

# McKinsey on Finance

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Perspectives on  
Corporate Finance  
and Strategy

2  
How the growth  
of emerging markets  
will strain global  
finance

10  
How CFOs can keep  
strategic decisions  
on track

16  
A return to  
deal making in  
2010

21  
Past lessons  
for China's new  
joint ventures

27  
The myth of smooth  
earnings



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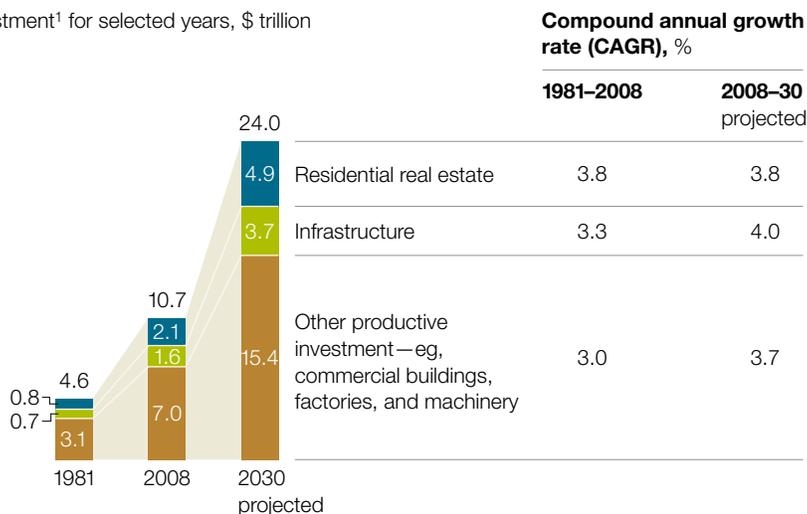




## Exhibit 1

## In 2030, global demand for investment is expected to reach \$24 trillion.

Global investment<sup>1</sup> for selected years, \$ trillion



<sup>1</sup>At constant 2005 prices and exchange rates; forecast assumes price of capital goods increases at same rate as other goods and assumes no change in inventory.

Source: Economist Intelligence Unit; Global Insight; Oxford Economics; World Development Indicators, World Bank; McKinsey Global Institute analysis

suggests, however, that the global saving rate is not likely to rise in the decades ahead, as a result of several structural shifts in the world economy.

First, China's saving rate will probably decline as it rebalances its economy so that domestic consumption plays a greater role. In 2008, China surpassed the United States as the world's largest saver, with the national saving rate reaching over 50 percent of GDP. But if China follows the historical experience of other countries, its saving rate will decline over time as the country grows richer, as happened in Japan, South Korea, Taiwan, and other economies (Exhibit 2). It is unclear when this process will begin, but already the country's leaders have started to adopt policies that will increase consumption and reduce saving.<sup>4</sup> If China succeeds at increasing

consumption, it would reduce the 2030 global saving rate by around two percentage points compared with 2007 levels—or about \$2 trillion less than China would have accumulated by 2030 at current rates.

Moreover, expenditures related to aging populations will increasingly reduce global saving. By 2030, the proportion of the population over the age of 60 will reach record levels around the world. The cost of providing health care, pensions, and other services will rise along with the ranks of the elderly. Recent research suggests that spending for the retired could increase by about 3.5 percentage points of global GDP by 2030.<sup>5</sup> All of this additional consumption will lower global saving, either through larger government deficits or lower household and corporate saving.

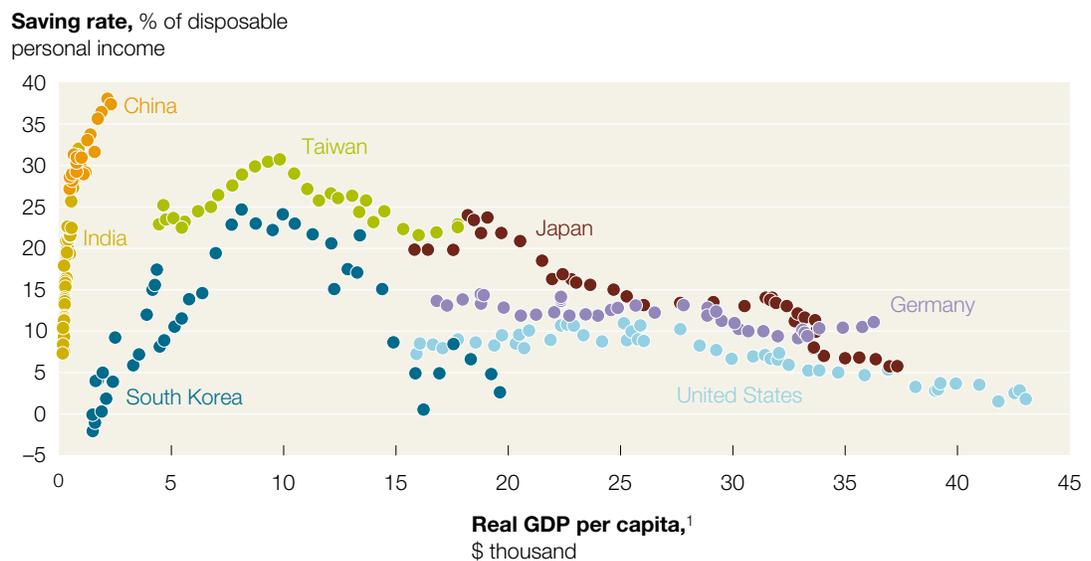
Skeptics may point out that households in the United States and the United Kingdom have been saving at higher rates since the 2008 financial crisis, especially through paying down debt. In the United States, household saving rose to 6.6 percent of GDP in the second quarter of 2010, from 2.8 percent in the third quarter of 2005. In the United Kingdom, saving rose from 1.4 percent of GDP in 2007 to 4.5 percent in the first half of 2010. But even if these rates persist for two decades, they would increase the global saving rate by just one percentage point in 2030—not enough to offset the impact of increased consumption in China and of aging.

Together, these trends mean that if the consensus forecasts of GDP growth are borne out, the global supply of savings will be around 23 percent of GDP by 2030, falling short of global investment demand by \$2.4 trillion. This gap could slow global GDP growth by around one percentage point a year. What’s more, sensitivity analysis of several scenarios suggests that a similar gap occurs even if China’s and India’s GDP growth slows, the world economy recovers more slowly than expected from the global financial crisis, or other plausible possibilities transpire, such as exchange-rate appreciation in emerging markets or significant global investment to combat and adapt to climate change (Exhibit 3).

Exhibit 2

**Historically, as countries grow wealthier their household saving rates decline.**

Household saving rate and GDP per capita for selected countries, 1960–2008



<sup>1</sup>At constant 2005 prices and exchange rates.

Source: Bank of Japan, Bank of Korea; Directorate-General Budget Accounting and Statistics, Republic of China; Global Insight; Reserve Bank of India; US Bureau of Economic Analysis; World Development Indicators, World Bank; McKinsey Global Institute analysis

### Implications

Our analysis has important implications for both business leaders and policy makers. Businesses and investors will have to adapt to a new era in which capital costs are higher and emerging markets account for most of the world's saving and investment. Governments will play a vital role in setting the rules and creating the conditions that could facilitate this transition.

#### Higher capital costs

Nominal and real interest rates are currently at 40-year lows, but both are likely to rise in coming years. If real long-term interest rates returned to their 40-year average, they would rise by about 150 basis points from the level seen in the autumn of 2010. The growing imbalance between the supply of savings and the demand for investment capital will be significant by 2020. However, real long-term rates—such as the real yield on a ten-year bond—could start rising even within the next five years as investors

anticipate this structural shift. Furthermore, the move upward isn't likely to be a one-time adjustment, since the projected gap between the demand for and the supply of capital widens continuously from 2020 through 2030.

Capital costs could easily go even higher. Real interest rates can also include a risk premium to compensate investors for the possibility that inflation might increase more than expected. History shows that real interest rates rise when investors worry about the possibility of unexpected spikes in inflation. Today, investors are beginning to anticipate higher inflation resulting from expansive monetary policies that major governments have pursued.

Finally, as the recent crisis demonstrated, short-term capital isn't always available in a capital-constrained world. Companies should seek more stable (though also more expensive) sources of funding, reversing the trend toward the increasing use of short-term debt over the past two decades.

## Exhibit 3

### Even if investment demand slows, the supply of savings still falls short.

Global investment demand and saving rate as % of global GDP

	2030 scenarios		
	Consensus global growth	Slower long-term growth in China and India	Weak global recovery
Global demand for investment	25.1	23.7	23.6
Global saving rate	22.6	21.3	22.7
<b>2030 savings shortfall</b>	<b>\$2.4 trillion</b>	<b>\$2.2 trillion</b>	<b>\$0.8 trillion</b>

Source: Economist Intelligence Unit; Global Insight; Oxford Economics; World Development Indicators, World Bank; McKinsey Global Institute analysis

## As incomes in emerging markets rise and capital markets develop, nonfinancial businesses can expect healthy growth from investing in both physical and financial assets.

The portion of all debt issued for maturities of less than one year rose from 23 percent in the first half of the 1990s to 47 percent in the second half of the 2000s. Financing long-term corporate investments through short-term funding will be riskier in the new world, compared with financing through equity and longer-term funding. To better align incentives, boards should revisit some of their inadvertent debt-oriented biases, such as using earnings per share (EPS) as a performance metric.

### Changing business models

If capital costs increase, companies with higher capital productivity—greater output per dollar invested—will enjoy more strategic flexibility because they require less capital to finance their growth. Companies with direct and privileged sources of financing will also have a clear competitive advantage. Traditionally, this approach meant nurturing relationships with major financial institutions in financial hubs such as London, New York, and Tokyo. In the future, it might also mean building ties with additional sources of capital, such as sovereign-wealth funds, pension funds, and other financial institutions from countries with high saving rates.

Moreover, for companies whose business models rely on cheap capital, an increase in real long-term interest rates would significantly reduce their profitability, if not undermine their operations. The financing and leasing arms of consumer-

durables companies, for example, would find it increasingly difficult to achieve the high returns of the recent past as the cost of funding increases. Companies whose sales depend on easily available consumer credit would find growth harder to achieve.

### Shifting investor strategies

Investors will want to rethink some of their strategies as real long-term interest rates rise. In the short term, any increase in interest rates will mean losses for current bondholders. But over the longer term, higher real rates will enable investors to earn better returns from fixed-income investments than they have in the years of cheap capital. This change could shift some investment portfolios back to traditional fixed-income instruments and deposits and away from equities and alternative investments.

For pension funds, insurers, endowments, and other institutional investors with multidecade liabilities, the world's growing infrastructure investment could be an attractive opportunity. Many of these institutions, however, will need to improve their governance and incentive structures, reducing pressure to meet quarterly or annual performance benchmarks based on market-to-market accounting and allowing managers to focus on longer-term returns. This change would be required as institutions come to manage portfolios with a growing proportion of less liquid, long-term investments, since volatility in market

prices may reflect market liquidity conditions rather than an investment's intrinsic, long-term value.<sup>6</sup>

Emerging markets, though they may present attractive opportunities, also pose many risks and complexities, and returns could vary significantly across countries. As incomes in emerging markets rise and capital markets develop, nonfinancial businesses can expect healthy growth from investing in both physical and financial assets. Returns to financial investors are less certain, however, particularly in countries with low returns on capital or savings trapped in domestic markets by capital controls or a "home bias" among domestic savers and investors.<sup>7</sup> These countries will remain susceptible to bubbles in equity, real-estate, and other asset markets, with valuations exceeding intrinsic levels. Foreign investors will need to assess valuations carefully before committing their capital. They will also have to take a long-term perspective, since volatility in these bubble-prone markets may remain higher than it is in the developed world.

#### A call for government action

Governments will need to encourage the flow of capital from the world's savers to places where it can be invested in productive ways while minimizing the risks inherent in closely intertwined global capital markets. Governments in countries with mature markets should

encourage more saving and domestic investment, rebalancing their economies so they depend less on consumption to fuel growth. Policy makers in these countries, particularly the United Kingdom and the United States, should start by putting in place mechanisms to sustain recent increases in household saving. They could, for instance, implement policies that encourage workers to increase their contributions to saving plans, enroll in pension plans, and work longer than the current retirement age. Further, governments can themselves contribute to gross national savings by cutting expenditures.

To replace consumption as an engine of economic growth, governments in these countries also should adopt measures aimed at boosting domestic investment. They could, for example, provide accelerated tax depreciation for corporations, as well as greater clarity on carbon pricing—the current uncertainty is holding back clean-tech investment. They should also address their own infrastructure-investment backlog, although this could require them to revise government accounting methods that treat investment and consumption in the same way.

In emerging economies, governments should promote the continued development of deep and stable financial markets that can effectively gather national savings and channel funds to the most productive investments. Today, the financial



systems in emerging markets generally have a limited capacity to allocate savings to users of capital. We see this in these countries' low level of financial depth—or the value of domestic equities, bonds, and bank deposits as a percentage of GDP.<sup>8</sup> Policy makers should also create incentives to extend banking and other financial services to the entire population.

At the same time, policy makers around the world should create the conditions to promote long-term funding and avoid financial-protectionist measures that obstruct the flow of capital. This will require removing constraints on cross-border investing, whether through restrictions on pension funds and other investors or on capital accounts. Policy makers must also create the governance and incentives that enable managers of investment funds with long-term liabilities, such as pension funds, insurance companies, and sovereign-wealth funds, to focus on long-term returns and not on quarterly results that reflect market movements and can deviate from long-term valuations.



At this writing, global investment already appears to be rebounding from the 2009 recession. The outlook for global saving is less certain. A climate of costlier credit will test the entire global economy and could dampen future growth. The challenge for leaders will be to address the current economic malaise and simultaneously create the conditions for robust long-term growth for years to come. ○

<sup>1</sup> See the McKinsey Global Institute (MGI) report *Farewell to cheap capital? The implications of long-term shifts in global investment and saving*, available free of charge on [mckinsey.com/mgi](http://mckinsey.com/mgi), as well as on Amazon.com and the Apple iBookstore.

<sup>2</sup> Throughout this article, “investment” refers to investment in physical assets but not to investment in stocks, bonds, or other financial assets. “Savings” refers to after-tax income minus consumption, so any type of borrowing that increases consumption also reduces savings.

<sup>3</sup> At constant 2005 prices and exchange rates. The consensus GDP forecast is an average of forecasts by the Economist Intelligence Unit, Global Insight, and Oxford Economics.

<sup>4</sup> Officials of China’s government have said publicly that increasing consumption, and hence reducing the current-account surplus, will be a goal in the 12th five-year plan. See also the MGI report *If you’ve got it, spend it: Unleashing the Chinese consumer*, available free of charge on [mckinsey.com/mgi](http://mckinsey.com/mgi).

<sup>5</sup> See *Fiscal Monitor: Navigating the Fiscal Challenges Ahead*, International Monetary Fund (IMF), Fiscal Affairs Department, 2010; and *Global Aging 2010: An Irreversible Truth*, Standard & Poor’s, 2010.

<sup>6</sup> See the comments of Blackstone cofounder Stephen Schwarzman on mark-to-market accounting during the Seoul G20 Business Summit: Sewell Chan, “Schwarzman takes on an old foe: Accounting rules,” *New York Times*, November 11, 2010.

<sup>7</sup> The home bias is the tendency of individuals to hold too little of their wealth in foreign assets to achieve the full benefits of portfolio diversification. See, for instance, Karen Lewis, “Trying to explain home bias in equities and consumption,” *Journal of Economic Literature*, 1999, Volume 37, Number 2, pp. 571–608; Harald Hau and Helene Rey, “Home bias at the fund level,” *American Economic Review*, 2008, Volume 98, Number 2, pp. 333–38; and Kiichi Tokuoka, “The outlook for financing Japan’s public debt,” IMF working paper, 10/19, January 2010.

<sup>8</sup> See the MGI report *Global capital markets: Entering a new era*, available free of charge on [mckinsey.com/mgi](http://mckinsey.com/mgi).



# How CFOs can keep strategic decisions on track

**The finance chief is often well placed to guard against common decision-making biases.**

**Bill Huyett  
and Tim Koller**

When executives contemplate strategic decisions, they often succumb to the same cognitive biases we all have as human beings, such as overconfidence, the confirmation bias, or excessive risk avoidance.<sup>1</sup> Such biases distort the way we collect and process information. Even in the rarefied context of the executive suite, judgment can be colored by self-interest leading to more or less conscious deceptions—for example, around the assumptions critical to the valuation of potential capital projects, M&A targets, divestitures, or joint ventures.

CFOs are often the most disinterested parties to such decisions. They seldom chair the relevant meetings, are often highly critical of decision-making

dynamics and biases, and can cite examples of past successes and failures. With the technical support of the finance staff, they can also provide hard data to counter the inherent biases of other executives. Yet only a minority of CFOs are fully leveraging their position to change the dynamics of decision making—to promote institutional learning in the interest of better strategic decisions.

To figure out why that might be so—and to look for techniques CFOs can use when playing this critical role—McKinsey’s Bill Huyett and Tim Koller recently talked with Olivier Sibony, a director in McKinsey’s Paris office and a coauthor of numerous articles on the subject of cognitive biases in business decision making.



**McKinsey on Finance:** *Why aren't CFOs better at using their position to improve the quality of decision making?*

**Olivier Sibony:** CFOs often struggle with a confusion of roles. They're expected to be both the impartial challenger and an important player in getting things done. They advise the CEO on M&A, but they also drive the discussions with the targets. They have to make sure that the company has the right financing structure, and they're also supposed to negotiate with the banks. Resolving that tension between roles is where the CFO can do a better job.

The way to do that, I would argue, is for the CFO to view herself not only as the impartial, cool-headed adviser of the CEO, nor just as the executor of the mechanics of a decision, but primarily as the owner of a safe and sound decision-making process—which is a role that no one else plays. And if there is one thing that we take away from the study of behavioral economics, it is that this role is vital. You need to have better processes to make decisions, because people can't make better decisions alone, but good processes can help if they build on the insights and judgment of multiple people. I'm not saying the CFO is the only person who can build such a process, but she's in a uniquely good position to build one.

**McKinsey on Finance:** *Why does process matter so much?*

**Olivier Sibony:** Process matters in decision making because we can't learn from our mistakes the way we think we can. Cognitive biases are everywhere, we all have them, and we pretty much know what they are. We know we're overconfident, we know we're susceptible to anchoring, we know we underresearch things that

disprove our hypotheses and overresearch things that confirm them, and so on. But these biases are hardwired, and there's not much we can do about them as individuals. So we can will ourselves to not be overconfident until we're blue in the face; we'll still be overconfident.

You can test this yourself. Ask a group of people if they think they are above-average drivers. In the United States, nine out of ten will tell you they're in the top 50 percent. Now, they all laugh when they get that feedback, but you ask them to do it again and you get the same results. They all think that it's all those guys around them who are overestimating themselves.

It's the same in business. We may agree with the proposition that businesspeople in general are overconfident. We may even accept that we've been overconfident ourselves in our past decisions, but we always think that *this time will be different*. Here I'm using the example of overconfidence because it's easy to demonstrate, but the same is true of other biases. Biases are very deeply ingrained and impervious to feedback.

**McKinsey on Finance:** *So you depend on a multiperson process to control bias?*

**Olivier Sibony:** Exactly. You build a multiperson process where your biases are going to be challenged by somebody else's perspective. And as CFO, if you manage this process, your goal is to ensure that the biases of individuals weigh less in the final decision than the things that should weigh more—like facts. In other words, you can't improve your own decision making in a systematic way, but you can do a lot to improve your organization's decision making through a good process, and that's what CFOs are uniquely well placed to do.

**McKinsey on Finance:** *It sounds like you're drawing a contrast between the processes of human interaction and decision making and the more obvious technical systems that the CFO runs—for example, around valuation procedures and merger-management procedures.*

**Olivier Sibony:** There is a contrast and there is also a synergy. The contrast is that CFOs already rely on processes to manage, as you point out, the technical systems. But it's very easy for people to subvert technical systems to get the answer they want. The typical example of this in M&A is when deal advocates work backward from the price demanded to determine how much in synergies the deal would require to make sense.

What people spend a lot less time thinking about are the interpersonal interactions—the processes of debate—that ensure high-quality decision making. And that is where the synergy lies for CFOs: if you already own the technical processes, you can build on them to improve the quality of debate, for instance by adjusting the agenda, attendees, and protocols of key decision meetings.

**McKinsey on Finance:** *What are some examples of process changes that companies can use?*

**Olivier Sibony:** Let me start with an analogy. Imagine walking into a courtroom where the trial consists of a prosecutor presenting PowerPoint slides. In 20 pretty compelling charts, he demonstrates why the defendant is guilty. The judge then challenges some of the facts of the presentation, but the prosecutor has a good

answer to every objection. So the judge decides, and the accused man is sentenced.

That wouldn't be due process, right? So if you would find this process shocking in a courtroom, why is it acceptable when you make an investment decision? Now of course, this is an oversimplification, but this process is essentially the one most companies follow to make a decision. They have a team arguing only one side of the case. The team has a choice of what points it wants to make and what way it wants to make them. And it falls to the final decision maker to be both the challenger and the ultimate judge. Building a good decision-making process is largely ensuring that these flaws don't happen.

**McKinsey on Finance:** *How do you build a process that has these features?*

**Olivier Sibony:** My coauthor, Dan Lovallo, and I did some quantitative research on this.<sup>2</sup> We asked executives to tell us about their investment decisions—which ones worked and which ones didn't and what practices made the difference—and we reviewed over a thousand of them.

One of the practices that we found made the most difference was having explicit discussions of the irreducible uncertainties in the decision. Notice the difference between that kind of conversation and the one elicited by the typical slide in a PowerPoint presentation, with the title "Risks we identified and risk-mitigating actions we will take." That's the way you frame it if you want to look like a confident presenter and want the meeting to go smoothly: you suppress

the discussion of uncertainties. Instead, you should be emphasizing them to make sure you have a debate about them.

Executives reported some other things making a big difference—for example, whether the discussion included points of view contradictory to those of the person making the final decision. In other words, did anyone voice a point of view that was contrary to what the CEO wanted to hear or to what they thought he wanted to hear? And did the due-diligence team actually seek out information that would contradict the investment hypothesis, as opposed to simply building a case for it? These types of things can be hardwired into the process to make sure that they happen, and some companies do this routinely.

**McKinsey on Finance:** *Let's talk about specific techniques. Take M&A as an example—does it help to assign people ahead of time to argue either side of a decision, regardless of what they actually believe?*

**Olivier Sibony:** When evaluating an acquisition, there is of course the issue of impartiality—as Warren Buffett said, relying on one investment bank to tell you if you should do a deal is like asking your barber if you need a haircut. And there

is the more subtle issue of *motivated error*: even people who sincerely believe that their assessments are objective are in fact often biased in the direction of their own interests.

So in this case, it can help in some settings to field two deal teams, at least at some stage in the process: one to argue for the deal and a second to argue against it. In other settings, if companies find that people avoid the direct confrontation that two deal teams imply, managers might prefer to ask the same people to argue both sides of the case or to make the uncertainties explicit. There are many different techniques to foster debate.

**McKinsey on Finance:** *What other techniques come to mind as effective in M&A situations?*

**Olivier Sibony:** Another technique we find useful addresses the overconfidence bias. It is the “premortem,” invented by psychologist Gary Klein, whom we interviewed in 2010.<sup>3</sup> In a premortem, you ask people to project themselves into the future and to assume that a deal has failed—not to imagine that it could fail, but to assume it already has. Then you ask them to write down, individually and in silence, the three to five reasons why it failed. And that forces people to speak up about the risks and the uncertainties that they've kept to themselves



## The goal of the CFO is to ensure that the biases of individuals weigh less in the final decision than the things that should weigh more—like facts.

for fear of appearing pessimistic, uncommitted to the success of the proposal, or disloyal to the rest of the deal team.

A third technique is, at some point in the process, to write a memo explaining why the CEO should *not* do a deal, including the things the CEO would need to believe to not do it. Because by the time companies get to the actual decision meeting, everybody has forgotten about those reasons. So unless they've actually been recorded, no one's left to argue the negative case. Everyone's framing the positive case, and all the reasons you used to be worried about the deal have disappeared.

Here's an example: when one company did a retrospective analysis of a deal that went wrong, it looked at a series of memos from the deal team to the investment committee, two months, one month, and two weeks before the deal was actually approved. The firm found that the top three things on a long list of worries in the first memo fell to the bottom of the list in the next memo and in the final memo had completely disappeared. Apparently, those concerns had been resolved to the team's full satisfaction. But when the deal was done and the acquirers prepared to take possession of the company, guess what were the top priorities on their agenda: the same three things that had been swept under the rug in order to do the deal in the first place. This illustrates the dynamics of deal frenzy: when you sense that

everybody around you wants to do a deal, you're very prone to suppressing evidence that might lead you to not do it.

Another technique we've used is to develop a taxonomy of deals and a checklist for each type of deal. Companies that do a lot of deals, especially private-equity companies, tend to function by association and by pattern recognition and to look at a deal and say, "Oh, this one is just like this or that previous deal." But usually the deals they're reminded of are not the failures but the great successes. And once they latch onto that pattern recognition, it's very difficult to see the broad range of things that actually can make the analogy irrelevant.

What you can do to remedy this bias is to use techniques such as multiple structured analogies or reference class forecasting.<sup>4</sup> The names sound complicated, but the techniques are actually simple to apply. Essentially, they are ways of making sure that you look at a range of examples, not just one, and to explicitly analyze what makes those examples relevant and what could make them less relevant.

If you do enough deals so that you can actually recognize the different patterns, the way to use this technique is to identify the different types of deals and the things that matter for each.

For instance, the things that we need to check in a deal where we acquire complementary product lines are not the same ones that we need to check for when we are doing a cross-selling kind of deal or a geographic-expansion kind of deal. So we will have different deal processes and different due-diligence checklists.

**McKinsey on Finance:** *What advice do you have for CFOs who want to incorporate these techniques into their decision-making processes?*

**Olivier Sibony:** The crucial thing to keep in mind is that there isn't one magic technique that will strip out all biases. This is more about putting in place a process that includes techniques to correct for the biases to which you've been susceptible in the past: probably not 20 techniques but 2 or 3 that you can use to help you avoid those biases in the future.

And once you put a process in place, it's only valuable if it's used consistently. First, because you're going to learn and become better at using the process. Second, because it is precisely when you're about to make a big mistake that you're likely to have made an exception. The temptation, when you have a decision-making process, is always to say that for a really exceptional, difficult decision, we're going to bypass the process, since the decision is an unusual one.

That's precisely what you want to avoid. That's why you need a process and the habit of following it, not just a tool kit of practices that you use from time to time. That's why in areas where we don't tolerate failure, we have routines. If you fly an aircraft, you don't say, "The weather is really bad and we're already behind schedule, so let's skip the takeoff checklist." You say, "This is a flight like every other one, and we're going to use the checklist—that isn't negotiable." ○

<sup>1</sup> Dan Lovallo and Olivier Sibony, "Distortions and deceptions in strategic decisions," *mckinseyquarterly.com*, February 2006.

<sup>2</sup> Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *mckinseyquarterly.com*, March 2010.

<sup>3</sup> "Strategic decisions: When can you trust your gut?" *mckinseyquarterly.com*, March 2010.

<sup>4</sup> Dan Lovallo, Patrick Viguerie, Robert Uhlener, and John Horn, "Deals without delusions," *Harvard Business Review*, December 2007, Volume 85, Number 12, pp. 92–99.



## A return to deal making in 2010

**M&A volumes rose last year for the first time since the crisis. Capital markets think deals created more value too.**

**David Cogman  
and Carsten Buch  
Sivertsen**

The global M&A market ended two years of malaise in 2010, rebounding decisively in the second half of the year. After languishing for the first six months in the wake of higher market volatility<sup>1</sup> and the sovereign-debt crisis in Europe, companies ended the year having announced more than 7,000 deals, at a value of \$2.7 trillion. This marked the first increase in M&A deal numbers and volumes since 2007, as well as a 23 percent increase over 2009 levels, which were the lowest since 2004.<sup>2</sup>

Judging by share price movements before and after deals were announced, investors felt upbeat in 2010 about the acquirers' ability to extract value from M&A. Our analysis found that deals

created more value overall than they did in any year since we began tracking them, in 1997—and that acquirers were more disciplined at capturing this value for their shareholders. Other trends in M&A for the year included continued growth in cross-border M&A, an increase in the number of deals in Asia and Latin America, and modest growth in private-equity deal volumes.

### **A measured rebound**

M&A activity recovered in 2010 but remained well short of a deal frenzy. A rally in stock markets around the world drove growth in the total value of deals: global market capitalization rose to around 80 percent of the 2007 peak, up from around 65 percent in 2009. M&A activity for 2010



as a share of market capitalization<sup>3</sup> (a good indicator of overall deal sentiment) was slightly below the long-term average of 7 to 8 percent. Despite the resurgence, M&A activity as a share of market capitalization was still considerably lower than it was in 1999, when volumes rose as high as 11 percent of global market cap. Last year's other highlights included:

- **Cross-border activity regained momentum.** The long-term trend of increasing cross-border M&A activity seemed to stall in 2009, with a significant drop to just 25 percent of global M&A volumes, down from 40 percent in pre-crisis years. But cross-border activity returned to pre-crisis levels in 2010 as a result of both megadeals<sup>4</sup> and numerous smaller cross-border transactions.
- **Asia-Pacific outbound M&A continued to grow impressively.** Asia-Pacific<sup>5</sup> acquirers increased their share of cross-border activity in 2010. Outbound M&A from that region into Europe and the Americas more than doubled (after having slowed down the year before), growing around twice as fast as M&A volumes in the opposite directions. The Asia-Pacific became a net exporter of around \$46 billion in M&A deal volume, while Europe, the Middle East, and Africa exported \$9 billion and the Americas imported \$55 billion. The Asia-Pacific region accounted for 23 percent of all global activity in 2010, up slightly from 2009.
- **Latin America saw by far its largest M&A volume ever.** In 2010, M&A volumes in Latin America grew to \$250 billion (more than double the 2009 level), accounting for almost 9 percent of global M&A. The growth has been continuous since 2005, and although 2010 volumes were supported by a few megadeals,

such as telco América Móvil's bid for Carso Global Telecom, the number of deals also stood close to an all-time high.

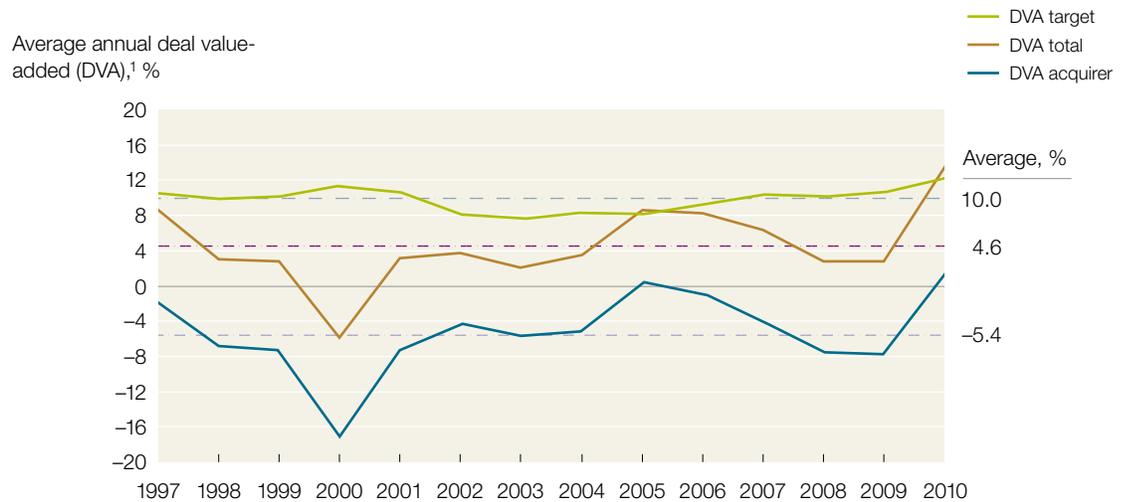
- **Private-equity activity recovered but remained concentrated in OECD countries.** From late 2007 to mid-2009, as access to cheap debt ended abruptly, private-equity activity levels declined steeply, falling to just 4 percent of global deal activity. As many predicted, private-equity activity picked up again in late 2009 and throughout 2010 as credit spreads narrowed and banks again started to offer financing for leveraged buyouts, albeit at significantly higher prices. For 2010, private-equity M&A, at a bit above \$200 billion, accounted for 8 percent of deals by volume. Although nearly double the levels of 2009, this remains far from the \$700 billion peak seen in 2006 and 2007. This rebound was, however, mostly a phenomenon of Organisation for Economic Co-operation and Development (OECD) countries. In 2010, as in previous years, private equity's share of M&A elsewhere remained small. Non-OECD countries constitute around 30 percent of global M&A but only 10 percent of private-equity activity.

### **Positive market sentiment toward acquirers**

Stock markets have typically assessed the value of M&A to acquirers cautiously. Over the past decade, capital market reactions to deals, as gauged by share price reaction to deal announcements, suggested that investors perceived them as creating around 10 percent of their value for the seller and destroying around five and a half percent for the acquirer. This perception reversed sharply in 2010, however: for only the second time in the past decade, markets viewed the average deal as creating value for both acquirer and

## Exhibit 1

## Markets viewed the average deal as creating value for both acquirer and seller.



Number of deals	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Number of deals	90	126	139	133	89	39	49	78	93	154	242	106	77	102

<sup>1</sup>For M&A involving publicly traded companies; DVA defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value. Source: Dealogic; Thomson Datastream; McKinsey analysis

seller. The net value created by M&A, measured as deal value added (DVA),<sup>6</sup> has fluctuated between 3 and 9 percent over the past 14 years, excluding 2000, when it fell to -6 percent. It fell to around 3 percent during the past recession but rose sharply in 2010, to 13 percent—the highest level seen over the past 15 years and far above the historic average of 4.6 percent (Exhibit 1).

Moreover, the data suggest that acquirers also exercised more discipline in their deal making in 2010. The proportion of deals in which the immediate market reaction caused the acquirer's share price to fall—the percentage of over-payers<sup>7</sup> (POP)—fell to 47 percent (Exhibit 2).

This level, which implies that investors thought slightly above half of the deals created value for the acquirers' shareholders and slightly below half destroyed value, is significantly better than the historic average of 60 percent, which we have observed since we began tracking this metric in 1997. Yet premiums paid remained fairly high during 2010.

Markets often treat cash and share deals differently, and that gap widened dramatically. Capital markets consistently perceive cash deals as creating more value than stock deals. On average, cash deals create 11 percent of the deal value, partly as a result of the positive signaling effects of using cash; in contrast,

markets typically perceive share deals as destroying around 3 percent of the deal value. The gap between the two funding methods dropped to a mere 4 percent in 2008, widened again in 2009, and rose as high as 20 percent by 2010. Markets gave extremely positive responses to cash-only deals in 2010, but they also perceived share deals as creating value on average, to the tune of 2 percent.

Furthermore, small deals created significantly greater value than larger ones. Indeed, deals with a value above \$5 billion had a significantly lower deal value-added (DVA), at 3 percent, than smaller deals, at about 15 to 16 percent

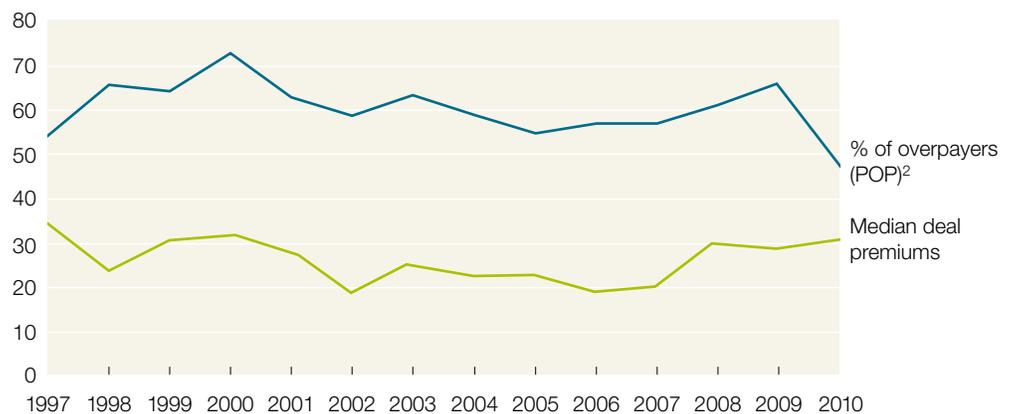
(Exhibit 3). While markets rewarded sellers equally, regardless of deal size, they on average rewarded acquirers significantly less for large than for small deals. This pattern lines up with long-term averages, in which large deals have a slightly negative DVA, while small to midsize deals have a positive 5 to 6 percent DVA.

The gap is not a result of higher premiums for large deals, as premiums paid are fairly similar across deal sizes: for stock deals, there is also no substantive difference across deal sizes. For cash deals, however, a significant difference can be found: markets give a much better reception to small cash-financed deals than to large

Exhibit 2

### Acquirers were also more disciplined in their deal making.

1-week premium,<sup>1</sup> %



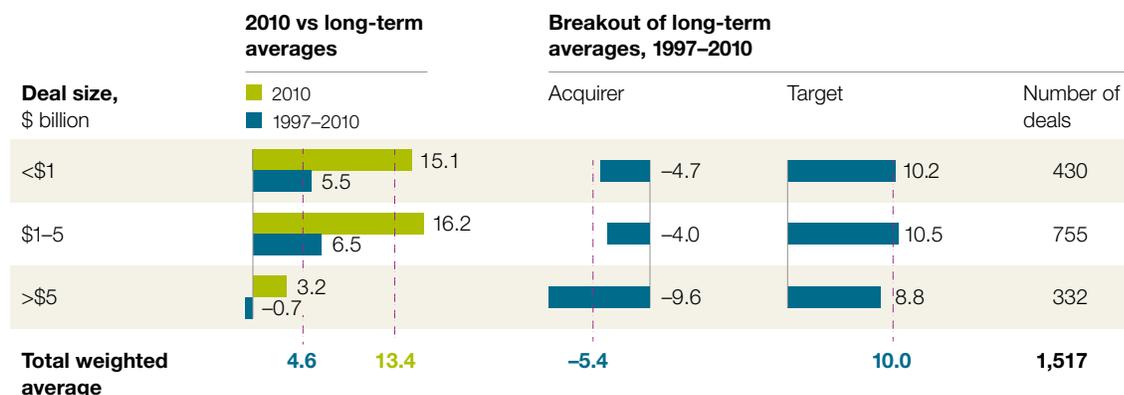
Number of deals	90	126	139	133	89	39	49	78	93	154	242	106	77	102
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<sup>1</sup>For M&A deals involving publicly traded companies; 1-week premium = price offered per share vs target company's share price 1 week before announcement.

<sup>2</sup>POP defined as proportion of transactions in which share price reaction, adjusted for market movements, was negative for acquirer from 2 days prior to 2 days after announcement.

Source: Dealogic; Thomson Datastream; McKinsey analysis

## Exhibit 3

**Markets see less value in big deals.**Average deal value-added (DVA),<sup>1</sup> %

<sup>1</sup> DVA defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value.

Source: Dealogic; Thomson Datastream; McKinsey analysis

cash-financed ones. Potential explanations for this negative attitude could be an anticipation of paying out cash as dividend, worry about increased debt levels, or a need for a rights issue.



The return of market confidence in deal making during the latter half of the year was perhaps the most encouraging aspect of M&A in 2010. Overall deal activity was measured rather than excessive, and capital markets looked favorably upon the resulting value creation. Companies also once again seem willing to engage in more ambitious cross-border deals. Barring any major macroeconomic upsets in 2011, a positive trend seems to have begun. ○

<sup>1</sup> The Chicago Board Options Exchange (CBOE) Volatility Index (or VIX) reached as high as 45, a level not seen since March 2009.

<sup>2</sup> M&A volume includes deals (announced and not withdrawn) of more than \$25 million (total deal value including debt).

<sup>3</sup> Market capitalization of World-DS Market Index as defined by Thomson Datastream.

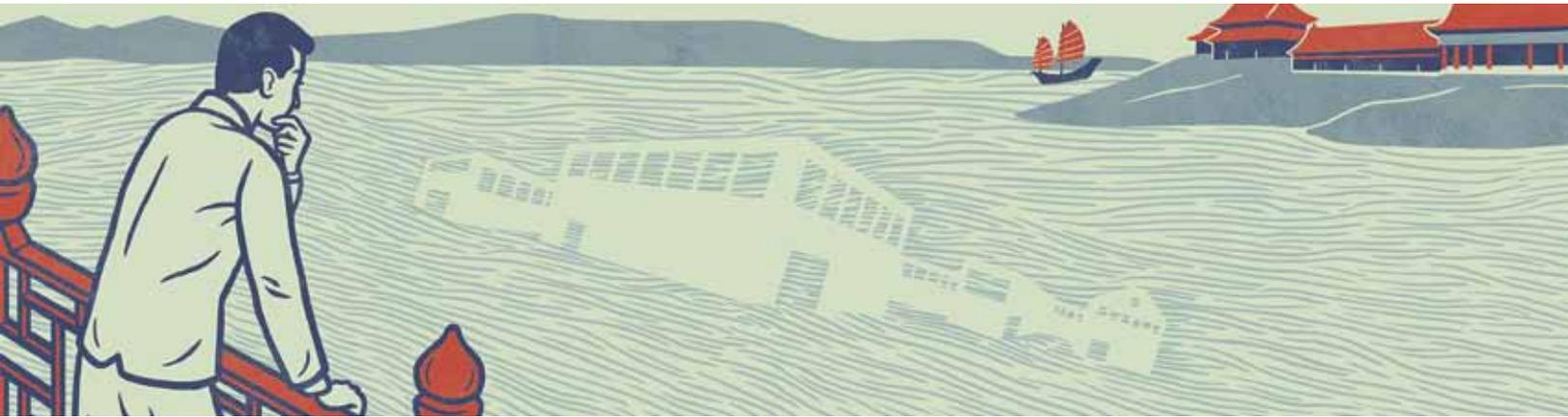
<sup>4</sup> Deals of more than \$5 billion.

<sup>5</sup> Includes all Asian and Pacific countries, including Australia and Japan.

<sup>6</sup> For M&A involving publicly traded companies; DVA defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from two days prior to two days after announcement, as percentage of deal value.

<sup>7</sup> For M&A involving publicly traded companies; POP defined as proportion of transactions in which share price reaction, adjusted for market movements, was negative for acquirer from two days prior to two days after announcement.

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# Past lessons for China's new joint ventures

**As multinationals revive interest in collaborating with Chinese partners, the lessons of past ventures bear remembering.**

**Stephan Bosshart,  
Thomas Luedi,  
and Emma Wang**

It's been ten years since multinationals first began turning away from joint ventures in China as the preferred way to take part in the world's hottest growth story. Many joint ventures failed to endure, and as multinationals gained experience in China, and foreign investment restrictions loosened, multi-nationals found it easier in many sectors to start a business from scratch—or to acquire an existing one outright—than to negotiate, establish, and manage a joint venture in the long term.

No longer. China's hot growth has boosted valuations and increased competition for outright acquisitions of Chinese companies that are often less interested in being acquired. That makes

joint ventures a more appealing option, and so does a growing pool of healthier prospective Chinese partners. All this is prompting some multinationals to reconsider the joint-venture approach as an alternate avenue for getting a stake in the continuing strength of China's economy.

But while the dynamics have changed, the fundamentals have not: companies pursuing joint ventures would do well to reflect on the lessons of past deals to improve the chances of success. In China, some of those lessons are especially critical, such as choosing partners that can make tangible business contributions, safeguarding intellectual property, ensuring operational control of the joint venture, and managing talent.

Others are critical for joint ventures in all geographies, such as aligning strategic priorities, creating a structure that permits rapid responses to change, and preparing up front for eventual restructuring.

### Choosing better partners

When China first opened its doors to multinationals, in the 1980s, some multinational corporations undertook joint ventures with local companies that appeared to be safe bets because of their access to and influence with the local or national government. Even today, many foreign executives prefer to engage with large, well-established Chinese partners.

Yet that preference hasn't benefited joint ventures, typically because the parent companies didn't share the same strategic or commercial interests. Multinationals, for example, have emphasized profitability, even when growth is slow, while their Chinese partners have emphasized growth, even without profitability. The result has been different priorities for investments and a lack of cooperation, both between the parent companies and within the mixed management team.

Instead, multinationals should pair with local companies that explicitly share their strategic goals. This doesn't eliminate large, well-established Chinese companies. But it does open the door to faster-growing, privately owned, and smaller companies that bring a strong commercial mind-set and tangible business assets to joint ventures. The global pharmaceutical corporations GlaxoSmithKline and Novartis, for example, chose such partners in 2009 for their joint ventures in the vaccine market. Thanks to partnerships with smaller local companies—Shenzhen Neptunus Interlong Bio-Technique Company and Zhejiang Tianyuan Bio-Pharmaceutical, respectively—both joint ventures had the access they needed to government vaccine-procurement programs, as well as a talent pool, R&D know-how, and an entrepreneurial management mind-set for further rapid growth.

One drawback that foreign companies may not have encountered in China before: as Chinese executives grow increasingly confident, many of these smaller players themselves hope to become national, regional, or even global players. That aspiration can make it difficult to agree on the scope of the partnership if it's to be limited



## Multinational companies still struggle to protect their intellectual property in China, and joint ventures are particularly vulnerable.

to China or to specific products. One approach is to outline the extent of cooperation both domestically and globally—for instance, whether it includes access to overseas sales channels, noncompete clauses for specific markets, and agreement in principle on the potential evolution of the partnership into additional product lines.

### **Safeguarding intellectual property**

Multinational companies still struggle to protect their intellectual property in China, and joint ventures are particularly vulnerable. Protection in most developed markets occurs primarily through legally binding agreements enforced in courts of law. But the concept of intellectual-property protection is still new in China, and recourse to the legal system can be lengthy and inadequate. Companies have had some success with more pragmatic, operational efforts, including the following:

- **Bringing only older technology to China.**

This approach works for products that may have been available in developed markets for some time but are still competitive in China's market. It also works in industries—such as bacteria streams for fermentation, vaccines, and certain motor engines—where innovation cycles are short.

- **Leaving the blueprints at home.** Multinationals can protect their intellectual property by delivering equipment or technology ready to be installed, without detailed design specifications. Negotiating agreements to do so can signal a lack of trust in the local partners, however, and can increase costs if spare parts and maintenance must be provided from overseas.
- **Keeping critical intellectual property completely out of a joint venture.** Some companies have set up joint ventures that are restricted to those steps in the value chain that involve limited intellectual property, like assembling, packaging, or tailoring. Such an approach is feasible only when local innovation lags behind global standards and, obviously, when the critical intellectual-property component can easily be separated into a step of the value chain.
- **Charging for intellectual property up front.** Some multinationals have chosen to sell their intellectual property to joint ventures, either through up-front cash payments or licensing fees. This approach can be challenging to execute, for while it resonates well with local companies, they generally are willing to pay for technology up front only at a significant discount.

**Taking charge**

In the past, foreign companies agreed to invest in joint ventures as minority or equal stakeholders, often failing to secure management positions that were meaningful enough to guide the development of the joint entity. Such companies often found themselves relegated to providing know-how and capital, with little influence other than board voting rights. In one extreme case, a global multinational had set up multiple joint ventures with leading national players in China. The company was unable to exercise sufficient operational control over, for example, decisions around roll-out plans or product development. Ultimately, it had to sell off its stakes in these ventures.

The ability to influence the course of a joint venture depends largely on the partners' ability to build trust-based relationships at the working level, the joint-venture board level, and even outside the joint venture, with the government or other industry players. Successful multinationals map out critical stakeholders in and around the joint venture (from local management to central regulatory bodies) and assign relationship responsibilities at multiple levels of the organization.

This approach requires developing interaction protocols—the composition of any delegation, the number of visits, the specific topics to be

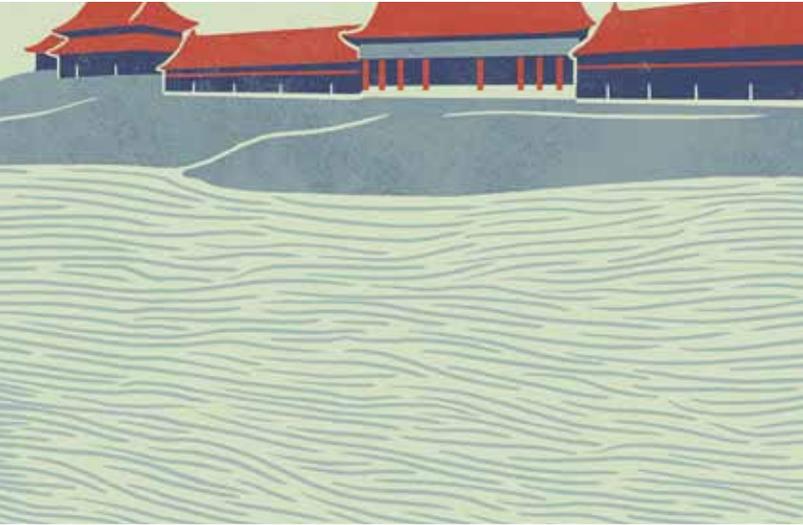
discussed, and so on, depending on the relative importance of the stakeholders and their specific agendas. The CEO of a leading global insurer, for example, often teaches management practices at the Central Party School. His willingness to do so gives him credibility with joint-venture partners by allowing him to interact with current and future decision makers who directly and indirectly influence the course of business in China.

**Managing talent**

Most leading multinationals learned from the first round of joint ventures in China that getting the right managers in place was critical. Many of these companies had simply dispatched available executives—often not top performers but rather average executives searching for new challenges. Most of these executives therefore had limited credibility with the corporate parent and were ill-prepared to manage demanding joint-venture partners. Today, experienced multinationals recognize that a successful joint venture requires credible, high-performing executives supported by strong local teams.

Yet with so many companies competing for the best local candidates, those men and women can afford to be choosy, and they understandably prefer leading companies that have a strong image and offer good prospects for career progression. So today, joint ventures must not

**Experienced multinationals recognize that a successful joint venture requires credible, high-performing executives supported by strong local teams.**



only invest in their corporate brands but also partner with top universities to sponsor undergraduate and graduate students and to establish a training platform for current employees. CEIBS, a leading business school in China (and itself a joint venture), has more than 80 corporate sponsors, which provide funding and in return can recruit on campus and send their executives on advanced training courses.

Finally, companies must continue their commitment even after candidates are hired. In our observation, this means sending some of a multinational's best people to the joint venture to create a strong team, compensating employees at or above relevant market rates, and fast-tracking the advancement of high performers—even breaking away from more tenure-based advancement systems.<sup>1</sup>

### **Aligning priorities**

Regardless of where a joint venture is located, companies spend too little time building

a shared understanding of its future business, the markets it will compete in, and how it will evolve over time. Differences of opinion that are deeply rooted in competing expectations of future performance can affect the joint venture's strategy and focus and eventually lead to its failure.

Take, for example, four life insurance joint ventures that failed in China over the past 12 months, after an average of four to five years of unsatisfactory business development and shareholder disputes. Chinese life insurance partners have been nonfinancial companies accustomed to short breakeven periods of three years or less, with an emphasis on top-line growth and profits. Foreign insurers, on the other hand, take a longer-term view and emphasize sustainable growth in the value of the insurance policies underwritten rather than accounting profits. In the four failed joint ventures, the inevitable tension over strategic priorities led to disagreements about, for example, the right channels for pursuing lower-profitability volume or whether to scale up an agency workforce more quickly, but with a lower level of skills, or more deliberately, with a higher-quality workforce.

These failures might have been avoided if the CEOs of the parent companies and the joint ventures' future management teams had spent time collectively developing business plans and preparing for changes in market dynamics. In contrast, at one of the three most successful foreign life insurers in China, a standing business-development group and a part of the future management team went through multiple iterations with its joint-venture partner to agree on key business priorities, such as volume versus value, channels, products, and target customer segments.

### Responding to change

Once a joint venture is up and running, multinationals should aspire to manage it as if it were their own, putting in place short lines of reporting from the joint venture back to the parent company. This move is important in any joint venture, to give senior managers the timely information they need to assess its performance. But it's especially true in China, where the fast pace in many sectors requires both partners to react quickly to changes in the marketplace or the regulatory environment.

In this respect, multinationals can be at a disadvantage. Decision-making processes for Chinese parent companies might include more people, but once decisions are made, managers execute them quickly. In contrast, foreign companies are slower to react, often encumbered by layers of country and regional management. It is not uncommon for the foreign executives of a joint venture to report back to the multinational's China head, who reports to the head of the international unit, who then eventually reports back to the CEO.

Some of the more successful multinationals we've observed provide for direct reporting lines to their CEOs. Others have assigned responsibility for China to a member of their management boards, sometimes with a dual-reporting line into the regional organization. When a European transportation company made China its second home market, for example, it elevated its China president to the global management board and sent its global CEO to China at least six times a year to meet with the joint-venture partners.

The result was improved cooperation with regulators and therefore faster approvals, more frequent interactions and deeper relationships between the senior management of the parent companies, and closer alignment within the joint ventures' mixed management teams.

### Preparing for breakup

Even in developed markets, joint ventures are often restructured within a decade of being set up. But in a market as dynamic as China's, partnership terms negotiated today might be ineffective in a few years, and even strong partners may struggle to survive. This dynamism and uncertainty mean that the partners in a joint venture must include provisions for restructuring its contract if the competitive landscape changes. HSBC, for example, in its credit card partnership with China's Bank of Communications, agreed to very specific steps if a change in regulation made it possible to convert the partnership into an independent credit card company. These detailed steps included the resulting board structure and the consideration to be paid to the partners.

Lacking such provisions, some multinationals have had to enter into tough negotiations with their Chinese partners to reach agreement on exit conditions. Others have languished in joint ventures that continued as formal partnerships while either partner pursued other avenues for growth. ○

<sup>1</sup> See Jeff Galvin, Jimmy Hexter, and Martin Hirt, "Building a second home in China," [mckinseyquarterly.com](http://mckinseyquarterly.com), June 2010.



# The myth of smooth earnings

**Many executives strive for stable earnings growth, but research shows that investors don't worry about variability.**

**Bin Jiang and  
Tim Koller**

Executives like their earnings smooth—even in normal times, they will go to great lengths to achieve steady growth in earnings per share quarter after quarter. As the economy emerges slowly from recession, we encounter even more deference to the conventional wisdom that investors prefer smooth earnings growth and shun earnings volatility. Those who make such claims have long cited stable earnings growth as a rationale for strategic actions. In 2002, for example, the CEO of Conoco justified that company's then pending merger with Phillips Petroleum in part by asserting that the deal would provide greater earnings stability throughout the commodity price cycle.

Our research shows that these efforts aren't worthwhile and may actually hurt companies

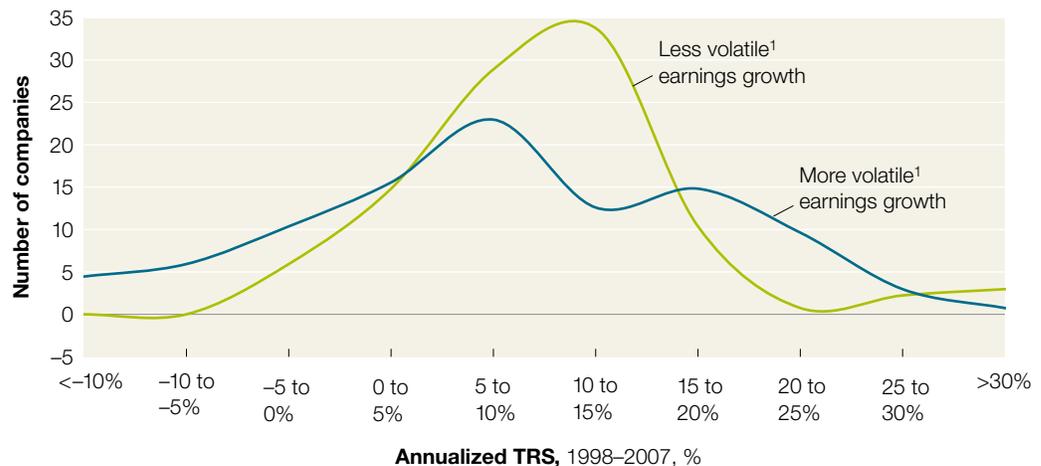
pursuing them. If investors really preferred smooth earnings, you would expect companies that achieve them to generate higher total returns to shareholders (TRS) and to have higher valuation multiples, everything else being equal. Yet using different techniques, company samples, and time frames, all the studies we examined<sup>1</sup> reached the same conclusion: there is no meaningful relationship between earnings variability and TRS or valuation multiples.

To illustrate these findings, we compared the TRS of 135 companies with above-average earnings volatility and the TRS of 135 companies with below-average volatility (Exhibit 1). While the median return of the low-volatility companies is higher, the statistical significance

## Exhibit 1

**Earnings volatility and TRS are not linked.**

Distribution of large, nonfinancial US companies by total returns to shareholders (TRS)



<sup>1</sup>Based on difference between each company's second-highest and second-lowest levels of growth during the 10-year period; 135 companies in each category.

of the disparity vanishes when we factor in growth and returns on capital. More interesting, however, is the fact that plenty of low-volatility companies have low TRS, just as plenty of high-volatility companies have high returns. You can also see that the very volatile companies have more extreme TRS results.

Investors, we believe, realize that the world isn't smooth. How could a company with five different businesses in ten different countries achieve a smooth 10 percent annual earnings growth for years? The chances of unexpected positive results in one area exactly offsetting unexpected negative results are slim. The chances that each business performs exactly as planned are

even slimmer. In fact, sophisticated investors tell us they get suspicious when earnings growth is too stable, since they know that isn't how the world works.

Part of the explanation for the results of our research is that smooth earnings growth is a myth; almost no companies have it. Exhibit 2 shows five that were among the least volatile 10 percent of all large companies by earnings growth from 1998 to 2007. The one with the most stable earnings was Walgreens, with annual earnings growth between 14 and 17 percent from 2001 to 2007. But after Walgreens, we quickly ran out of companies to compare. We looked at 500 others and couldn't find any with seven

such years of steady earnings growth. In fact, we could find only a handful of cases where it held steady for at least four years.

Most low-volatility companies follow a similar pattern. Anheuser-Busch, for example, had four years of steady growth, around 12 percent, from 1999 to 2002. Then, after 7 and 8 percent growth in 2003 and 2004, respectively, the company's earnings dropped by 18 percent in 2005. This pattern is common. Of the 500 companies we examined, 460 experienced at least one year of earnings decline during the period.

Investors expect the natural volatility associated with industries in which companies participate.

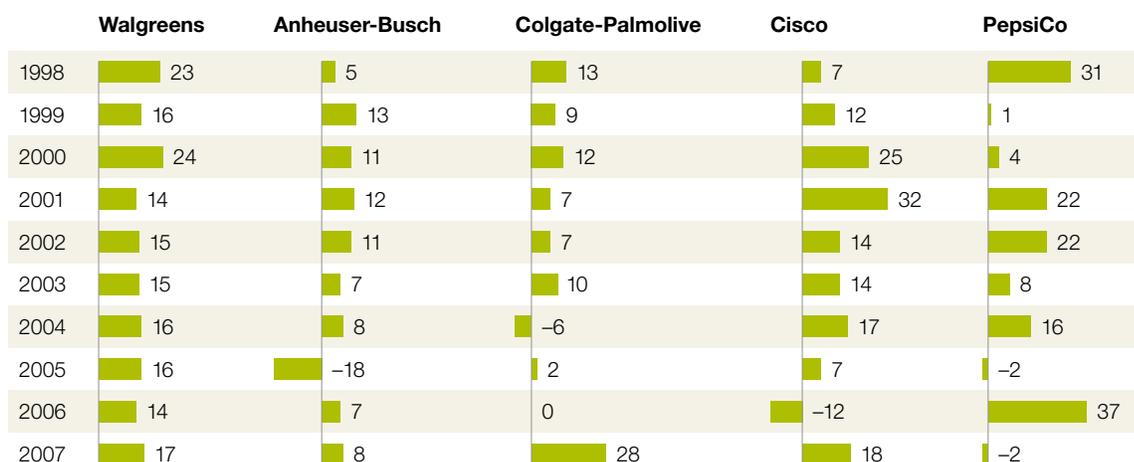
In some cases, such as gold-mining companies, investors actually want exposure to changing prices. Companies therefore shouldn't try to reduce natural volatility, especially if it means reducing expenses like marketing and product development.

Nor should they try to reduce volatility through more diversified corporate portfolios. The argument for them is that different businesses have different business cycles, so earnings at the peak of one business's cycle will offset the lean years of other businesses, thereby stabilizing a company's consolidated earnings. If earnings and cash flows are smoothed in this way, the reasoning goes, investors will pay higher prices for the company's stock.

Exhibit 2

**Even among the least volatile companies, earnings growth is rarely smooth.**

Earnings growth of the 5 least volatile companies,<sup>1</sup> 1998–2007, %



<sup>1</sup>Among the 500 largest, nonfinancial US companies; earnings defined as net income before extraordinary items, adjusted for goodwill impairment.

The facts refute this argument, however. First, we haven't found any evidence that diversified companies actually generate smoother cash flows. When we examined the 50 companies from the S&P 500 with the lowest earnings volatility from 1997 to 2007, we found fewer than 10 that could be considered diversified, in the sense of owning businesses in more than two distinct industries. Second, and just as important, we found no evidence that investors pay higher prices for less volatile companies. In our regular analyses for our clients, we almost never find that the summed values of the business units of a diversified company differ substantially from its market value.



Investors expect the natural volatility associated with the industry in which a company participates. Instead of trying to manage volatility, senior executives should spend their time making decisions that fundamentally increase a company's revenues or its returns on capital. ○

<sup>1</sup> See Brian Rountree, James P. Weston, and George Allayannis, "Do investors value smooth performance?" *Journal of Financial Economics*, December 2008, Volume 90, Number 3, pp. 237–51; John M. McInnis, "Earnings smoothness, average returns, and implied cost of equity capital," *Accounting Review*, January 2010, Volume 85, Number 1, pp. 315–42; and Ronnie Barnes, "Earnings volatility and market valuation: An empirical investigation," LBS Accounting Subject Area working paper, ACCT019, November 2002.





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