owners to manage, we don't need to solve this problem." An owner–manager can move much more rapidly than an executive hired from outside. The friction costs of delayed decisions from passing them up a chain of command or putting them in front of an uncooperative board, as well as many of the principal–agent challenges that confront non-family-controlled companies, are neutralized. Family-owned businesses can therefore place big bets quickly, though, of course, there's no guarantee that the bets will pay off. Still, owner–managers are largely relieved of the quarter-to-quarter, short-term benchmarks that can define—and distort—performance in Western public companies, so they're freer to make the hard choices necessary to create long-term value.

Exhibit 1 **A growing number of family-owned businesses in emerging markets could hit $1 billion in sales from 2010 to 2025.**

[1] Projection based on city GDP forecasts.
[2] As of 2013 or closest available year, captured at headquarters location.

Source: Bloomberg; company websites; *EXAME* magazine's 2013 Melhores & Maiores list; *Jeune Afrique*'s Top 500 African Companies; Kisvalue; Mexico's Secretariat of Finance and Public Credit; PRIME news agency's rating of Russian family-owned businesses; Prowess; Zawya; McKinsey Global Institute analysis

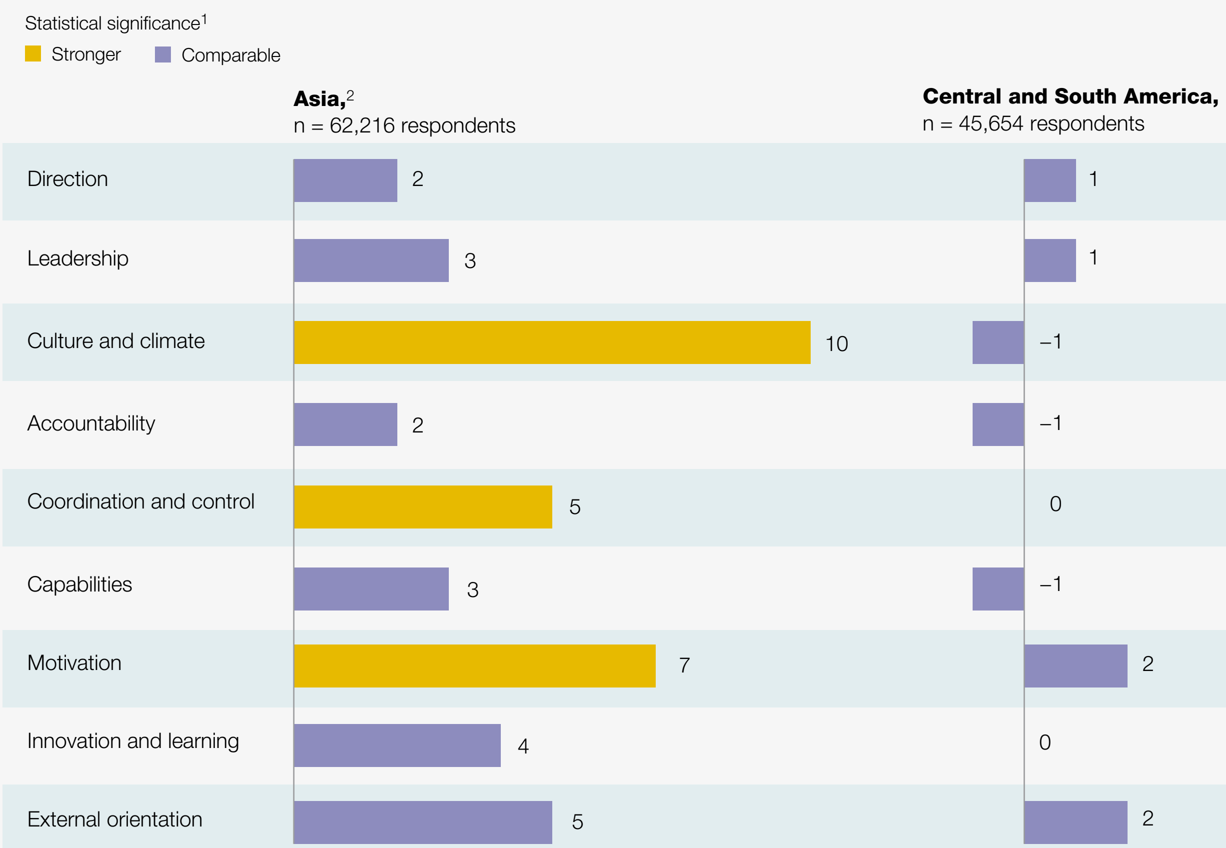
Indeed, the owners' long time horizons and sense of mission often suffuse the whole organization. A McKinsey survey of businesses owned by families and founders showed that 90 percent of board members and top managers—family members or not—said that family values were present in the organization, and fully 70 percent said these values were part of the business's day-to-day operations.

In McKinsey's long-running study of organizational health,[2] businesses owned by families and founders in emerging markets—some 60 leading companies in Asia, Central America, and South America, with more than 100,000 survey respondents—had health outcomes better than or comparable to those of other companies in the same markets (Exhibit 2). Moreover, in Asia these companies are stronger than

Exhibit 2

Family-owned businesses in emerging markets have organizational-health outcomes better than or comparable to those of non-family-owned businesses in those same markets.

Gap between Organizational Health Index scores of family-owned businesses vs those of non-family-owned



[1] Difference statistically significant at 95% confidence level.
[2] Emerging markets only.

Source: McKinsey analysis

their non-family-owned counterparts on several specific management practices, including shared vision, strategic clarity, employee involvement, and creativity and entrepreneurship.

For all these reasons, family businesses are attractive to investors. In a world where free-flowing capital seeks out success, the emerging markets' strong-performing publicly traded family businesses will likely be rewarded. In India recently, nearly 70 percent of private investment has gone into family businesses. Market-leading ones can expect to be sought out by potential investors and venture partners alike, for success is a magnet. Even weaker family-owned businesses can lure investment. Some have ownership models that are inflexible and lack transparency, drawing the attention of activist investors who see value in better governance, more disciplined capital structuring, and getting out of so-called hobby businesses that support family members.

Playing by the family rules

That said, investors need to tread carefully. The resilience of family-owned businesses in emerging markets contains a paradox for investors. Many private-equity firms and institutional investors approach these markets in search of rapid growth, yet the family-owned businesses they're considering partnering with are balancing the importance of liquidity against an extremely long view. Founders and families hold their shares for decades, even centuries. "For us," the chairman of such a business explained, "short term is 5 years, and medium term is 20 years—that is, one generation." Some investors have similarly long horizons. But others find that mismatched time horizons can create tensions that undermine strategic partnerships. Exacerbating matters is the volatility of many emerging markets. Many deal partners and portfolio managers have barely experienced a full business cycle, so they struggle to understand and quantify risk, to form a through-cycle view of the opportunities, and thus to partner meaningfully with their peers in family-owned businesses.

The conglomerate nature of many family-owned companies makes for a good fit with investors with similarly diversified interests. As our colleagues have noted, the largest conglomerates in China, India, and South Korea are entering new businesses (often in unrelated industries) at a startling pace, adding an average of one new-business entry every 18 months.[3] Almost 70 percent of these diversifying conglomerates are family or founder owned. In large part, they aspire to play the portfolio game, reallocating capital more frequently by taking advantage of access to talent and capital, as well as allocating family assets across different industries. This is an appropriate strategy for preserving wealth over the long term—and one that, our research finds, is paying dividends for conglomerates in the BRIC countries.[4]

However, investors must be prepared for the unexpected. Family-owned companies making moves into or out of seemingly unrelated industries can show up as competitors, partners, asset purchasers, or sellers, with varying degrees of success.[5] And families' expectations of investors can be high. In a recent survey of family-controlled portfolio companies of private-equity firms in India, most gave high marks to their investors for improving board efficiency and providing valued strategic input. But they had several unmet expectations, including access to new customers, new opportunities sourced from external networks, and expertise to support operational improvements. The survey also found that while investors support strong governance and strategic guidance from the vantage of a board seat, family owners often blur lines between governing and operational roles, placing value on developing new opportunities and capacity.

The big question for investors in family businesses is, of course, succession. Fewer than 30 percent of family- and founder-owned businesses around the world survive to the third generation as family-owned businesses,[6] and it's an open question whether those in emerging markets will fare any better. History suggests they won't. While statistics are scarce, a comparison of the top 20 family-owned businesses in a given emerging market 20 years ago with today's leaders shows great discrepancies. Nonetheless, there is some reason for optimism: the factors behind successful transitions are reasonably well known, and much can be learned from companies that failed the test. (Today's family-owned businesses in emerging markets are more likely than ever to engage in careful succession planning.) Still, the basic challenges—such as family feuds, nepotism, and the gradual loss of entrepreneurship when leadership passes on to new generations—will surely bring down many family-owned companies in emerging markets, as they have elsewhere.

The time when power transfers from one generation to the next is also a window for investment. As succession unfolds, the family must deal with the central question: Is the family the best owner or manager of a company, or is it in business to support the family? In essence, family first or business first? Potential partners, investors, and competitors should seek to understand a company's family tree, ownership models, and current succession processes before drawing conclusions about sustainability.

Finally, people who watch emerging markets should keep a weather eye on the role of regulation. Many governments in these countries struggle to strike a balance between, on the one hand, extending support to family-owned businesses that are, at times, synonymous with excess or entrenched privilege and, on the other, fostering development via entrepreneurship to promote job creation.[7] Would-be investors ignore at their peril both the potential of family-owned businesses and the policy interventions to reshape the nature of competition in these markets quickly and dramatically. ■

1 For example, across Asia, businesses owned by families or founders have increased their share of total market capitalization since 2008, while state-owned enterprises have ceded share over the same period. For more, see "Avoiding the dinosaur trap," *Economist*, May 31, 2014, economist.com.

2 McKinsey Organizational Health Index (a McKinsey Solution), mckinseysolutions.com.

3 See Martin Hirt, Sven Smit, and Wonsik Yoo, "Understanding Asia's conglomerates," *McKinsey Quarterly*, February 2013, mckinsey.com.

4 Brazil, Russia, India, and China.

5 To be sure, many founder- and family-owned businesses struggle in these circumstances. For example, one of India's largest such conglomerates has a long tail of value-destroying companies in sectors where more focused players have delivered higher returns. Ultimately, the fundamentals—coherence in strategy, strong decision making, and the ability to realize synergies—still apply.

6 See Christian Caspar, Ana Karina Dias, and Heinz-Peter Elstrodt, "The five attributes of enduring family businesses," *McKinsey Quarterly*, January 2010, mckinsey.com.

7 See "The new age of crony capitalism," *Economist*, March 15, 2014, economist.com.

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A conversation with Jim Coulter

In the second part of our 2014 interview, the veteran investor talks about emerging markets, industry consolidation, and why private equity is as bold as it ever was.

Aly Jeddy and Gary Pinkus

Jim Coulter is cofounder and CEO of TPG, a leading global private-investment firm. As one of the principals in the creation of the modern private-equity industry, and an experienced investor in other alternatives, Coulter has seen most of the sector's ups and downs. McKinsey's Aly Jeddy and Gary Pinkus spoke with him in September 2014. The first part of the conversation can be found on mckinsey.com.

McKinsey on Investing: *Market multiples, at least in the Russell 2000, are at historically high levels. What are the implications for private-equity returns?*

Jim Coulter: Given the current low-interest-rate environment, multiples for midsize companies are at levels that make me very nervous. Over the past four or five years, increasing multiples and rising earnings have floated almost all boats in public and private markets. However, today when we run three- to five-year models, we are consistently underwriting to exit multiples below today's levels. To reach the returns we seek for our investors in a period when we might expect multiples to contract, we have to find situations where growth or a positive discontinuity in the company's performance will create excellent returns. It is a period where private equity's ability to add value will drive performance that won't be available in the broad public markets.

McKinsey on Investing: *So there are certain subsectors where you'd expect multiples not to deteriorate or perhaps even to increase?*

Jim Coulter: Even if multiples come down, the growth and disruption in certain subsectors of the economy is such that you can reach returns

Jim Coulter

Vital statistics
Born December 1, 1959, in Buffalo, NY

Married, with 3 children

Education
Graduated from Dartmouth College and Stanford Graduate School of Business

Career highlights
TPG
(1992–present)
Founding partner and CEO

Keystone Asset Management
(1986–92)

Fast facts
Serves on numerous corporate and charitable boards

Serves on the Dartmouth College board of trustees and the Stanford University board of trustees

Cochairs the LEAD Commission, which seeks to develop a blueprint detailing the opportunity for using technology as a catalyst to transform and improve American education

that we consider attractive. For example, there is a fundamental shift under way in the healthcare industry, which represents an enormous portion of our economy. Government efforts to reshape the industry can provide significant opportunity if you know your way through the industry chaos. The combination of shale technology and price instability in the energy markets is currently yielding a very interesting set of energy-sector opportunities. E-commerce is disrupting the retail industry at an increasing rate. We are in a period when there will be a premium reward for wise sector choices.

McKinsey on Investing: *When you invest in these sectors, presumably you make different assumptions than you might in a classic leveraged buyout. How does the analytic process change, if at all?*

Jim Coulter: We've been very careful through this cycle not to lean too heavily on leveraged returns. In some ways, leverage can be the devil's candy of private equity. In 2007, 59 percent of leveraged buyouts were done with leverage ratios greater than six times. From 2009 to 2011, that fell to 13 percent. But in the second quarter of 2014, 72 percent of deals were done with more than six times leverage. One of the misconceptions about private equity is that periods when leverage is easily available are good for the industry. In fact, such periods tend to drive higher pricing, and my experience has been that one of the things you can't fix in the private-equity market is price. So in this cycle, we have not been leaning into the full availability of leverage in the marketplace.

At TPG we think of private equity as three types of business. One is traditional buyouts, typically high-quality companies where balance-sheet change and investment insights are the key differentiators. The second is transformations, which usually involve a change in management and almost always a strategic change. The third is more off the beaten path: one-off, situation-specific restructurings of one kind or another.

Today we are doing fewer traditional buyouts than we have at other times. The reason is not that there aren't some great companies for sale but rather that the combination of high multiples and widely available leverage suggests to us that this is a time to pull back from these types of transactions. On the other hand, the amount of disruption in the economy in various sectors means that we are doing more of the second type of investing, transformations. We are focusing on buying companies and changing them, which can pay off in interesting ways.

McKinsey on Investing: *Will that change as the economic cycle changes?*

Jim Coulter: In the early part of the cyclical upturn, one wants to invest in companies that will respond well to broad-based expansion. Consensus would put us now somewhere around the midpoint of the cycle, particularly in the United States. At this stage, I counsel caution on making cyclical calls, and a focus on sectorial or secular calls where one chooses industries or specific situations that are interesting. It's the equivalent of a stock picker's market. Later in the cycle, one might move into a more defensive posture.

McKinsey on Investing: *At the risk of asking you to call something that's uncallable, do you see a couple years remaining in this cycle?*

Jim Coulter: We're pretty constructive on both earnings and the market in the intermediate term. Our companies are doing well, with earnings before interest, taxes, depreciation, and amortization across the portfolio up 13 percent in 2013, and momentum seems to be continuing. However, for new investments, we are looking not at the intermediate term but out three to five years. As we get closer to the top of the cycle, we tend to become more conservative on the economy in general and more micro focused. It is a time to rely on our differentiated sector expertise to see things that the market doesn't. That's what active management and creating alpha is all about. So while we are constructive on the near term, we are increasingly cautious as we consider new investments. It's an interesting dynamic.

McKinsey on Investing: *Where are you seeing the greatest growth in the alternative-asset marketplace?*

Jim Coulter: Over the past few years, the greatest growth in alternative assets has actually been in credit-related products. That's been driven first by investors, who have exercised caution in the aftermath of the financial crisis; the coupon and downside protection have seemed relatively attractive. Second, it's been driven by performance. The historically low interest rates have obviously driven any credit-related product to reasonably strong performance over the past five to seven years. And third, many investors have had a desire for more alternatives, but with already relatively full allocations to private equity, they have been branching into credit.

Alongside credit, there's an area that I'm not sure I can quite define called "opportunistic," which a surprising number of our investors are designating as an asset class in its own right. These investments can sometimes be credit, sometimes equity. They're often highly structured. They can be distressed debt, medical royalties, intellectual-property portfolios, agricultural land, or timber. These assets may not have shown up historically in investors' portfolios but are areas of increasing interest to institutional investors.

McKinsey on Investing: *What has been happening in private equity outside the United States?*

Jim Coulter: The most attractive region for private equity over the past five years has been the US, not emerging markets, which have underperformed. That's due in part to the stock markets in those areas and in part to disappointing growth relative to expectations. European credit has been an area of high interest to limited partners [LPs] and provided good early returns. There's an emerging desire for what are sometimes called frontier markets: Africa, non-China and non-India Asia, Brazil, Colombia, Mexico, and Turkey.

McKinsey on Investing: *The approach to investing in emerging markets is different. How would you characterize it?*

Jim Coulter: It's a different business. Quite often if companies in these markets want to sell control, you don't want it. Investing in these regions is more about growth and partnership than leverage. And it's about value-added investing. If you think you're going to go into Asia because they need the money, you haven't studied economics recently.

McKinsey on Investing: *Partnership in these investments often comes down to control. We see control investments on the rise. Your thoughts?*

Jim Coulter: I would say they are on the rise, particularly in China and India. But they are still a relatively small part of the market. And emerging-market private-equity firms often define control differently. You'll find that most Asian general partners [GPs], if they have the right to a board seat or to appoint the CFO, they count that as control. But it's a shared control rather than absolute control. In many ways, it resembles the growth equity market in the US more than it does the traditional private-equity market.

McKinsey on Investing: *What do these regional differences mean for industry structure? The industry continues to have a lot of firms, but capital has concentrated dramatically in just a few of them. Do you see that changing?*

Jim Coulter: The industry will likely always be a complex combination of point products, specialty firms, and a limited number of large platforms. However, at the moment, it is relatively unconsolidated compared with most other financial-services industries. The entrepreneurial nature of the business means that it will not become as consolidated as many other financial services.

But we do think consolidation will increase, in part because the increasingly sophisticated large platforms are likely to grow faster than the rest of the industry, as they have been doing for the past seven or eight years. Second, a generation of firms has grown up and in some ways institutionalized over the past several years. Their founders are nearer to the end of their careers than the beginning. How leadership passes to the next generation, or whether some of these firms will consolidate, will be one of the more interesting dynamics to watch over the coming years.

McKinsey on Investing: *Mergers of firms in talent-based industries are often quite difficult. If they begin to happen, what do you think will drive them?*

Jim Coulter: One factor is capital. A key question for larger platforms as they mature is how important capital will be in that maturation. A number of the large platforms have been quite intelligent about using capital to build products and serve their clients.

A second factor is that with some participants now publicly traded, we see that there is enterprise value within private-equity firms. Founders and partners will want to realize the enterprise value they have created. The highest enterprise value is likely to be for diversified platforms. Investors will always be worried about single-product financial firms, whether they are investment banks or asset managers. If partners in firms require liquidity or access to value, a larger diversified platform may have advantages relative to individual-firm solutions. This could drive consolidation.

McKinsey on Investing: *If firms can solve that problem, how do they then manage the resulting combined firm? What are your thoughts on talent management in professional-services firms? Has it changed?*

Jim Coulter: At the end of the day, we have two raw materials: people and capital. Of those, people are the most likely source of long-term advantage. We consider ourselves a deeply talent-driven organization. My job as CEO is to enable and empower the "special forces"—our professionals, whose job is to go find next year's ideas and new areas with the right risk-reward ratio to take to our clients—and to continue to grow and innovate at our firm. Private equity continues to be a destination of choice for people who are interested in both investing and having an impact on the company they work for.

I tell people entering our organization today that it's the most fascinating time ever to be at TPG because your potential career path and intellectual growth have more upside than they ever have. If you want to build a traditional career in private equity and grow to run a sector, you can do that, but you can also transfer to our Beijing office, move over to credit or to hedge funds, or work in our distribution group. We now have more diversity of choice for people who want to be entrepreneurial with their careers than we have ever had.

McKinsey on Investing: *Some say the industry is now less bold than it once was. What are your thoughts?*

Jim Coulter: I think that's a misconception. The analogy I might use is that when you've been at a rock concert for four hours, it doesn't seem so loud anymore. If you've been watching private equity for 25 years, the boldness continues, although we are perhaps more inured to it. TPG began its existence with an airline restructuring, one of the biggest bankruptcies in that era. At the time, one of our LPs told us, "If it wasn't you, I'd think this was crazy." And yet today, there are whole firms built on this concept of restructuring bankrupt companies. Similarly, when we went into South Korea in the 1990s to restructure a bank, people scratched their heads. Well, we just restructured a bank in a much more exotic place, Sri Lanka, and barely anyone noticed.

Private equity is constantly moving out to the edge of new things, but because the industry is so big and complex, these moves don't stand out as much as they did historically.

McKinsey on Investing: *A final question. Secondary buyouts are about a third of the buyout market in the United States and more than 50 percent in Europe. LPs now have a decent chance of*

> "We have two raw materials: people and capital. Of those, people are the most likely source of long-term advantage."

being on both sides of these transactions. They owned the company before, and they owned it afterward, through two different GPs. Can you imagine a model emerging of some kind of permanent capital, which would remove transaction costs for LPs and allow them to manage to their liability stream in a way that's more efficient for the market overall?

Jim Coulter: I would make two points. First of all, secondary buyouts have performed much better than people had expected. They have tended to be less volatile and to perform in line with primary buyouts, in part because seasoned companies with demonstrated ability to function with leveraged balance sheets tend to dominate the secondary-buyout market. Second, a number of LPs and GPs are examining the question of whether there are alternative structures and different economic arrangements that would allow them to own assets for much longer periods of time. I think this is probably a likely evolution, but an evolution that will be challenged by the difficulty of knowing a priori which companies deserve a longer hold.

McKinsey on Investing: *So rather than a fund of permanent capital, you see potential for a structured set of investments in which some would have a component of longer-term capital?*

Jim Coulter: Yes. If you think about it, we have a limited-duration fund, and we're measured by how much capital we return over that time, which is when we're fund-raising again. That creates some incentives—not huge ones, but still incentives—for us to sell assets while our LPs are still comfortable holding them. So the question is whether there are ways to extend the holding period for certain companies in a way that would be attractive to both the LPs and GPs. I'm not sure that structure has yet been created successfully, but I suspect there are discussions under way. ■

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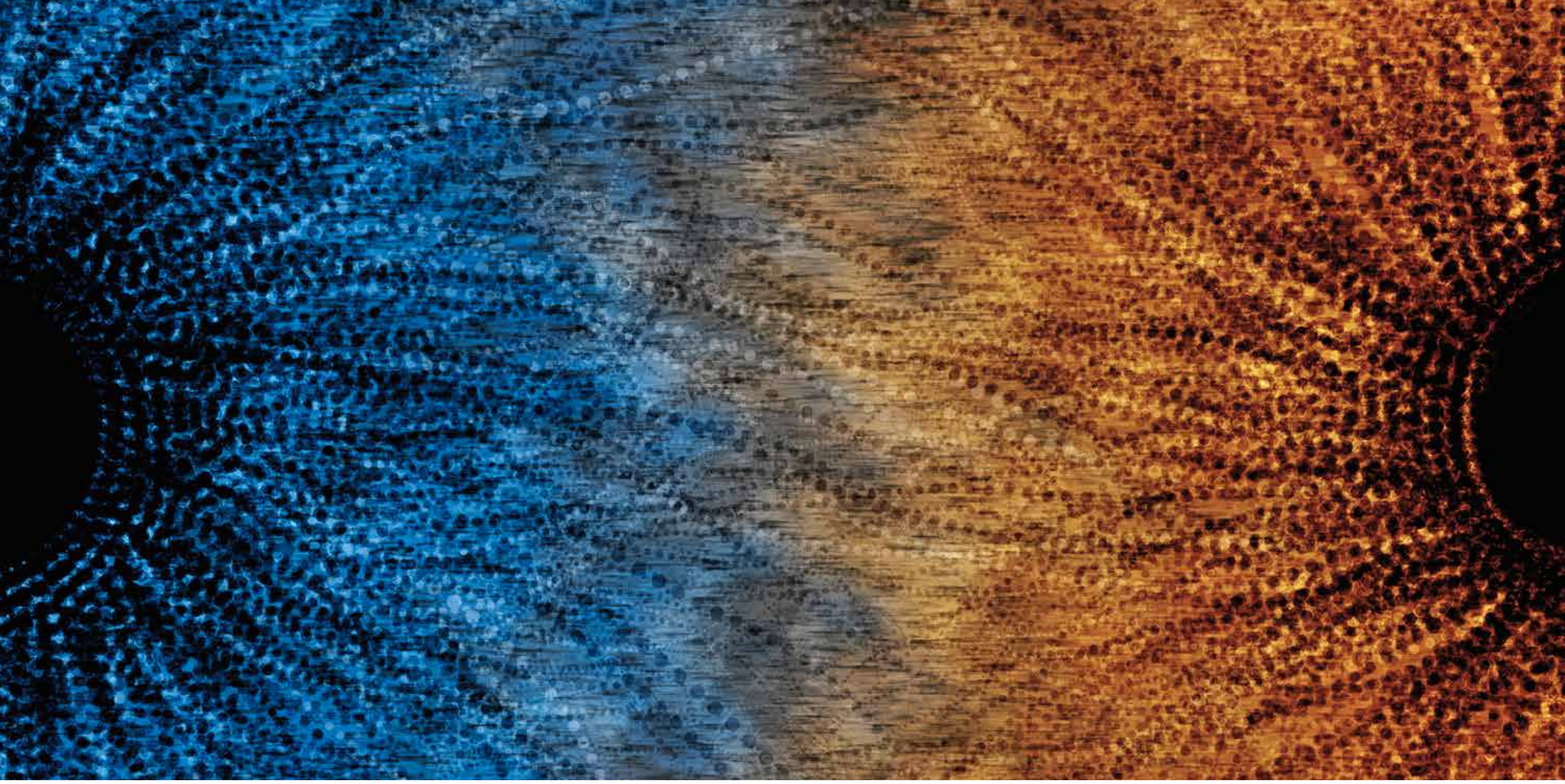

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Managing mergers: A conversation with Rob Leary

The president of TIAA-CREF Asset Management talks about why the industry is likely to see more tie-ups, how to prepare for big deals, and why finding growth depends on what you're good at.

Onur Erzan and Bryce Klempner

Rob Leary joined the Teachers Insurance and Annuity Association of America–College Retirement Equities Fund (TIAA-CREF) in June 2013. Less than 18 months later, the former lawyer and veteran asset manager had helped his company close the $6.25 billion acquisition of Nuveen Investments. This May, Leary spoke with McKinsey's Onur Erzan and Bryce Klempner about the state of the industry and the future of M&A.

McKinsey on Investing: *You've been with TIAA-CREF for about two years, the latest stage in a long career in global asset management. What do you see as the major trends in the industry today?*

Rob Leary: The biggest change in recent years is the shift from active to passive asset management. There's been a proliferation of exchange-traded funds more broadly, too. But even more important—particularly from a revenue perspective—is the move to alternatives, both liquid and illiquid. By 2020 or so, alternatives will be about 15 percent of global assets under management but about 40 percent of industry revenues. I don't think this will change soon; alternative investments will continue to play a huge role in the industry.

More broadly, I think we will see less focus on beating benchmarks and more focus on helping clients meet their financial goals. Given the events of the past 10 or 20 years, people are starting to realize that what actually matters are the outcomes, not how well you perform versus a benchmark.

McKinsey on Investing: *And how about from the distribution side? Do you see any major shifts there?*

Rob Leary: Well, it depends on what model you have—whether you're focused on retail or institutional investing or you're direct to consumer—but, generally speaking, I think the industry is becoming much more research driven and much more objective. We're seeing open architecture across the board. The industry is becoming more consolidated; nearly every gatekeeper is using similar filters and methods of screening investor performance. So your organization has to be professional—efficient, farsighted, continuously improving.

McKinsey on Investing: *These are big changes. How are they affecting the CEO agenda?*

Rob Leary: At the end of the day, it's about making sure you're increasing your market share. The CEO of any investment-management organization should first and foremost focus on risk-adjusted investment performance over the long term. You need to perform well, and you need the framework to do it on a regular basis.

That's not enough, of course. Companies also need the right mix of strategies and products, and they need the right tools in their toolbox. And not just for today—they need to be well positioned for where the market is going. To that point, most CEOs are probably thinking about alternatives, wondering if they can be in this space, if they should be, and where they can be especially strong. That's a big shift for CEOs, I think.

On the distribution side, CEOs need to make sure they have the right expertise for the markets they're in. There are certain areas, such as large market cap in the United States, that have seen a net outflow on the active side for a while now, which means that to win, you either have to gain market share or have truly amazing performance. If you don't have either of those things, you should be thinking about other markets you might want to enter.

And then there's scale. Small, very specialized managers can stay small, but only if they have great investment performance. Large companies have to perform well, of course, but they also have the benefits of scale. I think it's the in-between managers that should be asking where to go and where to focus.

Finally, the regulatory environment is much more complex than ever before. The Securities and Exchange Commission is getting much more involved in a number of issues, including cybersecurity. Foreign regulators are involved in issues such as compensation. And CEOs are thinking about things like SIFI[1] designation, too. So yes, I think regulations have created a big shift in the CEO agenda.

McKinsey on Investing: *What about talent—is that also on the CEO agenda? Is it getting easier or harder to find and retain the right people?*

Rob Leary: During and immediately after the financial crisis, there wasn't much movement in terms of talent. That's changing, especially in alternatives and distribution—there's a huge focus on talent in both of these areas right now. Compensation is certainly an important part of attracting and retaining the best people, but there's more to it than that. If you want your team to stay, you have to give them the resources and freedom they need to succeed. This is a big part of our talent proposition. Our investment and distribution teams are compensated fairly, as long as their performance is solid. But equally important, we let our people focus on what they do really well, and we make sure they have the resources they need to do so.

McKinsey on Investing: *Another CEO topic might be M&A. You've led TIAA-CREF through a*

Rob Leary

Vital statistics
Born March 20, 1961, in Brooklyn, NY

Education
JD, Fordham University

BA, Union College

Career highlights
TIAA-CREF
(June 2013–present)
Executive vice president
President, asset management

ING
(2007–12)
Chairman and CEO, ING Investment Management Americas

AIG
(1995–2007)
Executive vice president, AIG Financial Products
President, AIG Financial Securities

JPMorgan
(1990–95)
Vice president

White & Case
(1986–90)
Attorney

Fast facts
Member, board of directors, AmeriCares

Director, Intact Financial Corporation

Member, board of directors, Friends of Acadia

Former director, College Year in Athens; Convent of the Sacred Heart, Greenwich; ING Foundation; Long Island Soundkeeper; Mystic Seaport; and Pomona Capital

couple of important transactions. What trends are you now seeing? How do you see mergers and acquisitions evolving?

Rob Leary: There are a number of players in the middle, the in-between managers, that don't quite have the scale they need. They have to either shrink or grow. Shrinking is hard, and so is growing organically. So we're going to see more and more M&A moves as small as "lift-outs" and as big as major acquisitions. M&A offers lots of benefits in addition to scale. It can help companies expand their offerings into passive investments, exchange-traded funds, target-date funds, alternatives—this is where the market is going, and every investment company should have them or at least have given a lot of thought to why they don't. M&A can help fill other gaps, too: geographies where you don't yet have distribution, for example. But you can't let M&A interrupt your own investment and distribution platform, or that of your new partner, and you can't let it disrupt your culture.

McKinsey on Investing: *Ultimately, is the industry's move toward consolidation more about scale or more about scope?*

Rob Leary: It depends. Sometimes it's about scale. For example, to win in US mutual-fund markets, you have to be really big or a smaller play with excellent investment performance. But even for very small companies, it's getting harder—for players outside of the top quintile, at least—to get onto platforms. Ultimately, nearly everyone in this market will need scale. But scope matters, too. Sooner or later, if you want to be a global asset manager, you need a business model that can survive different cycles and trends. Increasing scope and diversifying can diminish the overall risk to your business.

McKinsey on Investing: *You mentioned that an important part of M&A is preserving culture and values and making sure investment platforms continue uninterrupted. How can companies do that?*

Rob Leary: First and foremost, everyone has to agree that the client comes first. Second, the organization has to operate with integrity. This means, among other things, valuing your own people and treating them well. And it's critical that the new organization operate as one team—not on a star system. Some managers like the star system, and in some cases it can work. But it means you're relying on a small set of individuals, which I think is very risky. Their performance can take a turn for the worse, or something can take them out of the picture. I don't think that's a great proposition for clients or for an asset-management business.

McKinsey on Investing: *Looking back at your recent deals, is there anything you'd have done differently—or that you'll do differently next time, if there is a next time?*

Rob Leary: That's a great question. We're in the early days of our acquisitions of Nuveen and of the Henderson Group's real-estate business, but both integrations are going well so far. I think this is in large part because we worked hard to prepare. We had a dedicated team of internal people—really talented people who could focus on these mergers—so our investors and our distribution folks could continue to do their jobs.

We've also been lucky. So far there haven't been a lot of surprises. We didn't lose any clients in either deal, and we didn't lose any key individuals at TIAA-CREF or the organizations we acquired. Things went well with the regulators and the rating agencies, and we had buy-in from just about everyone. Of course, no matter how many checklists you make, no matter how many advisers you have on your team, little things can always slip through the cracks. It's more about making sure the big things don't. We did our own debriefs after each transaction: what went right, what went wrong. The things that went wrong were, I think, pretty minor.

Another point—it's an old adage, but it's surprising how valid it is—is that you have to manage everyone's expectations from the outset: the companies', the boards', the mutual-fund boards', and so on. You have to be honest and open about what each should expect. You have to communicate early and often.

McKinsey on Investing: *What about functional challenges to M&A? Are there particular parts of the business that are especially difficult to integrate with one another?*

> "No matter how many checklists you make, no matter how many advisers you have on your team, little things can always slip through the cracks. It's more about making sure the big things don't."

Rob Leary: It's especially difficult for monolithic managers—huge, fully integrated companies—to acquire businesses. And it's hardest of all when there's a lot of overlap. You have to integrate investment teams, distribution teams, middle and back offices, and so on. That can cause a lot of anxiety among employees, investment consultants, and investors. Maintaining investment performance in that environment while keeping sales and asset retention high can be challenging. Nuveen was a very large acquisition for us, but our business models were quite complementary with regard to both investments and distribution. We didn't have a lot of overlap. We're a multiboutique manager and Nuveen is a multiboutique manager, so it was a good fit—our platform fit well with theirs.

McKinsey on Investing: *Do TIAA-CREF and peer companies have an M&A mind-set at this point? Are firms waiting for the right thing to come along, or are they taking a proactive stance?*

Rob Leary: I don't see us as a serial acquirer, but we're certainly always looking to fill gaps in our investment strategy, and we are always looking to expand or enhance distribution. We look for geographic opportunities, too. So I do think we'll continue to be active. We just launched a team dedicated to midmarket loans, and we think they'll do great things. The timing was right. It was an area where we needed more heft, and the move was complementary to Nuveen's Symphony affiliate, which invests in debt equity across the capital structure, and our private credit platform as well. We will continue to look for opportunities, but our primary focus right now is making sure the Nuveen and Henderson acquisitions continue to go well.

McKinsey on Investing: *TIAA-CREF aside, do you expect multiboutiques to be more active acquirers, or will it be the monolithic firms?*

Rob Leary: I think we'll see a bit of both. Even if a multiboutique is confident that it has everything covered, that doesn't necessarily mean it's firing on all cylinders. So it's certainly going to look for M&A opportunities. As for monolithic firms, very few already have enough scale and size and scope, so M&A is on their agendas, too. And as we discussed, M&A is especially important for those in the middle.

I think we'll also see a lot of dislocation. We've seen it already with banks and bank-owned asset managers that have had to divest from certain types of activities because of the Volcker rule or other regulations. Other macroeconomic and regulatory factors are going to cause managers to sell some really appealing properties. That's going to present opportunities for both monolithic firms and multiboutique shops.

McKinsey on Investing: *What about wealth managers? Do you think they'll get back into asset management?*

Rob Leary: It's a good question, but I think the answer is no. Given the regulatory environment and the industry's overall direction, wealth managers will be more successful by embracing open architecture and becoming more research driven. It may be more profitable to have proprietary funds in their stable, but that brings increased scrutiny.

McKinsey on Investing: *What about domestic versus international? Are there any places where you expect to see more or less M&A?*

Rob Leary: It's important to remember that it's not just about finding the right regions. It's about finding specific growth opportunities within those regions. Sometimes it's institutional, sometimes it's retail, and sometimes it's something in between. It could be defined-contribution investment only or the Afores pension system in Mexico or something else entirely.

You have to look at your skills and capabilities. For example, US defined contribution is growing, so if you have the right products and strategies, that's a really appealing place to be. For other companies, that may be a terrible move, and it would be better for them to focus on institutional defined benefit, even though it's shrinking. If you have the right thing for the customer, whether it's liability-driven investing or solutions for defined-benefit plans in the current macroenvironment, go there. Sources of growth are highly specific to each manager.

That said, one area that we think will continue to grow, both in the United States and abroad, is real assets—infrastructure in particular. The developed world needs to replace a tremendous amount of infrastructure, and a lot of the developing world needs to build out theirs. That's an area we are focusing on, and I think other managers will focus on it as well.

McKinsey on Investing: *One last question, about the macroenvironment. Asset prices are on the rise, and the idea that we might be approaching a top is gaining ground. Do you have a sense of what might happen next, and how are you preparing for that?*

Rob Leary: Asset managers like us are well diversified across equities, fixed income, and even other asset classes such as commodities, currencies, and the like. We're in the United States and in developed and emerging markets around the world. We're in hedge funds and private equity and real estate and other real assets. So we feel like we have a well-diversified portfolio that could weather a serious storm.

This is such an unprecedented time, particularly because of central-bank investment. We've seen quantitative easing in the United States, in Europe, and in Japan. We're not complacent at all about what might happen. This feels like uncharted waters, and I've been in the business for 25 years. We're focusing on risk management, and we're sticking to our knitting. No matter how diversified we are, we know we would feel a significant market disruption, as would all managers. But we like to think we will be nimble. We're focused, and we have tools that will help us adjust if we need to. ■

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[1] Systemically important financial institutions; this designation by regulators requires greater oversight.

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Are you ready for the new-look UK retirement market?

Both domestic and international asset managers are excited about an unparalleled opportunity. Here's a primer on the changes remaking the market.

Philipp Koch, Christine Korwin-Szymanowska, and Ildiko Ring

The UK retirement market is undergoing profound change. For the past several years, technological change has been brewing and customer preferences shifting. Now, new regulations are taking effect. All these forces are coming together to create an opportunity for asset managers that may be unique in Europe; no other market has so many assets up for grabs. But with so much changing at once, grasping the opportunity is by no means straightforward. In this article, we examine the factors driving change and outline six actions that asset managers can take to capture a bigger share of the assets that are newly available.

A market in play

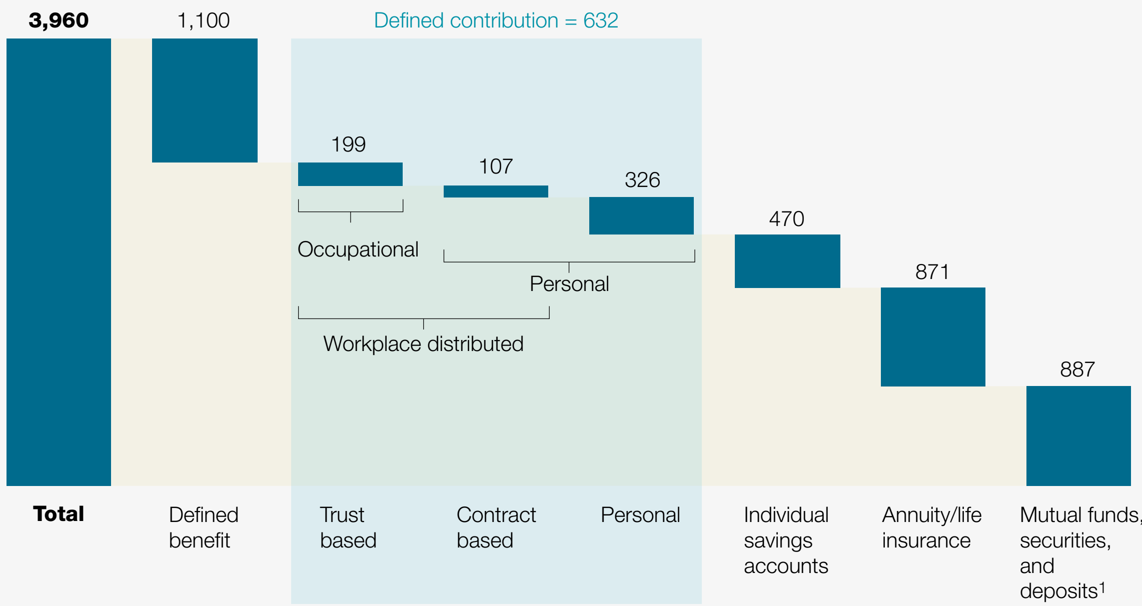
We estimate that total retirement assets[1] in the United Kingdom amount to about £3.9 trillion (Exhibit 1). Of this, about £155 billion is in motion each year, as workers and employers make contributions and pensioners (about ten million at present) draw down on their savings. That figure is about to expand. Our analysis of the various factors—changes in regulation, distribution technology, and customer preferences, all explored in more detail in this article—suggests that the money flowing into and out of the retirement pool will grow to about £180 billion by 2020. Asset managers are particularly interested in the moment of retirement, when we expect that about £8 billion to £10 billion annually that used to move into insurance products will be accessible to these players.

New rules

In March 2014, the Chancellor of the Exchequer announced the 2014 budget, which included new rules for pensions. In March 2015, the new budget clarified the rules, especially with respect to annuities. About 4.2 million British savers over

Exhibit 1 **UK retirement assets are at about £3.9 trillion.**

UK retirement assets, 2013, £ billion



[1] We made age-based assumptions of the share of assets held against retirement (ie, people up to 44 years old hold on average 25% of those assets as retirement savings, those 45–64 hold 50%, and 65 and older hold 100%); based on McKinsey Global Banking Pools.

Source: Financial Conduct Authority; Office of Fair Trading; Spence Johnson; McKinsey analysis

the age of 55 now have more freedom than ever before to manage their retirement pots.

Previously, the rules forced people to buy an annuity when they retired. The new rules allow them to withdraw lump sums or stay invested. That will favor asset managers and their investment products. Customer research conducted shortly after the announcement indicated that only one in three people aged 50 to 75 intended to buy a traditional annuity—and then only for a portion of their assets. If this shift bears out, with annuities relegated to the role of covering basic expenses and other products used for discretionary assets, we estimate that annuities' share of in-retirement products could decline from the current 75 percent to about 30 to 40 percent. That equates to about £8 billion to £10 billion annually.

On the accumulation side, defined-contribution plans are a bright spot, with more than £630 billion of assets and £1 billion of profits. The United Kingdom is the largest defined-contribution market in Europe and is forecast to grow by about 10 percent annually over the next five years, driven mainly by a rise in the number of retirees. Autoenrollment, another recent rule change, is taking effect in phases. Although it is going through some growing pains, autoenrollment is expected to add an additional £8 billion to £12 billion to the current £78 billion in annual workplace pension contributions by 2018—an increase of about 10 to 15 percent. And defined-benefit plans continue to convert to defined contribution.

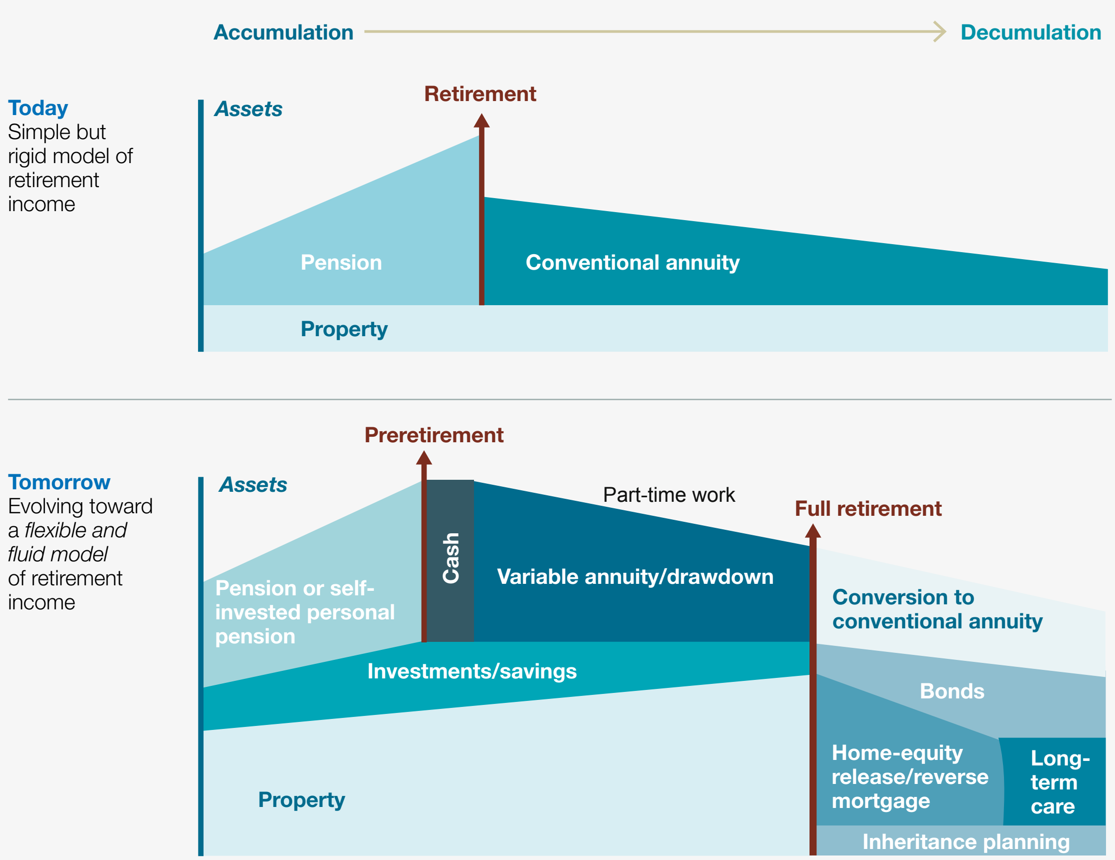
Other rule changes will also affect the market. In 2014, the UK government banned companies from imposing a compulsory retirement age, except in certain circumstances. As a result, more individuals may now continue to work part-time, pushing out their retirement age. This will strengthen an ongoing trend: the number of people over 65 and still working has doubled in the past 15 years and is expected to continue growing. As customers shift away from one-time decisions (for example, buying an annuity at 65) to a more prolonged and engaged decision process, opportunities will arise for providers to interest customers in other products, such as long-term care, home-equity release, and fixed-income solutions. Exhibit 2 lays out how the retirement-product mix might shift.

One final regulation bears mentioning: the Retail Distribution Review. The rule addresses the lack of transparency in the dealings of this heavily intermediated market by ending behind-the-scenes commissions and making fees visible to customers. The impact of this regulation is still unfolding, but some things are becoming clear.

Distribution disruptions

Changes in distribution have been simmering for some time. Platforms—the systems used by asset managers, pension providers, and others—are becoming more sophisticated; technology is now

Exhibit 2 **The product mix will shift significantly over time.**



Source: Capita; Cazalet Consulting; *Money Management*; McKinsey analysis used to steer customer decisions. More changes are on the way. Given the similarities among these electronic offerings, as well as the pressure on providers' economics, many will choose to further modernize their platforms. This should help in creating seamless, end-to-end experiences that guide self-directed customers. Pension providers may also consolidate assets, which would give customers broader offerings that embed some forms of advice. In general, there is consensus among many that platforms will become even more critical influencers that drive planning and investment choices.

Another big change is the expansion of direct-to-customer models. Digital distribution of financial products is already commonplace in the United Kingdom. Multichannel banking is widespread, if not quite as prevalent as in the Nordic countries. At the current rate, we expect UK digital distribution to reach maturity in the next three to five years. For example, the share of direct distribution in life insurance is about 10 percent today, and it is forecasted to reach 15 to 20 percent by 2020. Similarly, the share of retail-investment funds sold through direct-to-customer platforms such as Nutmeg has been growing at about 10 percent annually, a trend we expect to accelerate.

Digital direct-to-consumer models can disrupt the retirement market in many ways, including digital advisory and the rise of new intermediaries. These new companies can carve out a niche, unencumbered by channel conflicts and legacy operations and IT costs.

One thing that is not changing much is that bundled models appear to be maintaining their popularity, unlike their US cousins, which are losing ground to defined-contribution investment only.

The changing customer

Savers' preferences are also evolving, partly in reaction to these shifts in distribution. We surveyed 2,300 British savers and pensioners in March 2015 and found that despite the public debate on pension overhauls, awareness of retirement solutions is generally low. Only 50 percent of people over 50 are aware of the changes affecting annuities. Product understanding is also generally limited; about 30 to 40 percent of British customers do not understand the value proposition of drawdown products (Exhibit 3). Savings rates have rebounded to pre-crisis levels, and people are once again eager to get guidance—but they have limited appetite to pay for it. More than 40 percent of customers say they won't open their checkbooks for this service. That's a problem, as the Retail Distribution Review, in a bid for transparency, has shifted the burden of paying for advice to the customer.

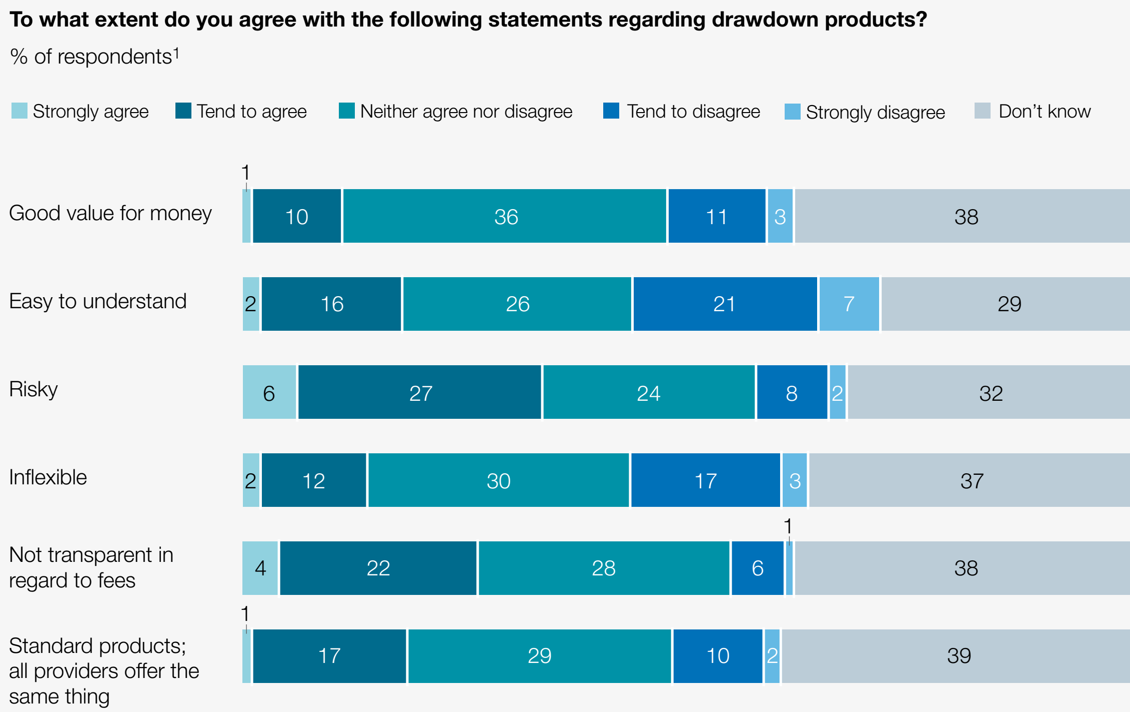
Instead, customers look to their employers as their primary source of retirement information, leading to new opportunities in workplace distribution. About 20 percent of people turn first to their employers for retirement advice, even though most employees do not understand their workplace pension that well. Over time, customer expectations are likely to rise. Already, about a third of employees state that their employers' pension schemes are a key reason to remain in their current jobs. Pensions are also becoming more relevant for recruitment efforts, though they are not yet as critical as health benefits.

Between their unwillingness to pay and the sometimes competent but often narrow advice they get from their employers, middle-class customers still have significant unmet needs. Pensions and equity individual savings accounts are the two financial-product categories where people want most advice. Customers are also not yet fully comfortable with self-service solutions such as the emerging robo-advisers.

How to approach the market

With everything in flux and assets seemingly there for the taking, managers are eyeing the UK market with interest. Indeed, some international players are talking about entering or reentering it.

Exhibit 3 **Customers have a poor understanding of drawdown products.**



[1] n = 2,300; figures may not sum to 100%, because of rounding.

Source: McKinsey analysis

The enthusiasm is tempered, however. Asset managers know that capturing these shifts will be difficult. Many have tried recently. Consider workplace distribution—a clear opportunity but an elusive one. Using an institutional relationship to launch up- and cross-selling of individual financial products to employees has proved notoriously difficult in both the United Kingdom and other major defined-contribution markets. Or take middle-market advice, a heavily regulated and difficult business. To avoid running afoul of the rules, many managers offer packaged information rather than advice per se. But such "productized" advice has limits and will be a tough challenge for retail providers.

In the face of these uncertainties,[2] many players are proceeding cautiously. Strategic exploration and targeted pilots, such as investments in digital distribution and various financial-technology start-ups, are the order of the day. We argue that these moves, however useful, are not enough. We see six opportunities for asset managers to improve their distribution, value proposition, and operations. The window created by the confluence of sweeping changes is necessarily limited; actions that providers take in the next 12 months or so will likely set their course for years to come. In brief, the six opportunities are as follows:

Distribution

- Build a *direct-to-consumer channel* for execution only—or at most for providing simple advice. A critical success factor here is traffic generation, including the use of various digital-marketing vehicles and online partnerships. Managers with experiments in progress should push them harder and faster, and others should enter the fray.

- Partner with employers and employee-benefit consultants to build better *digital interfaces* and associated services that help employees manage their defined-contribution plans. Such workplace solutions might help employees roll up the various plans they hold with different providers, as well as assist with the purchase of other individual products and broader employee benefits. One manager is successfully selling individual savings accounts from its clients' intranets along with pensions.

Value proposition

- Drive growth in the *small and midsize defined-contribution pensions segment* by setting up master-trust structures and creating low-cost, functional self-service solutions. This segment is growing faster than others, and the master-trust structure allows for new economies of scale.

- Develop a *holistic retirement proposition* that serves individuals to and through retirement, including a broad product suite, distinctive service anchored in deep customer insights, and multichannel delivery. This includes *fit-for-purpose nonannuity products* (for example, drawdown with annuity-type features such as outliving riders) or life-cycle product structures that follow customers beyond their retirement dates, potentially accommodating variations such as partial retirement. Seamless customer experience is critical, as evidenced by leading US providers that have mastered the art of capturing rollovers from defined-contribution plans to individual retirement accounts. Examples of smooth rollover processes include one-click account opening, fast-tracked processing of internal rollovers, systematic customer outreach at life events that trigger a financial decision, and automated identification of clients at risk.

Operations

- *Drive down costs by 15 to 30 percent* to preserve competitiveness in a transparent, regulated, fee-based, and fee-capped environment. Savings of this magnitude will likely require addressing the full range of efficiency levers: front-to-back digitization, distribution transformation, and lean operational practices.

- *Pursue M&A opportunities* to add new capabilities (for instance, digital capabilities) or scale. At-scale providers enjoy operational efficiencies and can use their institutional relationships with employers to drive individual product sales. ■

[1] Including pensions, individual savings accounts, annuities, life-insurance products, and select other savings (for example, securities).

[2] These uncertainties continue to multiply. In July 2015, the UK government announced it may consider taxing pension savings at the time of saving and not at the time of disbursement. That could affect current trends, in which flows are accelerating toward asset managers and away from life-wrapped products.

This article was adapted from the authors' white paper, *In the eye of the storm: Transformation in the UK retirement market*, April 2015, mckinsey.com.

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Bending the third rail: Better investment performance for US pensions

Improving the investment organization is a good first step on the way out of the funding crisis.

Sacha Ghai, Bryce Klempner, and Josh Zoffer

America's public pensions are in trouble. On current trends, these funds will not be able to meet all of their obligations to their beneficiaries—teachers, police officers, nurses, and other public servants. Between 2006 and today, the average funded ratio of major public pensions has dropped from 83 percent to just 72 percent—meaning nearly 30 percent of pensions will not be paid, unless taxpayers cover the difference. In dollar terms, we estimate that gap at $1.6 trillion.

The situation has been deteriorating for some time and has recently been made worse by three structural changes. First, life expectancy is rising; today's retirees will be drawing their pensions for about two years longer than in 2000. That accounts for about $300 billion of the funding deficit, by our calculation. Second, in a related phenomenon, the population is aging; fewer working-age people are supporting more retirees. The ratio of pension contributors to beneficiaries has shrunk, from 2.8 in 1991 to 1.6 in 2013.

Third, the markets in which pensions invest have changed. In the 1980s, when many current portfolio managers came of age, high interest rates on Treasury bonds made returns of 7 percent or more relatively easy to achieve. Pensions invested heavily in fixed income. Between 1992 and today, however, the average annual yield on 30-year Treasuries has fallen from about 7.5 percent to about 3 percent. Meanwhile, the return assumptions used in pensions' calculations long remained at 1980s levels.

The gap between expectations and reality has become wide and noticeable, and under public scrutiny, pensions have begun to gradually reduce their discount rate—from 8.2 percent in 1999 to 7.4 percent today. That has pushed up estimates of future liabilities by about $150 billion.

Pensions have also shifted their investments away from low-risk fixed income and toward higher-volatility equities and alternative assets. Pensions' fixed-income allocations have shrunk from more than 75 percent in 1982 to just 27 percent today. Allocations to equities increased dramatically, and allocations to alternative investments more than doubled between 2006 and 2012, from 11 percent to 23 percent. So when the global financial crisis hit, pensions were far more exposed to risk than ever before. Pensions have slowly recovered from their investment losses, but they are still well behind their pre-2008 trajectory.

The hard way

Two solutions—increasing contributions to pension funds and cutting benefits—are immediately obvious. But neither is easy to do. Funds could ask for greater contributions from workers, but achieving this is politically difficult. Only a few states have been able to get the required legislation passed. Even when these bills are enacted, the changes tend to be too small and compromised to make a difference. Between 2008 and 2014, almost all legislated increases were from 1 to 3 percent—and they were offset by decreases in employer contribution rates. In addition, most increases affect only future members rather than current contributors.

Cutting benefits is also a significant political challenge. Thirty-five states cut benefits in some manner between 2008 and 2011, but most of these shifts apply only to future retirees. Twelve states made changes that affect active members, and eight enacted reforms affecting retired beneficiaries.

To be sure, there are some bright spots in benefit reform. Rhode Island raised the retirement age and began a transition to a hybrid defined-benefit/defined-contribution plan. It also suspended its cost-of-living adjustments until the pension's funding reaches 80 percent of liabilities. Together, these reforms cut $3 billion of the state's unfunded liability of $7 billion. However, most states have done much less, or nothing at all, opting instead to kick the can down the road.

A third option

Improving investment performance is not simple, but for many institutions it may be easier to accomplish than cutting benefits or increasing contributions. Strengthening the pension organization and deepening its skills and knowledge can produce superior investment returns. Both the Washington State Investment Board (WSIB) and Teacher Retirement System of Texas (TRS), for example, have embarked on serious programs to boost their returns. WSIB has been among the highest-performing state funds over the past ten years, while TRS ranks as the top-performing pension investor in private equity after pursuing a program focused on that area. These pensions and other top performers are taking three core steps to improve their investment performance.

Most critically, top performers recognize the need for a full staff of professional portfolio managers. The typical US public pension is run on a shoestring. Top US public pensions average more than $1 billion in assets under management for each employee, including noninvestment and administrative staff. One state fund manages about $175 billion with a staff of 50; that's $3.5 billion for each portfolio manager, IT manager, and executive assistant. Compare that with other investment organizations, where similarly huge funds are managed by much larger staffs. BlackRock, the largest asset-management firm, oversees $4.77 trillion with more than 12,000 employees (more than $358 million per employee). The Canada Pension Plan Investment Board manages $265 billion with a staff of 1,157 ($229 million per employee), while the Ontario Teachers' Pension Plan manages $155 billion with a staff of 1,100 ($141 million per employee). These pensions, despite (or perhaps due to) their fuller staffs, tend to be among the better-performing funds.

Not only must pensions add staff, but that staff must also be paid well; boosting compensation is a second essential step. Plenty of talented investment professionals are keen to serve the public but find the drop in pay that they would experience in leaving the private sector too steep to bear. The success of Canada's pensions in drawing talent away from the private sector has been due in no small part to their adherence to pay-for-performance concepts, including bonuses, and a deeply seated performance culture. The result is considerably higher compensation—in our estimate, up to ten times higher than in the United States—and performance that justifies these paychecks. Yet getting agreement from state legislatures for big pay raises will not be simple; nor will it be easy to gain understanding from taxpayers. But make no mistake: improving investment performance will require an overhaul of the way pensions attract and compensate their investment professionals.

Third, US pensions must upgrade their governance approach. In Canada, home to several of the world's top-performing public pensions, pension boards tend to be drawn from the ranks of business professionals. In the United States, by contrast, boards tend to comprise public officials, union representatives, and employee representatives. Twenty-eight percent of Canada's board members have an investing background, more than double the 12 percent at top US public pensions.

This lack of experience is costly. American boards are often less familiar with the operating models and investment needs of institutional investors. In a study of 35 of the largest North American pension funds, we have found a positive and statistically significant relationship between a pension board's investment experience and its funded ratio. It appears that boards with greater investment experience are taking the steps necessary to preserve pension funding, while others are lagging behind.

Professional strength

Funds that have professionalized their investment organizations and boards get better results. The big

Canadian pensions all have funded ratios above 90 percent (with most of the top ten above 98 percent), compared with the US average of 72 percent. And this difference is likely understated, as most Canadian pensions use more conservative discount rates to calculate liabilities than their US peers.

How do they do it? Our research[1] has found that across all institutional investors, top performers display consistent strengths in five areas: the mandate, the governance model, the investment philosophy, the investment strategy and processes, and talent management. The mandate and governance model provide strategic direction and effective leadership toward the organization's goals, while the investment philosophy, investment strategy, and talent management ensure that the investor capably executes its core function: putting money to work.

Better investment performance from highly capable organizations will not be enough on its own to eliminate the funding gap that America's public pensions face. But it is a vital—and too-seldom discussed—component of the total solution. If pensions put their investment house in order, they can more credibly ask for major contribution and benefit reforms. In that way, they can bend the "third rail" of politics—the programs that support Americans in their old age. America's state pensions should act now to stem the crisis, and improving investment performance is the right place to start. ■

[1] See Sacha Ghai, Ju-Hon Kwek, and Danish Yusuf, "What overachieving institutional investors get right," *McKinsey on Investing*, Winter 2014/15, mckinsey.com.

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A conversation with CDPQ's Michael Sabia

A leading institutional investor reflects on the industry.

Peter Bisson and Jonathan Tétrault

Michael Sabia joined la Caisse de dépôt et placement du Québec (CDPQ) in 2009, at the depths of the global financial crisis. Since then, the industry has recovered, as has CDPQ, which now has $226 billion under management. In April 2015, he spoke with McKinsey's Peter Bisson and Jonathan Tétrault about what he's learned in his six years on the job.

McKinsey on Investing: *You joined CDPQ at a difficult time for investors. What was your approach to leading the organization's transformation?*

Michael Sabia: First, we looked very closely at the needs of the people whose assets we manage. That was our starting point—we wanted to understand our depositors, their obligations, and what kind of returns they needed in order to meet them. Then, as is the case with all turnarounds, we broke the challenge we faced into two questions: what to do and how to do it.

The "what" of the transformation was a new investment strategy, based on what we call a "business-owner mind-set." Investing as a business owner is the key to everything we do. We have a deeply held belief that operations and operational excellence—not financial engineering—are the sources of durable value creation. I think my experiences working in two industrial companies before joining CDPQ have influenced how I think about this.

Here's an example. When I got here, I met with some of our transportation-research people and I asked for a summary of a particular railroad company's strategy for managing its rail yards. At the time, they couldn't do it—but now they can. This kind of information is important. What happens in a rail yard is the source of service quality for railroads, and it's the source of cost management. It's fundamental to the creation of value in the business. If you can't answer that question, you shouldn't invest in railroads, because you can't differentiate one company from another.

The "how" was about changing the culture of the organization—that is, how work gets done. This change had three parts. One: we did a lot of work on recruitment and personnel development. Two: we created decision-making processes that are more rigorous and collaborative. A big part of this was breaking down silos—things like changing IT platforms so that the platforms themselves support collaboration, which hadn't been the case in the past. And the third part was a revamp of our compensation program. This is important everywhere, but it's particularly important in an investment institution.

McKinsey on Investing: *Can you expand on the concept of the business-owner mind-set? What does it mean for institutional investors like CDPQ?*

Michael Sabia: If you own a business, you have a deep knowledge of the fundamentals—knowledge that goes way beyond the P&L and the balance sheet. The fundamentals of the business involve, in our minds, its culture, its people, its operations—essentially, the company's value drivers. Having a business-owner mind-set also means understanding

Michael Sabia

Vital statistics

Born September 11, 1953, in St. Catharines, Ontario

Education

Bachelor of arts in economics and politics from the University of Toronto

Graduate degrees in economics and politics from Yale University

Career highlights

La Caisse de dépôt et placement du Québec
(2009–present)
President and chief executive officer

Bell Canada Enterprises
(2002–08)
President and chief executive officer

Canadian National Railway
(1993–99)
Various roles, including chief financial officer

Fast facts

Member of the governing council of Finance Montréal

Former member, North American Competitiveness Council

Honorary chairman of the Bal du Centre hospitalier universitaire de Québec

Cochair, Campaign for Centraide du Grand Montréal the industry and the competition. And it means being patient, too. But, of course, being patient doesn't mean being complacent. We expect performance over the medium and longer term.

Now, how does that translate into the principles of an investment strategy for a firm like us? It means we have a strong preference for investing in assets that people use every day and that are rooted in the real economy—buildings, ports, IT services, consumer products, and so on. It also means we stay focused on the intrinsic value of a business, which is largely based on a deep understanding of its operations, rather than getting caught up in the smoke screen of its market value. We stay focused on the fundamentals, rather than relying on market indexes. In fact, we're agnostic about benchmarks.

Because of all of those things, and because of the depth of analysis we do, we are very comfortable taking concentrated positions without being overly preoccupied with diversifying within each portfolio—because diversification has steeply diminishing marginal returns. Our view is that the best risk-management tool is deep diligence—not just due diligence, but deep diligence.

McKinsey on Investing: *What does it mean to be agnostic about benchmarks?*

Michael Sabia: Take public equity, for instance. The traditional approach starts with a market index like the S&P 500. By and large, you buy the stocks in the index and adjust the size of your position relative to their market weight depending upon what you like and what you don't like. That style of investing assumes that the market itself is a compass that shows where true north is. Well, I don't believe that markets show you where true north is. I think markets are subject to all kinds of vagaries and exogenous influences. They often reflect fads, not fundamentals—as they say, more noise than signal.

We don't believe that an index should be the starting point for an investment process. A benchmark-agnostic approach means proceeding in a bottom-up way, by focusing only on companies you like. In other words, if you believe in fundamentals, and if you believe in operational excellence as a source of value, you build a portfolio from the bottom up, without using the composition of a market as your compass.

So in late 2012, we started building a benchmark-agnostic portfolio in global, high-quality public equities from the bottom up. Today it's a $20 billion portfolio, invested in about 70 different securities, and it's performing well beyond our expectations. We're committed to this path. We've just recently finished converting $20 billion in Canadian equities to the same approach. Of course, investments like real estate, infrastructure, and private equity are—or should be—inherently benchmark agnostic. When we've finished the conversion process a couple of years from now, almost 80 percent of our total portfolio assets will be managed this way.

McKinsey on Investing: *You mentioned a difference between "deep diligence" and "due diligence." Can you talk a bit about your research capabilities, then versus now?*

Michael Sabia: The railroad story I shared earlier is an example of the kind of thing we've changed. Our people are able to answer those kinds of questions now—deep questions about the operations, strategy, and vision of the companies we're investing in. We've also hired geologists, mining engineers, people with experience in consumer products, people with experience in IT companies—people who bring a deep understanding of how value is created in each of these sectors.

I think of it this way: an analysis of a P&L or a balance sheet is like taking a photograph of a company. It's one-dimensional. Our approach to research is more like an MRI. It goes beyond a single dimension. If you're going to be a fundamentals-oriented investor with concentrated positions, you have to go much deeper than a snapshot.

McKinsey on Investing: *How did you transform these principles—deep diligence, business-owner mind-set—into organizational changes?*

Michael Sabia: Obviously, the first element is people. The change in research is one example of a broader change in the profile of the people we hire. All of our employees are financially capable, of course, but we needed people who are comfortable letting go of indexes, investing for the long term, and who have a deep grounding in operations—be it in companies, infrastructure, or real estate. More than half of our 800 staff members are new since 2009. So there's been a substantial shift in the people we hire. That's one organizational change.

It's not just about new hires though. I don't think the investment industry puts enough emphasis on leadership. Good investors are not always good leaders. So we spent a lot of time and effort on building leadership and structuring compensation, so that we got incentives pointing in the direction we wanted to go.

Finally, in a turnaround situation, you have to take specific steps that demonstrate to the organization that the changes you're suggesting are actually doable. If that demonstration isn't done, the organization will either have a lot of self-doubt, or it will resist change because of the usual status quo bias. For instance, the idea of a benchmark-agnostic portfolio was new at CDPQ. The success we've had so far in converting public equities to this approach has been especially important in mobilizing change because it signaled to the organization that it is, in fact, possible to step out of the traditional thinking. This experience has made it a lot easier to make other changes.

McKinsey on Investing: *How were you able to convince the different stakeholders—the board, the depositors—to embrace such a different approach?*

Michael Sabia: First and foremost, it's important to remember that the financial crisis of 2008–09 was very fresh in everyone's memory. The need for change was obvious. That made building a consensus around a long-term, fundamentals-based investment strategy a lot easier. And as far as becoming benchmark agnostic, whenever I met our depositors or members of our board, I spent a lot of time discussing this simple question: "If there are six Canadian banks, using the traditional investing logic you'd underweight the three you don't like and overweight the three you like. But if you don't like three of them, why would you invest in them at all?" And the answer was always, "That's a good question."

That simple question took us pretty far. If you're a fundamentals-oriented investor and you don't like three banks, don't own them. It doesn't matter that they're in the index. We never had any serious pushback from any of our stakeholders. On the benchmark-agnostic issue, the biggest challenge was internal. There were a lot of people in the organization who just didn't believe the new strategy was doable. That's why it was so important to take steps to demonstrate it was possible. We were fortunate that the creation of the first benchmark-agnostic portfolio went so well and could serve as proof.

McKinsey on Investing: *Investors are deploying more and more capital in alternative investments. What's your sense of the rise in competition? How is CDPQ approaching alternatives?*

Michael Sabia: Increasing our exposure to alternative assets is a centerpiece of our plan. That said, when faced with a crowded market, you have to differentiate. Capital is a commodity, it's not a differentiator. In our minds, our ability to differentiate involves two things: how we analyze the investment opportunity and the operational value added that we bring.

Our work in real estate is a good example. Our subsidiary Ivanhoé Cambridge runs our $32 billion real-estate portfolio. This is a group of 1,700 people who not only invest in but also build and operate shopping centers and office towers. Because of that, because they are in the market, operating buildings, finding tenants, they have much deeper insights into the intrinsic value of a property, beyond the traded value of properties. That's the analytics part.

The second point is that when we acquire a building, alone or with partners, we're not just bringing capital to the table. We're bringing an operating capability that enriches the product. This is why we're planning to build a new subsidiary to handle our infrastructure business in a manner that will be similar to what we do in real estate. Again, it comes back to operations. Investment expertise is always important when it comes to differentiation, but it's not enough. It's about marrying investment and operational expertise.

McKinsey on Investing: *Your new model for infrastructure has attracted a lot of international attention. What is it exactly, and what's your plan for it? And can you say how it differs from the classical public–private partnership?*

Michael Sabia: As we all know, there is a tremendous need for new and better public infrastructure, and not just in places like India and China—the United States needs trillions of dollars of infrastructure, too. But governments are significantly limited when it comes to providing that infrastructure—there are fiscal constraints and constraints from indebtedness as well.

Our new platform will do several things. First, it will take greenfield-infrastructure projects off governments' balance sheets—a significant difference from typical public–private partnerships—while still safeguarding government's role in defining a project's public-policy dimensions: where it's built, how big it is, how it will be priced, and so on. Those are fundamental public-policy issues. So this platform allows governments to act as the guardian of the public interest but transfers the execution and financial risk to us. We know that managing those risks is a challenge. With the expertise we've built and with the right partners, we believe it is very doable.

Second, the platform creates a one-stop shop for all aspects of project development, financing, and coordination, including a heavy emphasis on tendering for every service so that costs stay low.

And finally, the new platform makes us responsible for ongoing operations of the infrastructure project, which furthers the goal of keeping the infrastructure off the government balance sheet. As an institutional investor, we won't handle operations ourselves; CDPQ will partner with world-class infrastructure operators. This brings me back to one of my earlier points—that operational precision can have a big impact on the value of the asset. The platform is in its early stages, but we're very encouraged by the amount of interest it has been receiving, in the United States, Europe, and elsewhere.

McKinsey on Investing: *Your investment strategy hinges on a deep understanding of the companies in which you invest. Given that, is there a role for external managers?*

Michael Sabia: We manage 90 percent of our assets internally, first because it's essential for the strategy to work and second because we believe it is—by far—the most economical way to manage. That said, we will continue to work with external managers in a few areas. First, we'll look for expertise in highly specialized areas where we just don't have sufficient expertise, such as value investing in emerging markets. Second, there are areas—distressed debt is a good example—where we're building knowledge, but it's not quite there yet. So we will continue to rely on the expertise of others as we're building up our own. And there's a third area that's slightly more abstract. Increasingly we want to work with external experts in a way that ensures we're involved in decision making, especially in private equity. We want to be part of the process itself. Being the recipient of external expertise is great, but working with outside experts also creates an opportunity for knowledge transfer. We want to work with people who are going to give us an opportunity to learn and to participate; we don't want to just write a check to someone else, who then goes about investing it.

More broadly speaking, I think partnerships are the future of large-scale institutional investing. Pension funds and sovereign funds are getting large enough that many of the organizations managing them are now developing substantial expertise across many asset classes. As the industry evolves, we're going to see big transactions across all kinds of asset classes, through partnerships among long-term institutional investors. I think these partnerships are going to become a bigger and more influential voice in the capital market. So learning how to truly partner with other organizations is a really important part of building investment capability for the future. It won't be possible to be a lone wolf anymore.

McKinsey on Investing: *You're a strong advocate of long-term capitalism. In your view, what are the changes that would most affect how capital-market participants think about the balance between short-term and long-term horizons?*

Michael Sabia: There's certainly an important public-policy dimension to long-term capitalism. There are tax- and corporate-law changes that are needed as well as changes in voting rights—a whole range of things. And those things are both important and challenging. But these are going to take time. So I think we have the responsibility to kick-start the process ourselves. We need to just do it. Institutional investors like CDPQ and our counterparts, which have long-dated assets managed in the interest of long-dated liabilities, need to become much more visible, active, long-term investors.

So what does "just doing it" mean? Some things are simple, like changing the way we interact with the companies we operate or invest in. We shouldn't be asking a CEO to simply help fill in an earnings model for the next two quarters. We should be asking, "How do you manage talent development? What are the biggest obstacles to your strategic plan for the company? What's it going to look like five years from now? How can we help you get there?"

Having been the CFO of one publicly traded company and the CEO of another, I can tell you that the shareholders you hear from most often are only worried about next week. The shareholders who are thinking longer term tend to be less vocal. That has to change. ■

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Sector insights

Illustrations by Keith Negley

North American oil and gas: Caveat emptor

The drop in oil prices has piqued investors' interest in oil and gas producers. But new research suggests that high-quality investments are scarce—for the moment.

Sanjay Kalavar, Hyder Kazimi, and Mihir Mysore

The oil and gas industry was shocked as oil prices fell by more than half, from $104.48 per barrel in July 2014 to $51.53 in March 2015. While prices have recovered since, they remain well below the $100 per barrel level that producers and consumers are accustomed to. Valuations have also fallen, in some cases rather steeply. This sudden shift has escalated investors' interest in the sector, especially in North America, where private-equity firms and others have accumulated a war chest of more than $80 billion specifically intended for upstream assets. Investors are moving quickly to evaluate acquisitions across the value chain, with exploration and production (E&P) and oil-field services garnering the most interest.

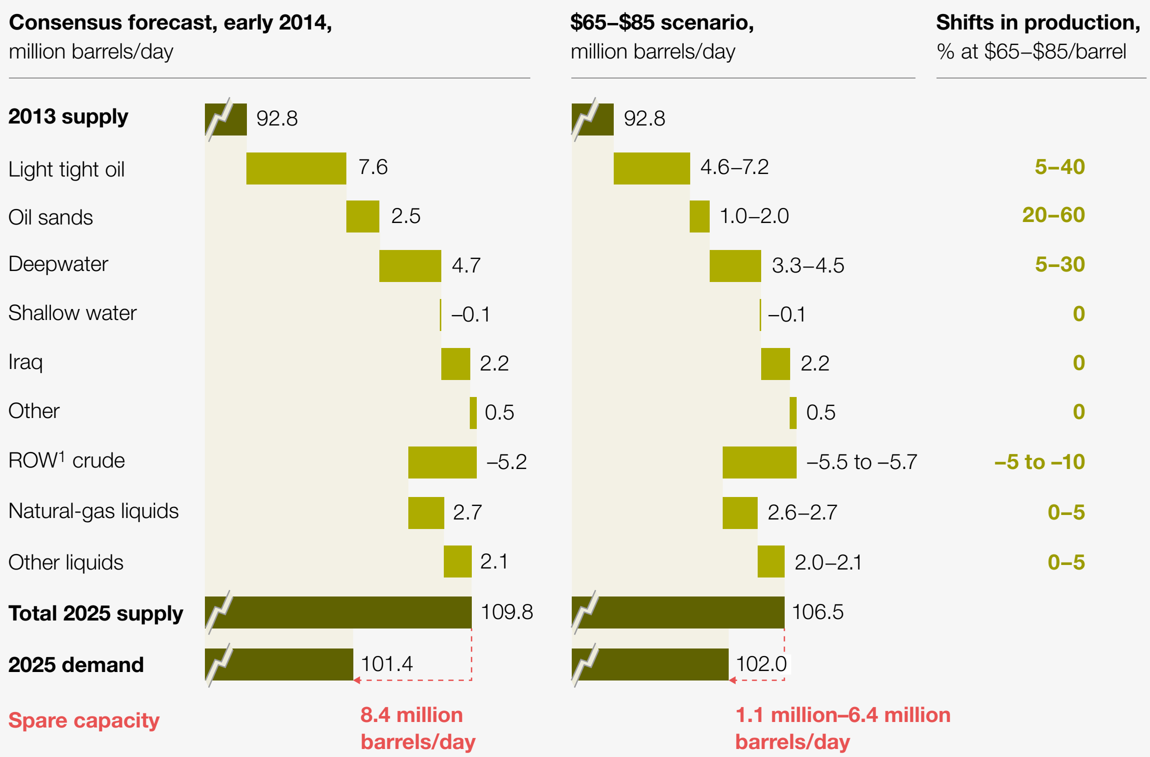
The logic behind this surge seems robust. While most investors are rightly cautious about a recovery of prices to former levels, they believe that the market rout is cyclical rather than structural, and the low prices seen in early 2015 are unlikely to last. Oil demand is expected to grow for the next decade in most scenarios. In a scenario where oil prices return to equilibrium between $65 and $85 a barrel, both onshore and offshore unconventional assets (including deepwater) will contribute more to the global oil-supply "stack" (Exhibit 1). Investors that believe in this scenario find today's market to be a buying opportunity for good-quality assets.

This argument has certainly been behind some prominent deals recently. In January 2015, Blackstone's $70 billion credit arm, GSO Capital Partners, committed up to $500 million to help cash-strapped LINN Energy develop its production assets. Two months later, Kohlberg Kravis Roberts & Co. bought $135 million of discounted loans that were used to finance the 2014 buyout of Scottish oil-field-services firm Proserv, a provider of subsea equipment and services.

These deals notwithstanding, the wave of M&A and consolidation that some industry watchers predicted has not yet happened. In the first quarter of 2015, just 49 deals worth $10 million or more were announced. That's down from 2014, when at least 104 deals (and as many as 149) got done every

Exhibit 1 **If oil returns to ~$75/barrel, spare capacity will be reduced, and an equilibrium could be reached.**

Global crude-oil supply and demand, 2014–25E



[1] Rest of world.

Source: Analysis of data provided by McKinsey Energy Insights (a McKinsey Solution)

quarter. The total value of M&A in the first quarter of 2015 is also down from 2014, at $9 billion relative to quarterly totals of $50 billion to $88 billion in 2014. We see three primary explanations for this:

- North American operators have quickly adjusted to the new reality by rapidly cutting their activity (the rig count has halved, to fewer than 900 rigs), shifting development to the most prospective and predictable parts of their acreage (driving up initial production rates by more than 25 percent in some cases), and driving down development costs (by between 30 and 40 percent at many big unconventional operators).

- Firms are financially stronger than expected. Many operators enjoyed cheap and covenant-light credit before the crash and had large revolvers of debt that they could draw on. While these lines begin to mature next year, they are sustaining operators through the down cycle. Also, production at many operators is hedged.

In a sample of 25 US E&P companies we studied, around 54 percent of oil production in 2014 was hedged through a combination of fixed-price swaps and three-way collars. Hedged production drops to around 30 percent in 2015 and around 15 percent in 2016.

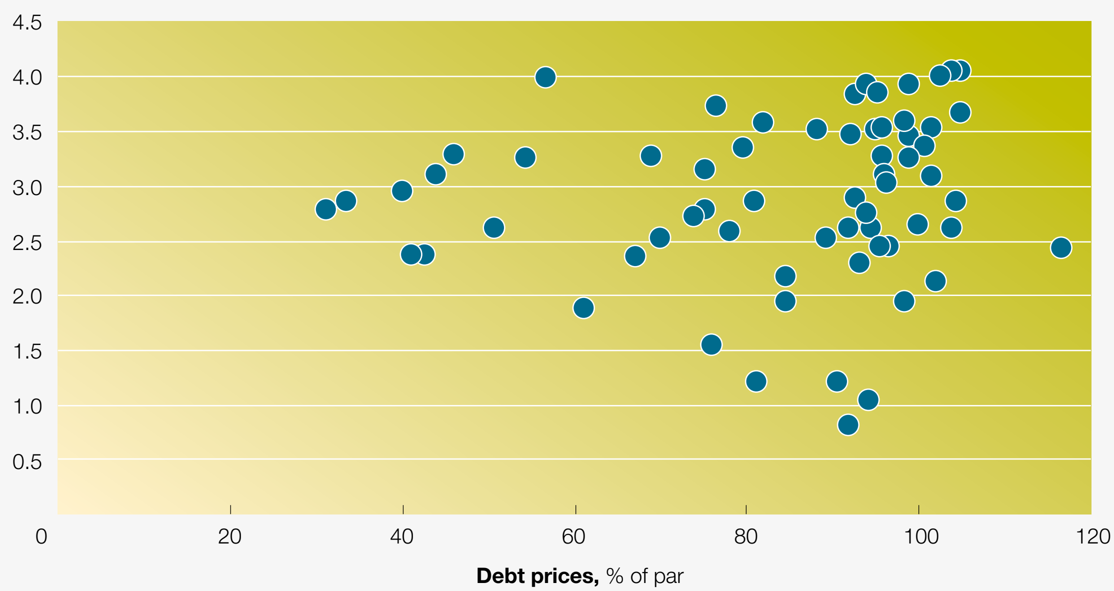
- Several pure-play E&P companies seem to be valued by the market at substantially higher levels than can be justified by current prices. For example, the economic value of one operator in the Permian Basin is down by just 17 percent since 2014, in spite of a much larger drop in oil prices. To believe this valuation, the market would also have to believe that oil will return to $80 a barrel, that the company can reduce capital expenditures by around 30 to 40 percent on future wells (even though it has increased 15 percent annually for the past several years), and that the company's acreage in a new play can be "down spaced" to close to 40 acres per well, similar to what is only now being achieved in the most advanced sections of the Eagle Ford and Bakken Formations.

Does this mean that the E&P subsector is an unattractive one for investment? Hardly. We believe that investment opportunities can be found by patient investors with a fundamental approach. We recently examined nearly 1,000 E&P companies operating in North America and benchmarked their operations "outside-in" to understand how they

Exhibit 2 **Few unconventional producers are currently distressed.**

Intrinsic value and traded prices of debt of largest North American LTO[1] producers, 2015

Intrinsic-valuation index



[1] Light tight oil.

Source: Bloomberg; S&P Capital IQ; McKinsey analysis performed on essential sources of value such as asset quality; drilling performance; selling, general, and administrative performance; and other metrics. We adjusted for geological differences and weighted the attributes for their relative impact on value creation. The result is an intrinsic-valuation index, which we then compared with the capital markets' perspective. A snapshot of the resulting analysis (large light-tight-oil producers) is shown in Exhibit 2. Across all the 1,000 or so E&P firms we studied, less than 5 percent can truly be called undervalued.

That picture may change over time; if prices stay low, more producers will become distressed. Investors can also take heart that distress is only one of several possible investment themes. Opportunities for recompletions of older wells, high-quality management teams, and other themes offer ways to drive value.

Finally, a word on North American oil-field-services companies. Many investors struggle with the subsector, perceiving it to have low entry barriers, high cyclical exposure, and a mixed history of "real" value creation. While these concerns are valid, we believe that there are certain niches that offer a promising upside at current valuation levels. A rapid drop in demand has driven some small mom-and-pop firms out of business, granting more pricing power and other benefits to the survivors. In some niches, companies are more exposed to operating expenses, rather than capital expenditures, and their earnings have not suffered the way that companies in other segments have. The market has not completely recognized this difference, which might represent a buying opportunity. ■

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Why US education is ready for investment

As education transforms, the traditional and highly limited openings for private companies are growing wider. Investors should take note.

Jake Bryant and Jimmy Sarakatsannis

US education is a $1.5 trillion industry and growing at 5 percent annually. On the face of it, those figures warrant attention from investors. But most of that spending is hard for investors to access: education is everywhere seen as a public good, entrusted to government and nonprofit institutions, and most spending is on personnel. For-profit companies have historically achieved scale by stepping in to provide education where society has left gaps—by acting as school operators in K–12 and higher education or by providing ancillary services such as tutoring, day care, and test preparation. Private companies have also found niches in corporate training and textbook publishing, though the latter is a heavily consolidated industry.

This decades-old picture is now changing in several ways. The pressure on schools to deliver a higher-quality product is intensifying as the labor market demands better-skilled workers and students and families enjoy greater transparency into schools' performance. Moreover, students are coming to education with greater needs. Most US public-school students in the primary grades now come from low-income households, and about half of post-secondary students need remedial-level instruction when entering college. Finally, technology is disrupting education, as it has so much of modern life and business; more than a third of today's college students have taken at least one course online.

These forces are causing traditional providers to rethink how they serve their students—and providing a moment for investors to reconsider the sector. The number of annual private-equity deals has more than doubled, from 30 in 2007–10 to about 70 in 2012–14. Venture-capital investment hit a record high in 2014 of $1.87 billion, up 55 percent from 2013.

These deals have mostly been dedicated to the traditional investment theses—school operators, large publishers, tutoring and test-preparation services in traditional education settings—as well as corporate training. In the future, investors will likely pursue more fine-grained opportunities as the paths to growth and scale in the space become more diverse. We have identified nine investment themes in education, all driven by the broad forces upending the sector. Here we focus on three of the most prominent—one each in pre-K–12 education, postsecondary education, and corporate training.

Digital resources for K–12 schools. Primary and secondary schools are adopting digital curricula at unprecedented rates, yet teachers report they have trouble finding digital products that meet their needs. We surveyed teachers and found that 60 percent lack the digital instructional resources they need. The gap is the worst in science and language arts in the early grades, where more than 70 percent of teachers can't find what they need. New companies are sprouting up to answer these needs. These companies are benefiting from the widespread adoption of the Common Core State Standards, which makes investments in product development relevant to a significant base of potential customers. Many of them are subscale and not yet on investors' radar but could be ripe for roll-up.

Completion services for postsecondary institutions. The focus has shifted from a race to enroll new students to a realization that sustainable growth will only come from helping more students who start a college education actually complete it. Enrollment growth is slowing. And both public attention and government regulations are pressuring colleges and universities to help more of their students graduate and find jobs. Schools are therefore looking to get help from three types of companies: marketing and recruiting services that specialize in finding the kind of student who is likely to succeed, remedial-curricular companies that can help at-risk students catch up to their peers quickly, and companies whose risk analytics can flag students who need intervention throughout their time in college. These companies are worth a look from investors. Many are already at scale, and others are teaming up to provide powerful end-to-end "completion" offerings.

Digital innovation in corporate training. Employers increasingly say that university graduates are not ready for the workplace. Only 40 percent of US employers believe their new employees have the skills they need to succeed. Many are therefore investing more seriously in training their employees themselves, aided by a new generation of online companies whose sophisticated and comprehensive offerings make returns on such investments more certain. The game in corporate education is changing quickly. Recent deals have focused on new types of players (such as informal-learning players and skills-oriented "boot camps") and are integrating the once-distinct offerings of HR services providers, learning-management systems, and training providers. Investors will want to look closely and move quickly. ■

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Global agriculture's many opportunities

The first green revolution advanced agriculture a long way. Today, more investment is needed. Here's a look at one of 24 promising investment themes.

Lutz Goedde, Maya Horii, and Sunil Sanghvi

Food and agribusiness form a $5 trillion global industry that is only getting bigger. If current trends continue, by 2050, caloric demand will increase by 70 percent, and crop demand for human consumption and animal feed will increase by at least 100 percent. Meeting this demand won't be easy: for example, 40 percent of water demand in 2030 is unlikely to be met, and more than 20 percent of arable land is already degraded.[1]

Sensing an opportunity, strategic and financial investors are racing to capture value from technological innovation and discontinuities in food and agriculture. Since 2004, global investments in the food-and-agribusiness sector have grown threefold, to more than $100 billion in 2013, according to a McKinsey analysis. Food-and-agribusiness companies on average have demonstrated higher total returns to shareholders than many other sectors.

But finding new investment opportunities is not easy and requires a detailed understanding of crops, geographies, and complex value chains that encompass seeds and other inputs, as well as production, processing, and retailing. Much of the potential lies in geographies unfamiliar to some investors and is dependent not simply on crop yields but also on how different parts of the value chain perform.

To identify markets and companies that may be attractive, we analyzed changes in population growth, income, demographics and behaviors, productivity, industry structure, and several other factors. Based on this analysis, we identified 24 hot spots that may prove attractive to investors over the next decade, and then assessed these opportunities on market size, risk, and growth potential (exhibit).

Let's look more closely at an important hot spot.

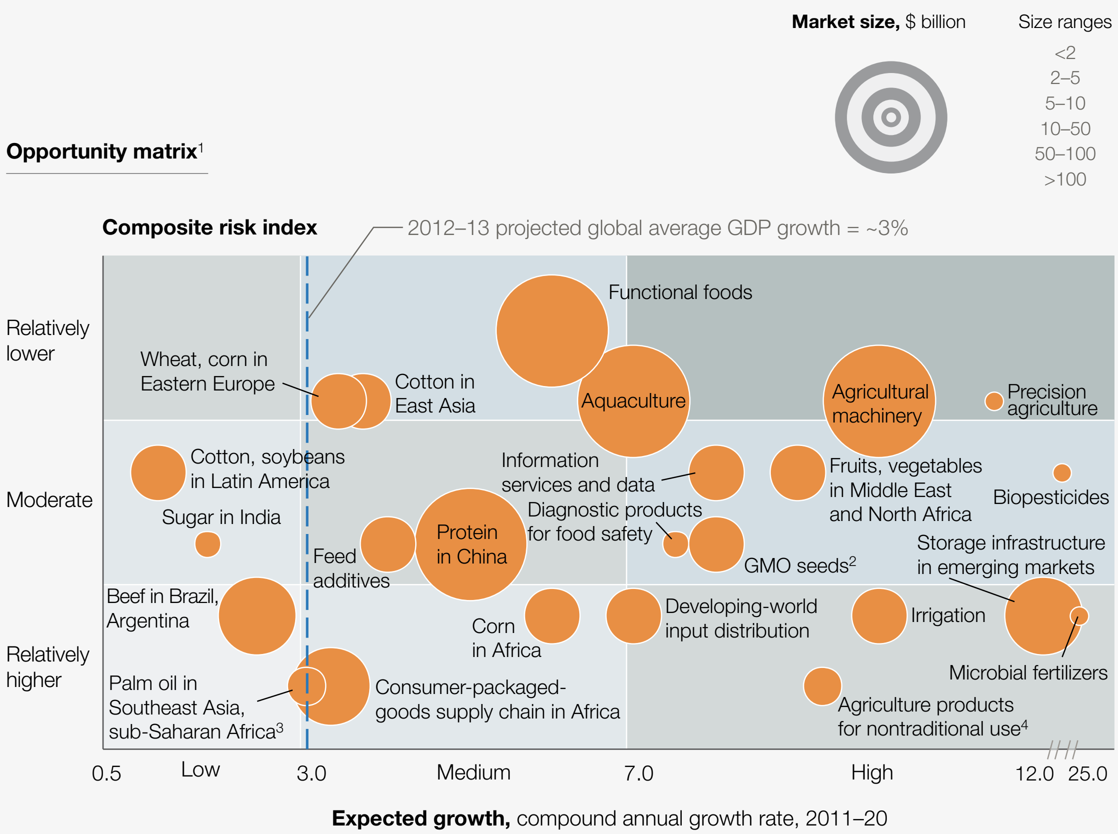
Protein in China

With annual spending of $300 billion, China is the world's largest consumer of meat, two-thirds of which is pork. Protein consumption of all kinds is expected to grow there at 3 to 4 percent a year, mostly as a result of increasing demand from a rising middle class. While levels have risen dramatically, the Chinese continue to trail Western diets in protein consumption. The government has made a strong commitment to modernize the sector, moving from what is largely backyard farming to sophisticated commercial agribusiness. These structural changes and discontinuities make the sector a hot spot worthy of further exploration.

However, the space is vast and complicated, with multiple areas to examine and prioritize across products (pork, poultry, dairy, beef, and fish), value chain (inputs, production, and processing), and cross-cutting themes such as infrastructure. After we assessed major trends, industry structure, and investment opportunities, two areas emerged as attractive possibilities: pork breeding and cold-chain logistics.

Exhibit We have identified 24 hot spots where agribusiness investment is likely to focus.

Opportunity matrix[1]



[1]Growth segments (horizontal axis) are low, <3%; medium, 3–7%; high, >7%. Risk (vertical axis) is measured as the sum of scores across 4 types of risk assessed: execution, geopolitical, regulatory and market, and technological.
[2]Seeds from genetically modified organisms have high regulatory risk in some regions and high acceptance in others (eg, North America).
[3]Palm oil has higher risk in sub-Saharan Africa, where most growth will come.
[4]Agriculture products used for construction and pharmaceuticals (not cotton, energy, food, tobacco, or wood).

Source: *Ag2020: Growth and investment opportunities in food and agribusiness*, a joint report from McKinsey and Paine + Partners, 2013

China's pig-breeding market is substantial, with about $1 billion in annual revenue and favorable economics. Breeding is one of the critical means to modernize the protein industry. The technology and intellectual property developed in genetic research allow companies to capture significant margin. Investors must identify international players that are well positioned, with reliable Chinese partners. It is critical to offer a compelling value proposition to the Chinese government that combines contributing to local production and productivity improvements with food-security solutions, including direct supply chains into China. Meanwhile, Chinese companies are not standing still: WH Group (formerly Shuanghui International Holdings), China's biggest pork producer, completed the $4.7 billion acquisition of Smithfield Foods, the 87-year-old US meat giant with brands such as Armour and Farmland, in September 2013.

On the back of the increased protein demand and formalization of the Chinese food system, there is a potentially big investment opportunity in developing the cold chain, or refrigerated storage and transportation, in the Chinese food industry, given increasing consumer and government expectations for food quality and safety. To reach developed-market scale in both cold storage and transportation, the Chinese cold-chain-logistics market would have to grow more than 20 percent a year for the next five to ten years. Annual growth rates of more than 15 percent are required to reach government targets for cold-chain penetration of agricultural products. Analysts forecast the global cold-chain market to grow at 16 percent annually to 2018. The current industry is fragmented at the local and regional levels, suggesting that more consolidation and vertical integration can be expected. Given the capital intensity of the sector, the opportunity for investors may lie in acquiring an international player that is well positioned in warehouse-logistics management (where the margins are highest) and has the right customer relationships and local partners.

■ ■ ■

Global agribusiness is moving quickly and is already catching up to some of the opportunities our analysis revealed. And conditions are always changing, making investment more difficult in some markets. Nonetheless, the global gap between supply and demand requires more resources—technical, human, and financial. Investors have a critical role to play in meeting this challenge—and opportunities to benefit. ■

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[1] Z. G. Bai et al., *Global assessment of land degradation and improvement: 1. Identification by remote sensing*, Food and Agriculture Organization of the United Nations and ISRIC—World Soil Information, 2008, isric.org. The report defines degradation as a long-term decline in ecosystem function and measures it in net primary productivity.

This article was adapted from "Pursuing the global opportunity in food and agribusiness," July 2015, mckinsey.com.

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Capturing returns in healthcare

New research finds that the healthcare sector has been very good to private equity, especially payor and pharmaceutical services. And specialist firms seem to have an edge over generalists.

Feby Abraham, Myoung Cha, and Garikai Nyaruwata

We recently analyzed 140 private investments in US healthcare companies from 1995 to 2014 and found that returns were 1.5 times higher than the broader public market, and, in five of eight subsectors, outstripped the US private-equity industry. That strong performance was mirrored in the return multiples that sellers achieved, which were 2.3 times for healthcare versus 1.7 times for all US private equity. An aging demographic has propelled the industry. And the scope for innovation and a steady supply of profitable businesses have made it a fertile market for private-equity investors.

Healthcare covers a wide range of businesses. Some provide services to hospitals and physicians, insurers, and drug companies; others supply products such as pharmaceuticals, biotechnologies, and medical technologies. Naturally, profit pools, margins, and growth rates vary widely among these subsectors; so do risk and returns (Exhibit 1).

What may surprise some is the identity of the outperforming subsectors. Consider payor services, where investors have been skeptical of growth prospects because of the pressures that payors face. Much of the activity has been driven by payors' need for technological capabilities, to deal directly with individuals as direct purchasers of health-care or to diversify into new populations.

Also surprising is the strong performance of buyouts in pharmaceuticals (including both generics and specialty pharma). As is well known, Big Pharma has been on an acquisition spree. Private owners have sold into this wave, capitalizing on the scarcity of new high-growth pharmaceutical products. TPG's exit from Par Pharmaceutical Companies, which earned it a sevenfold return in three years, is a recent notable example. Others include Stiefel Laboratories (sold by The Blackstone Group to GlaxoSmithKline), Ikaria (New Mountain Capital/Madison Dearborn Partners to Mallinckrodt Pharmaceuticals), Talecris Biotherapeutics (Cerberus Capital Management/Ampersand Capital Partners to Grifols), and JHP Pharmaceuticals (Warburg Pincus to Par Pharmaceutical Companies).

Selecting the right subsector is not enough; we found a wide range of performance within every sub-sector. In part, this is driven by a handful of deals that achieved outstanding performance. These outliers skew subsector averages much higher than medians. Leave aside these deals, however, and performance still varies considerably. We see two factors at work.

First, our research suggests that exits to strategic buyers produce higher returns than sales to other private-equity funds (Exhibit 2). Naturally, strategic buyers are often willing to pay over the odds because of the synergies they can reap, but private-equity firms have also begun to bid multiples higher.

The research also found that there is significantly greater variance in holding periods than in multiples. The variance suggests that investors should think about the time to exit at least as much as they think about multiple expansion. Entering a transaction with a clear exit plan, based on an understanding of the asset's strategic value, is one way to do so.

Success also seems to be driven in part by superior knowledge (Exhibit 3). Sector specialists have long argued that they have an advantage in industries as complex as healthcare. Although the data set here is small (14 deals done by specialists and 84 by generalists), it indicates that specialists have attained somewhat higher median returns than

Exhibit 1 **Payor services and pharma services have generated the greatest median returns.**

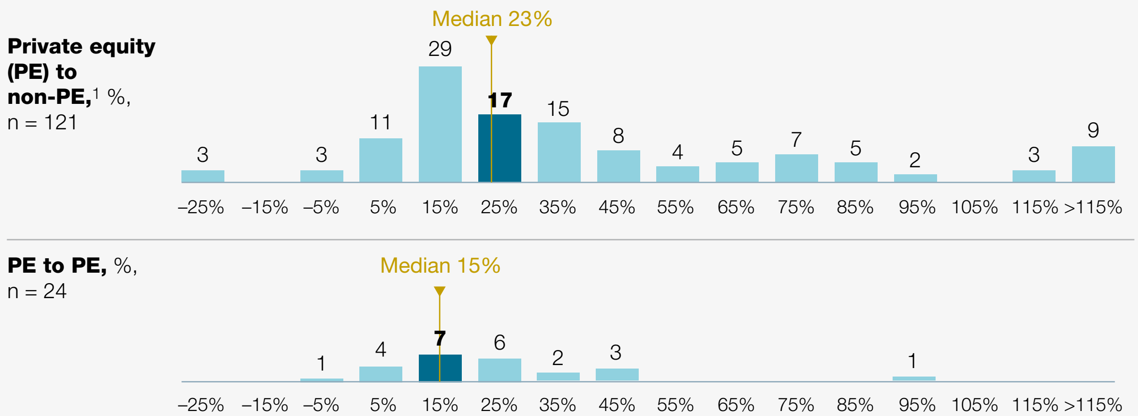
Target sector	**Sector type**[1]	**Number of targets**	**Average deal size,** $ million	**Median return rate,** %	**Multiple of median deal by return,** x	**Holding period of median deal by return,** years
Payor services	Services	14	476	39	3.3	3.6
Pharma services	Services	15	321	39	2.2	2.5
Diagnostics	Services	6	183	27	2.4	3.7
Pharma and biotech	Products	22	470	26	2.7	4.0
Medical technologies	Products	29	605	20	5.4	9.4
Provider services	Services	35	356	16	2.0	4.5
Healthcare IT	Services	5	428	12	1.8	5.0
Radiology	Services	5	164	7	1.4	4.7

[1] Sectors with n <5 were excluded. Consumer-health and animal-health products and services were excluded as a result.

Source: PitchBook Data; Preqin; press search; S&P Capital IQ

Exhibit 2

Exits to strategic buyers have provided greater median returns.

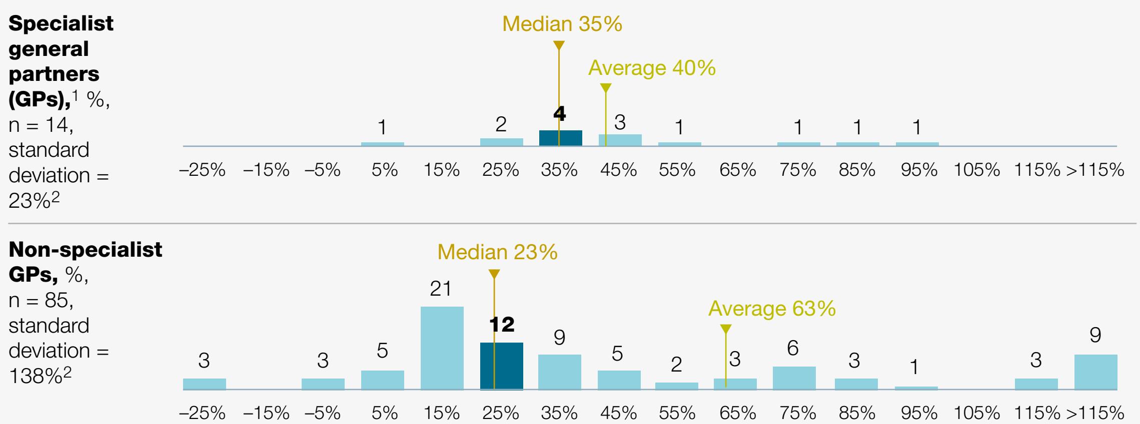


[1]Includes trade sales, IPOs.

Source: PitchBook Data; Preqin; press search; S&P Capital IQ

Exhibit 3

Specialists have higher and less-variable returns but fewer 'blockbuster' deals.



[1]>40% of past 10-year deal volume in healthcare-related transactions. Excludes consortium deals.
[2]Standard deviations are statistically different at the 1% significance level (2-tail F-test p-value = 0.00).

Source: PitchBook Data; Preqin; press search; S&P Capital IQ

generalists. That they have done so with significantly less variability is what sets them apart. Healthcare expertise apparently helps to mitigate risk. Risk aversion also has a downside, of course. Specialists tended to produce fewer "blockbuster" deals (those with an internal rate of return of more than 100 percent) than generalists. ■

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The new dynamics of automotive supply

The sector is popular with private investors. But before jumping in, buyers must understand the nuances that will drive growth in the next five years.

Jeremiah Connolly and Parmeet Grover

The years 2013 and 2014 were banner ones for private-equity investment in the automotive sector—two of the most active since 2002 (Exhibit 1). Deal flow looks set to remain strong in coming years, driven by a wave of potential secondary sales as firms look to exit the investments they made in the 2006–08 investment boom.

However, we believe that the sector will require a more discerning eye in the future. Over the past five years, the recovery of new-car sales from the depths of the 2008–09 crisis created a natural tailwind that supported a number of investment theses in the sector. With vehicle sales now fully recovered, that tailwind seems to be fading. As a result, investors will need to look closer and analyze targets for their exposure to subtle dynamics that will generate pockets of outsize returns in the next five years. Here we examine several dynamics affecting the world's largest aftermarket, the United States, and the world's fastest-growing large aftermarket, China.

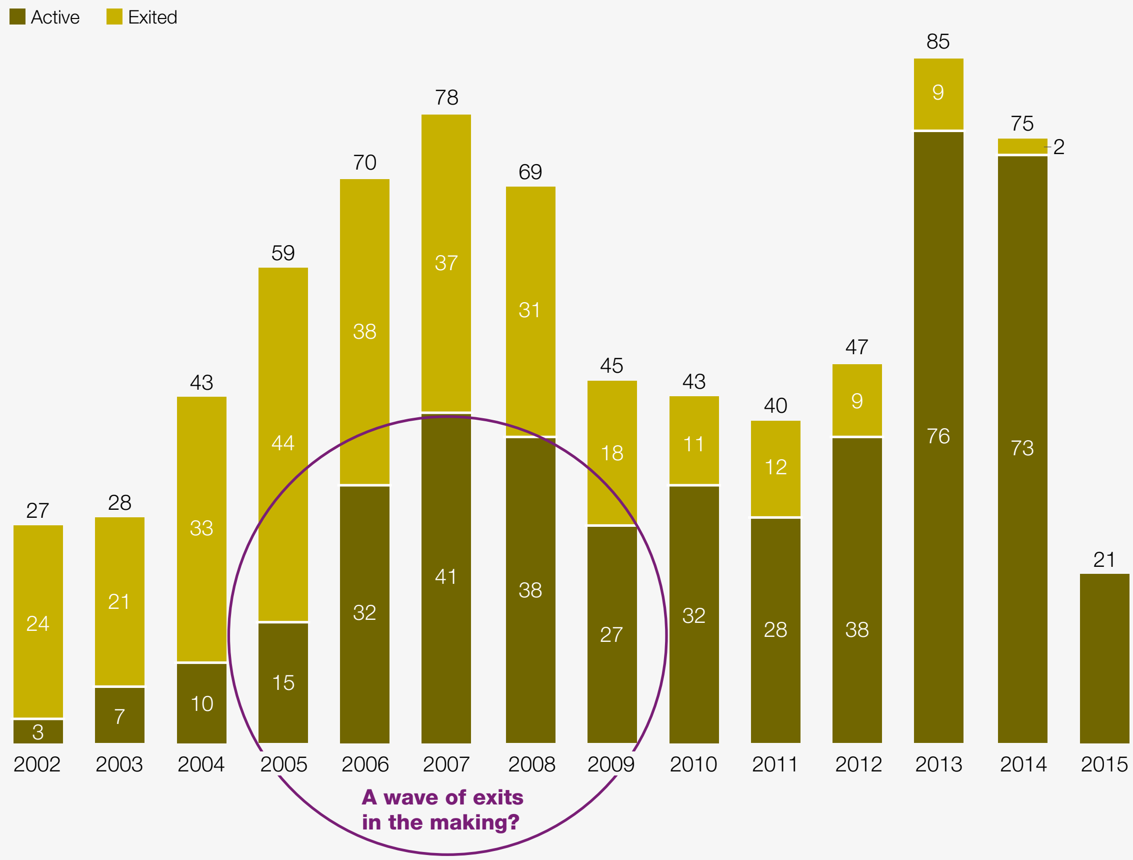
US aftermarket: The echo effect and changes in distribution

Because of the 2008–09 dip in new-car sales and subsequent recovery, the number of 8- to 11-year-old vehicles in the US auto fleet will grow substantially between 2017 and 2020. Parts age at different rates, and the parts that the autos of this age group are more likely to need will see outsize growth versus the market. Starters and ignition wires, for example, are much more likely to need replacement in a decade-old car than in a slightly newer one (Exhibit 2).

Shifts in the distribution system are also important in the US aftermarket. Consider three examples. First, customers' channel preferences are shifting. From 2002 to 2014, the Automotive Aftermarket Industry Association estimates that the total US aftermarket grew 2.8 percent annually, but during that time, aftermarket sales through warehouse clubs and superstores grew 9.9 percent, and online sales grew 7.6 percent annually.

Exhibit 1 **Automotive is an active sector, with more activity to come.**

Buyouts of global automotive companies, 2002–15



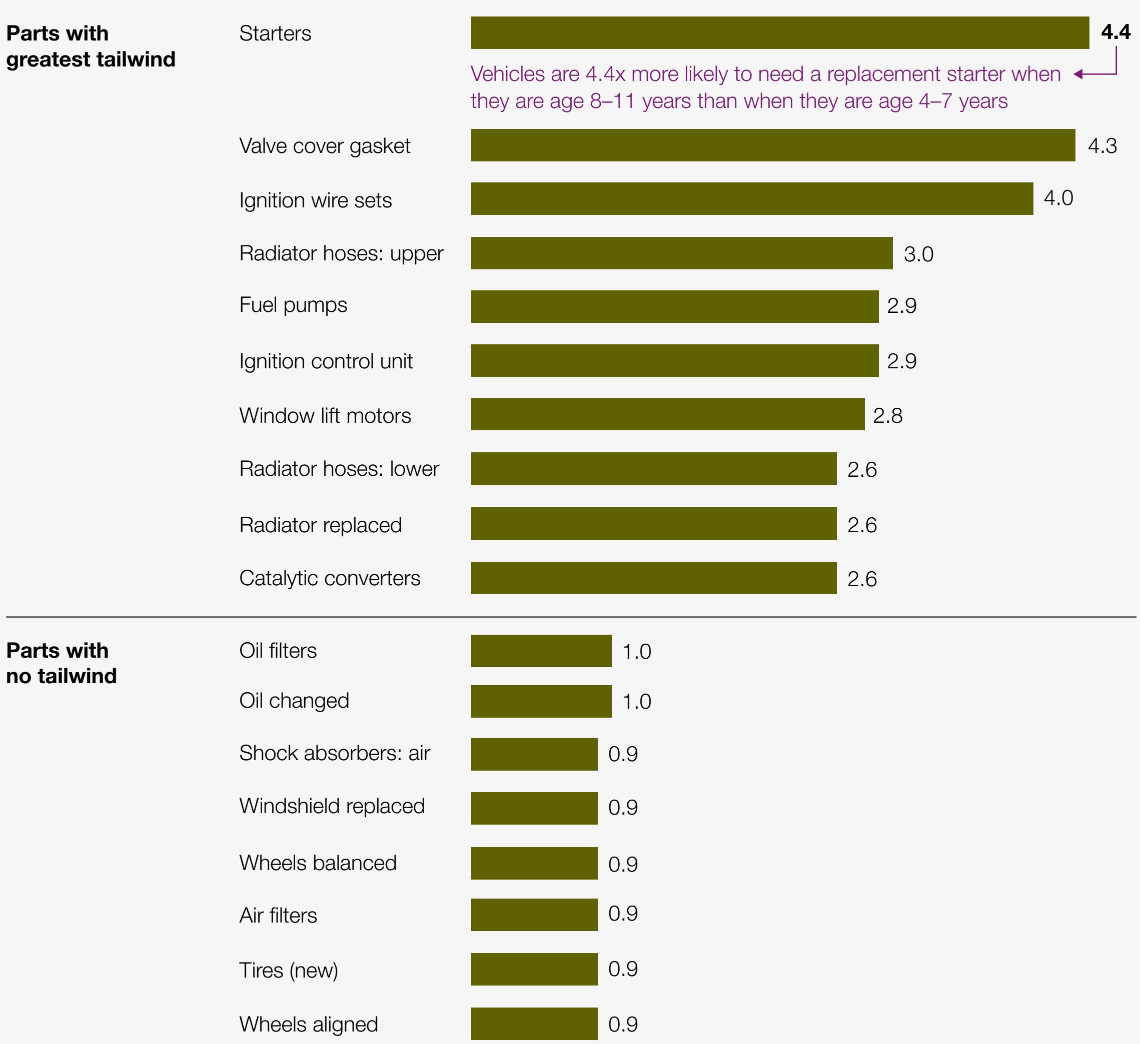
Source: Preqin; McKinsey analysis

Second, the rise of digital is radically reshaping the consumer decision journey and giving rise to new players. Customers are using online resources to become radically better informed before making decisions at brick-and-mortar retail points. Players such as Autotrader and Kelley Blue Book not only capture value through their services but also influence the distribution of value across the industry by using their platform to influence consumers in all channels.

Finally, channels are consolidating or changing their focus, with implications for suppliers. As one example, the National Automotive Parts Association and Motion Industries are consolidating US aftermarket distribution, creating opportunities for suppliers that enjoy good relationships with those consolidators to "ride along" and capture share through their roll-up. Perhaps more dramatic is the consolidation and shift in the dealer channel. Over the past ten years, the number of US dealers has fallen by 20 percent, and profits have shifted substantially from new-vehicle sales to aftermarket parts and service. Suppliers that have the channel management required to navigate these shifts will be poised to capture share as the market evolves.

Exhibit 2 **Some aftermarket parts will benefit strongly from the echo effect.**

Ratio of replacement rates, 8- to 11-year-old vehicles vs 4- to 7-year-old vehicles

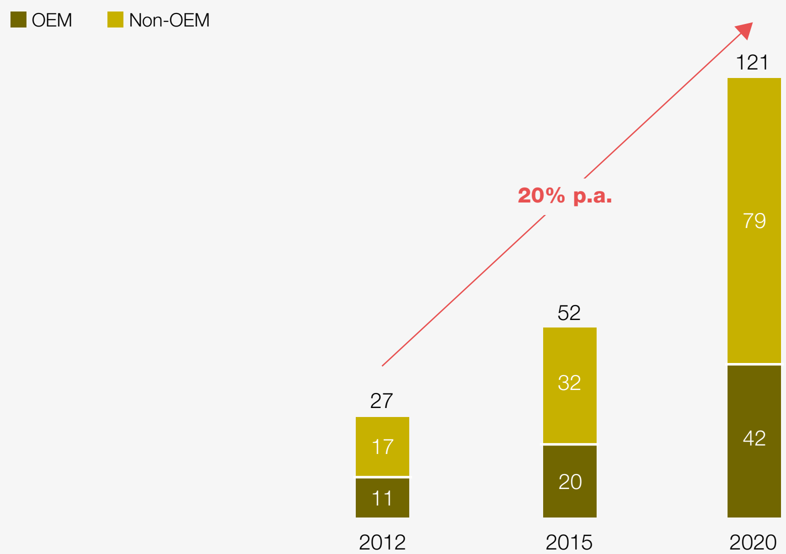


China's aftermarket: Chains up, mom-and-pops down

By contrast, the Chinese aftermarket requires no timing. Rapidly growing vehicle production and rising per-vehicle spending as GDP grows make the Chinese aftermarket the industry's best opportunity for growth, at about 20 percent annually (Exhibit 3). At that rate, China's aftermarket could be worth more than $100 billion in 2020. But catching this wave requires an understanding of two shifts in channel structure. First, we expect that independent aftermarket players will capture share versus OEM-affiliated players (independents could have 45 percent share in 2020 versus 40 percent in 2014). Second, within the independent segment, chain stores will likely expand their share substantially in the next ten years (at the expense of mom-and-pop aftermarket stores). By 2020,

Exhibit 3 **China’s aftermarket is among the world’s best opportunities for growth.**

$ billion[1]



	2012	2015	2020
Spend/vehicle, $	~360	~425	~565
Vehicles in operation, millions	76	122	217

[1]Numbers may not sum, because of rounding.

Source: IHS; McKinsey analysis

chain stores will likely have 70 percent of the independent channel, up from 55 percent in 2014. Investors should look for suppliers with a strong position in independent chain stores, rather than those that depend on OEM stores or mom-and-pops.

All in all, automotive supply will continue to be an attractive hunting ground for investors looking for GDP-plus opportunities. But knowing the terrain—the new market dynamics that will make some segments grow faster than others—is essential to success. ■

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