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M&A as competitive advantage

Treating M&A as a strategic capability can give companies an edge that their peers will struggle to replicate.

**Cristina Ferrer,
Robert Uhlener, and
Andy West**

Most companies approach deal making as an art rather than as a corporate capability deployed to support a strategy, and they see individual deals as discrete projects rather than integral parts of that strategy. Few have found a way to build and continuously improve, across businesses, an M&A capability that consistently creates value—and does so better than competitors. As a result, many lament how hard M&A is and worry about the statistics highlighting the failure rate of deals rather than how to build a capability that helps them win in the marketplace.

In our experience, companies are more successful at M&A when they apply the same focus, consistency, and professionalism to it as they do to

other critical disciplines.¹ This requires building four often-neglected institutional capabilities: engaging in M&A thematically, managing your reputation as an acquirer, confirming the strategic vision, and managing synergy targets across the M&A life cycle. The ability to approach M&A in this way elevates it from a tactical necessity focused on risk management to a strategic capability delivering a competitive advantage that others will struggle to replicate.

Engage in M&A thematically

At many companies, strategy provides only vague direction on where and where not to use M&A—and an unspecific idea of the expected source of value creation. We often find companies



using M&A indiscriminately to purchase growth or an asset, without a thorough understanding of how to create value in a deal relative to others, a so-called “best owner” mind-set. Rarely is there an explicit link to organic investments or the business cases for broader growth initiatives, such as developing new products or building a sales force to deliver an acquired product. As a result, companies waste time and resources on targets that are ultimately unsuccessful and end up juggling a broad set of unfocused deals.

Successful companies instead develop a pipeline of potential acquisitions around two or three explicit M&A themes. These themes are effectively business plans that utilize both M&A and organic investments to meet a specific objective while explicitly considering an organization’s capabilities and its characteristics as the best owner of a business. Priority themes are those where the company needs M&A to deliver its strategy and have the ability to add value to targets; they are also highly detailed and their effect is measurable in market share, customer segment, or product-development goals.

Consider, for example, the M&A theme of one global retail company: to grow by entering into two emerging markets, acquiring only local companies that are unprofitable yet in the top three of their market. That’s a level of specificity few companies approach. To get there, managers started with the company’s strategic goal: to become the third-largest player in its sector within five years, something it could only achieve by aggressively entering emerging markets. A less disciplined company might have stopped there and moved on to a broad scan for targets. But managers at the retail company refined their M&A goals further. They concluded that trying to enter too many markets at once was impractical due to constraints

on management time and the complexities of entering new geographies, so they limited their search to the two most promising regions. They also knew their lean operations would offer cost synergies in companies with bloated operations—especially given the importance of economies of scale in the industry—and that local branding and catering to local preferences was critical. With their M&A theme defined so precisely, managers were able to narrow the list of potential candidates to a handful of companies. Well ahead of its five-year schedule, the company has successfully completed the acquisitions needed to enter its targeted emerging markets and has nearly achieved its revenue goals.

Manage your reputation as an acquirer

Few companies consider how they are perceived by targets or how their value proposition as an acquirer is better or worse than that of their competitors. Many are too slow and reactive at identifying potential acquisition targets, too timid in courting and building relationships with them, or too tactical when initiating conversations. They may have such broad goals that they can’t proactively approach a list of potential targets. As a result, they end up being overly dependent on targets proposed by outside sources or burdened by constant fire drills around potential targets. In many cases, they earn a reputation among potential targets as opportunistic, process heavy, and laden with overhead.

In our observation, companies that invest in their reputation as acquirers are perceived instead as bold, focused on collaboration, and able to provide real mentorship and distinctive capabilities. Even some of the largest and most complex organizations are perceived as attractive buyers by small and nimble targets, largely due to the way they present themselves and manage M&A. The

best among them tend to lead with deep industry insight and a business case that is practical and focused on winning in a marketplace instead of on synergies or deal value. They let target-company managers see how they fit into a broader picture. They also have scalable functions and a predictable, transparent M&A process that targets can easily navigate. Finally, they are purposeful about how they present themselves, supporting executives with consistent and compelling materials that demonstrate the best of the organization. As a result, they are able to use their position in the market to succeed in dimensions that go beyond price—and are often approached by targets that aren't even yet “for sale.” This is a real competitive advantage, as the best assets migrate to the companies they perceive will add value, decreasing search time, complexity of integration, and the chances of a bidding war.

A big part of developing a reputation is managing interactions and using them in a coordinated way. It's not unusual for companies to join conferences, partner with universities that control needed intellectual property, and talk to angel investors and venture capitalists. But most of them do so with no structure or understanding of how many relationships they're looking for with which kinds of partners possessing what specific attributes—and few of them do so to build their reputation in the ecosystem around potential targets.

To get it right, companies must be more purposeful. At one high-tech company, for example, these concepts came together around the theme of enabling innovation. The company's investment in its reputation as an acquirer started with a thoughtful external marketing campaign but quickly made its way deep into the M&A process. In discussions at conferences and in

engineering communities, managers used testimonials from acquired employees and old-fashioned jawboning to underscore their track record at buying companies and providing them with the expertise and resources they need to accelerate their product pipelines. They developed useful personal relationships with target-company executives by discussing ways to work together even beyond the context of a deal. And when it came time to present integration plans and future investment models to targets, managers made sure they were consistent with the acquiring company's reputation.

Confirm the strategic vision

For many companies, the link between strategy and a transaction gets broken during due diligence. By focusing strictly on financial, legal, tax, and operations issues, the typical due diligence fails to bring in data critical to testing whether the strategic vision for the deal is valid.

To do so, companies should bolster the usual financial due diligence with strategic due diligence, testing the conceptual rationale for a deal against the more detailed information available to them after signing the letter of intent—as well as seeing whether their vision of the future operating model is actually achievable. A strategic diligence should explicitly confirm the assets, capabilities, and relationships that make a buyer the best owner of a specific target company. It should bolster an executive team's confidence that they are truly an advantaged buyer of an asset. Advantaged buyers are typically better than others at applying their institutional skills to a target's operations, marketing and sales, product development, or even labor and management. They also employ their privileged assets or proprietary knowledge to build on things like a target's brand, intellectual property, financing, or industry insights. Naturally,

Companies can employ a number of tactical activities to build a real capability at managing synergies.

they also turn to their special or unique relationships with customers, suppliers, and the community to improve performance, leading to synergies that in many cases go far beyond traditional scale synergies.

It is critical for executives to be honest and thorough when assessing their advantages. Ideally, they develop a fact-based point of view on their beliefs—testing them with anyone responsible for delivering value from the deal, including salespeople, R&D engineers, and their human resources and finance departments.

Such an approach would have helped one large financial company that acquired an asset two years ago to expand its services to regional clients. Due diligence for the deal focused on auditing existing operations rather than testing the viability of the future operating models. The advantaged-buyer criteria assumed by the company focused on being one of the most effective operators in the industry, supported by strong IT systems and processes. Executives proceeded with the deal without ever learning that the IT team had a different picture of the eventual end state, and they learned only after close that the two companies' IT systems could not be integrated.

Reassess synergy targets

Failing to update expectations on synergies as the buyer learns more about the target during integration is one of the most common but avoidable pitfalls in any transaction. Companies

that treat M&A as a project typically build and get approval for a company's valuation only once, during due diligence, and then they build these targets into operating budgets. To drive speed, efficiency, and simplicity, they either have an overly rigid approach to integration, which fails to recognize the unique attributes and requirements of different deal types, or they are totally unstructured, ignoring established deal processes to rely instead on a key stakeholder or gatekeeper to make up his or her mind. There is rarely an opportunity to revisit value-creation targets with executives, board members, and other stakeholders.

The overly rigid or undefined nature of these processes makes it hard to reassess synergies and targets throughout the life cycle of a deal because valuation targets are set early on and are virtually locked in by the time integration starts. This forces the organization's aspirations down to the lowest common denominator by freezing expectations at a time when information is uncertain and rarely correlated with the real potential of a deal—overvaluing or undervaluing synergies more than 40 percent of the time, by our estimate. The reason is simple: financial due diligence is conducted with intentionally imperfect information, as each side does its best to negotiate favorable terms in short time frames, and it's typically focused on likely value instead of potential value. This is appropriate for managing the risk of overpaying, but it's not the way an operator would actually manage a business to maximize its potential.

Managing this challenge can be complex but worthwhile. One consumer-packaged-goods company boosted run-rate synergies by 75 percent after managers recognized that the target's approach to in-store promotions could be used to improve its base business. One pharmaceutical company raised its synergies by over 40 percent on a very large transaction by actively revisiting estimates immediately after the deal closed, creating a "risk free" environment for managers to come up with new ideas, and throwing away initial assumptions. A few years later, it had captured those higher synergies.

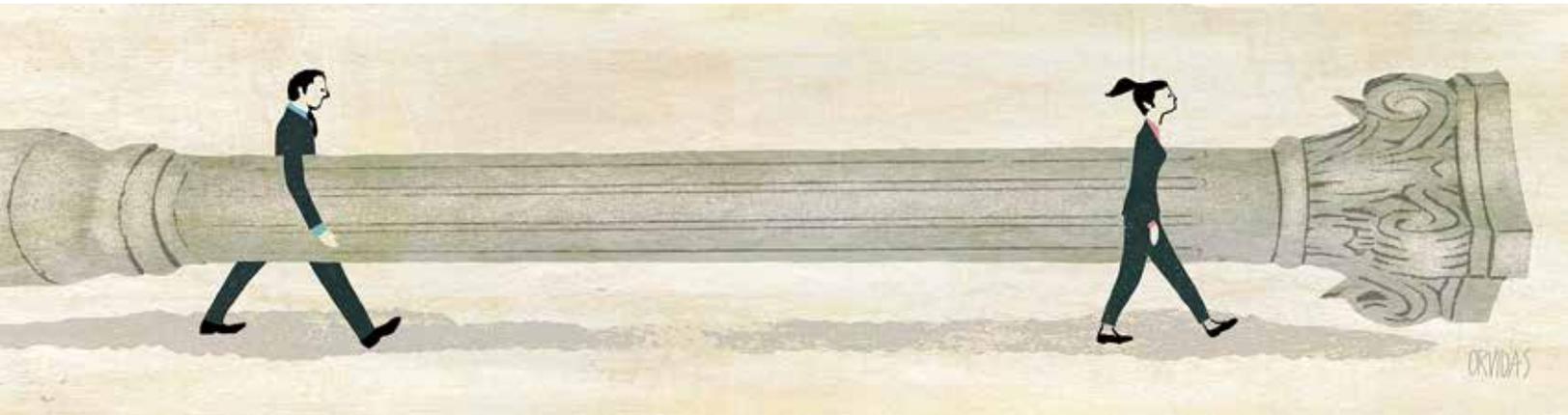
Companies can employ a number of tactical activities to build a real capability at managing synergies. They might, for example, bring stakeholders together in so-called value-creation summits that mimic the intensity and focus of a due-diligence effort but change the incentives to focus on the upside. And we've seen experienced acquirers take a blank-sheet approach to foster creativity, rather than anchor the exercise in a financial due-diligence model, which often leads to incremental synergies. These

and similar activities allow companies to reinforce the idea that due-diligence synergy estimates are the lowest acceptable performance—and get managers used to setting their sights higher.



M&A is complex, and it isn't the answer for every strategic goal. Companies that can achieve a strategic goal internally, with a sensible investment profile and within a desirable time frame, should do so and avoid the deal premium and integration risk of an acquisition. But those that can manage the complexity of M&A by building the capabilities and insights required to realize its full potential for growth can enjoy an enduring competitive advantage. ○

¹ Long-term returns vary significantly by deal pattern and by industry. Companies with the right capabilities can succeed with a pattern of smaller deals in most industries, but in large deals, industry structure plays as much of a role in success as the capabilities of a company and its leadership. See Werner Rehm, Robert Uhlener, and Andy West, "Taking a longer-term look at M&A value creation," *McKinsey on Finance*, January 2012, and Ankur Agrawal, Cristina Ferrer, and Andy West, "When big acquisitions pay off," *McKinsey on Finance*, May 2011.



What's next for the restructuring of Europe's banks?

The long period of stagnation is over, and European banks are increasingly undergoing restructuring.

**Patrick Beitel,
Pedro Carvalho, and
Joao Castelo Branco**

European banks are ripe for restructuring—and a lot of it. After five years of relatively stagnant economic conditions, many of them continue to face pressure from difficult funding conditions, a transition to higher costs of capital, changing regulations, and tighter capital requirements. They need to shed capital-intensive operations and simplify businesses to compete more profitably in fewer market segments. All told, Europe's banks are considering the sale of up to 725 business lines across various business segments and geographies (exhibit).

So far, activity remains subdued. Since 2007, when banks struck deals worth €207 billion, the only bump in deal activity came in 2008, as

governments began injecting €322 billion of public capital¹ to save vulnerable financial institutions. Deal volume hit €67 billion in 2012, a modest increase from the low levels of 2010 and 2011, and although 2013 so far has been slow, with around €28 billion in deal value, what activity there has been may offer a glimpse of what's to come and who will be involved.

We expect such activity to continue given the following trends.

Forced restructuring of bailed-out banks.

Aid from national governments often comes with restrictions and conditions. One key feature of the support extended by European and national

authorities is the requirement of banks to divest assets to increase liquidity and pay back the aid. The result is that many CEOs of European banks now face restructuring programs to satisfy the terms of agreements signed with European or national regulators. In extreme cases, the asset base of some banks may be cut in half, and painful measures will be unavoidable.

Government divestiture. Bailouts put billions of euros of financial-services assets into government hands. In general, the authorities do not consider themselves to be a natural owner of banks. There is an expectation that ownership will be returned to the private sector when conditions in capital markets permit it. Growing public deficits, pressure from public opinion,

Exhibit

European financial institutions are considering selling 400 to 725 business lines in various subsegments and geographies.

As of Feb 2013: ■ >15 opportunities ■ 5–15 opportunities ■ <5 opportunities

Subsegment	Eastern Europe	Mediterranean ¹	United Kingdom	Germany	France	BNL ²	Others ³	Total
Retail banking	50–100	40–50	5–10	5–10	10–15	5–10	0–5	115–200
Corporate and investment banking	10–15	5–10	5–10	0–5	5–10	5–10	0–5	30–65
Asset management	0–5	5–10	10–15	0–5	5–10	5–10	5–10	30–65
Private banking	0–5	5–10	10–15	0–5	20–25	5–10	25–30	65–100
Payments ⁴	0–5	0–5	10–15	15–20	5–10	5–10	5–10	40–75
Others ⁵	15–30	20–35	45–60	0–15	25–35	5–20	10–25	120–220
Total	75–160	75–120	85–125	20–60	70–105	30–70	45–85	400–725

¹Mediterranean: Greece, Iberia, Italy, and Turkey.

²BNL: Belgium, Netherlands, and Luxembourg.

³Denmark, Finland, Norway, Sweden, and Switzerland.

⁴Including security services and market infrastructure.

⁵Disposal of specific assets (eg, real-estate portfolio, asset leasing), including life and P&C insurance. Might overlap with other subsegments.

and the desire to promote competition and realize profits will naturally drive governments to divest their holdings. Some divestments are already under way.

Pressure to strengthen the capital base.

Governments across Europe are encouraging banks to rid their balance sheets of toxic assets. For example, in Spain, the European Union required the establishment of a so-called bad bank—the Company for the Management of Assets proceeding from Restructuring of the Banking System, or SAREB—as a precondition in exchange for aid of up to €100 billion to the Spanish banking sector. By the end of February 2013, SAREB had acquired €52 billion of property-development loan assets from Spanish institutions.

Moreover, despite efforts to deleverage and improve capital ratios, banks are still hungry for capital. Given its scarcity in the market, banks are being forced to divest assets in order to raise capital—and such sales may be practically necessary before investors will again open their wallets. We estimate that European banks need to raise more than €100 billion of equity to meet their capital needs.

Pressure to improve returns. Industry returns are expected to be substantially (and structurally) lower than before 2008. To boost them, financial institutions must build critical mass in their core businesses and divest subscale, noncore, and capital-consuming operations. Consequently, there will be a shift toward scale and to having business lines run by their best natural owner. This will result in the unraveling of some acquisitions made in the last M&A wave and, perhaps, a spate of mergers among equals looking to create scale in their core business.

Domestic roll-ups are already under way. In 2011, Spain's Bilbao Bizkaia Kutxa acquired fellow Basque bank Kutxabank for €1.64 billion. This was followed by Banco Popular's €1.34 billion acquisition of Banco Pastor and several other roll-ups in Spain during 2012. And in the United Kingdom, there was Virgin Money's opportunistic acquisition of Northern Rock.

In the same vein, many banks will want to divest low-margin, low-growth businesses, such as infrastructure activities like clearing and securities servicing where scale effects and efficiency gains are elusive. Such infrastructure-type services can, instead, be outsourced. Indeed, this is

In general, the authorities do not consider themselves to be a natural owner of banks. There is an expectation that ownership will be returned to the private sector when conditions in capital markets permit it.

already happening. ING sold its local custody and securities-services businesses in Bulgaria, the Czech Republic, Hungary, Romania, Russia, Slovakia, and Ukraine to Citi in April 2013.

When activity does pick up, acquisitions by non-European banks are likely to be an inevitable part of the sector's restructuring. More than 16² of the top 20 global banks are non-European; most of them are better capitalized and trade at higher multiples than their European counterparts—for whom the capital needed to shore up the

sector is likely out of reach. That puts non-European banks in a strong position to snap up some assets that are still priced at book value³ as well as others, such as retail banking, which at this writing are trading at very low valuations and could offer potentially outsize returns. ○

¹ Up to the end of 2011, not including guarantees, in the form of asset-relief interventions and other liquidity measures.

² As of June 30, 2013.

³ The Datastream European banking index is currently trading at a price-to-book value of 0.97.

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China's growing role in global finance

The country's financial markets are deepening, foreign investment keeps pouring in, and capital is flowing outward. What would it take for China to assume a new role as world financier?

**Richard Dobbs,
Nick Leung, and
Susan Lund**

China, as the world's largest saver, has a major role to play in the global financial rebalancing toward emerging markets. Today, these countries represent 38 percent of worldwide GDP but account for just 7 percent of global foreign investment in equities and only 13 percent of global foreign lending.¹ Their role seems poised to grow in the shifting postcrisis financial landscape, since the advanced economies face sluggish growth and sobering demographic trends. As a lead player in that shift, China could become a true global financier and, with some reform, establish the renminbi as a major international currency.

Yet a long-closed economy—even one with more than \$3 trillion in foreign reserves—can't swing

open its doors overnight. China's domestic financial markets will have to deepen and develop further, and returns earned by the government, corporations, and households must rise if the country is to attract and deploy capital more effectively. At the same time, the barriers that prevent individuals and companies from investing more freely outside the borders of China, and foreigners from investing within them, will have to diminish gradually, and the country must build the trust of global investors. Continued reform in China, coupled with its vast domestic savings and outsized role in world trade, could make the country one of the world's most influential suppliers of capital in the years ahead.

Growth and growing pains in China's markets

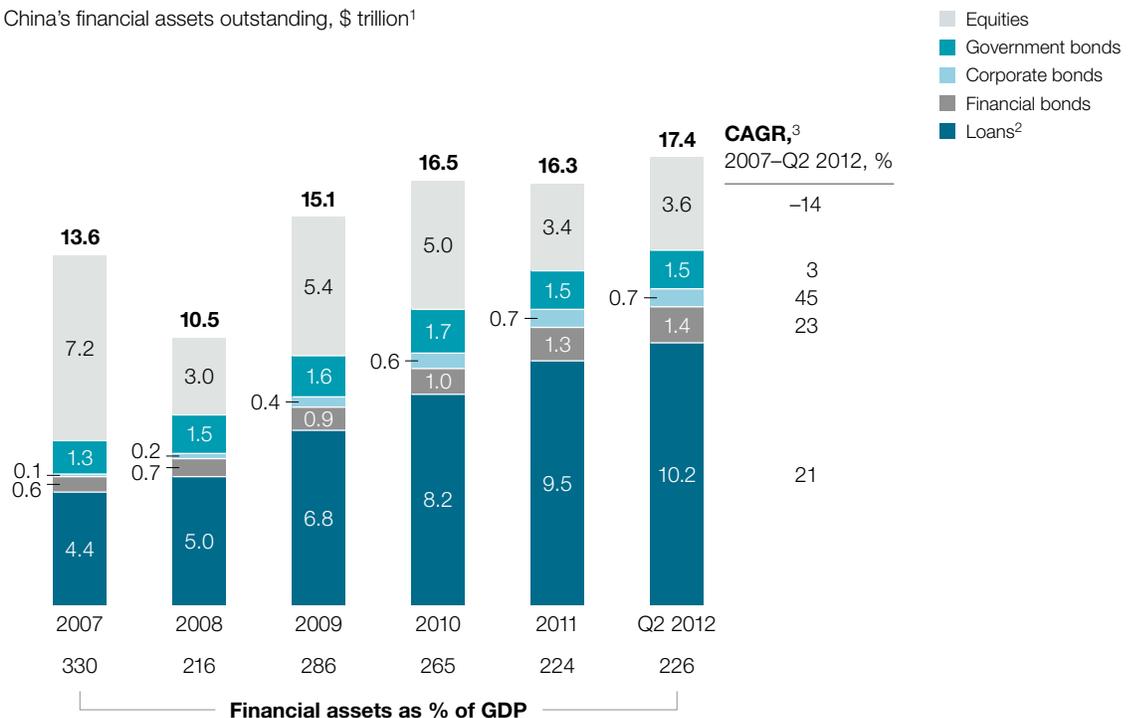
As China's financial markets have become more robust and deeper, the value of its domestic financial assets—including equities, bonds, and loans—has reached \$17.4 trillion, trailing only the United States and Japan (Exhibit 1). That's a more than tenfold increase in a span of two decades, and it doesn't include Hong Kong's role in channeling funds to and from China.

In contrast to most advanced economies, where lending has been stagnant amid widespread deleveraging, bank loans in China have grown by \$5.8 trillion since 2007, reaching 132 percent of GDP—higher than the advanced-economy average of 123 percent. About 85 percent of that Chinese lending has been to corporations; households account for the rest. This rapid growth has raised the specter of a credit bubble and a future rise in nonperforming loans, though

Exhibit 1

A surge in lending has boosted China's financial assets by \$3.8 trillion since 2007, but growth has not kept pace with that of GDP.

China's financial assets outstanding, \$ trillion¹



¹Constant 2011 exchange rates; figures may not sum, because of rounding.

²Sum of securitized and nonsecuritized loans.

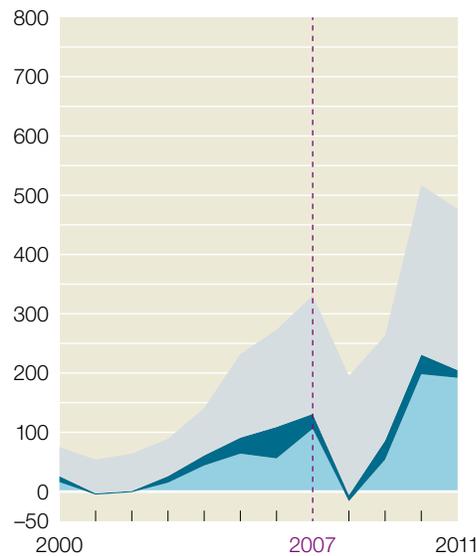
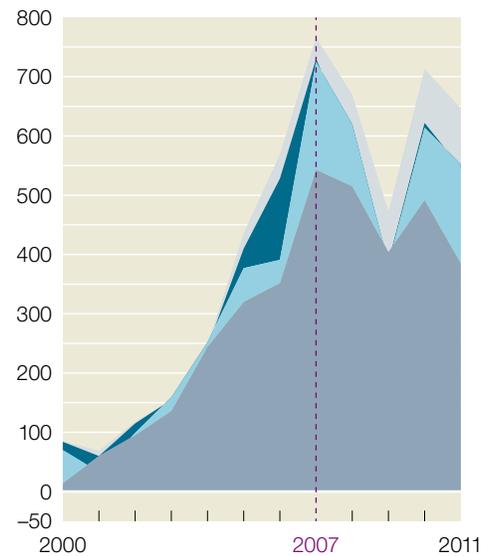
³Compound annual growth rate.

Source: McKinsey Global Institute analysis

Exhibit 2

China's capital flows have been approaching new heights.China's capital inflows and outflows, \$ billion¹

■ Foreign direct investment ■ Equity and debt securities ■ Loans and deposits² ■ Reserves

Capital inflows**Capital outflows**¹Constant 2011 exchange rates.²In 2008, inflows of loans and deposits totaled -\$16 billion, while in 2009 outflows of loans and deposits totaled -\$19 billion.

Source: McKinsey Global Institute analysis

regulators have attempted to slow the pace in overheated areas such as real estate.

China's corporate-bond market is also developing. Bonds outstanding from nonfinancial companies have grown by 45 percent annually over the past five years, bonds from financial institutions by 23 percent.² There is ample room for further growth, since China's levels of bond-market borrowing are significantly below those of advanced economies. Indeed, bond financing could provide an alternative source of capital for the country's expanding corporate sector, enabling banks to increase their

lending to households and to small and midsize enterprises.

Unlike many major equity markets, China's stock market has not rebounded since the financial crisis and global recession. Total market capitalization has fallen by 50 percent since 2007, plunging from \$7.2 trillion in 2007 to \$3.6 trillion in the second quarter of 2012.

Investors sent valuations soaring at the market's peak, but fears of a slowdown and a more realistic view of company valuations dampened their enthusiasm, underscoring the fact that China's

equity markets, like those of other emerging economies, remain subject to sharp swings.

Cross-border investment surges

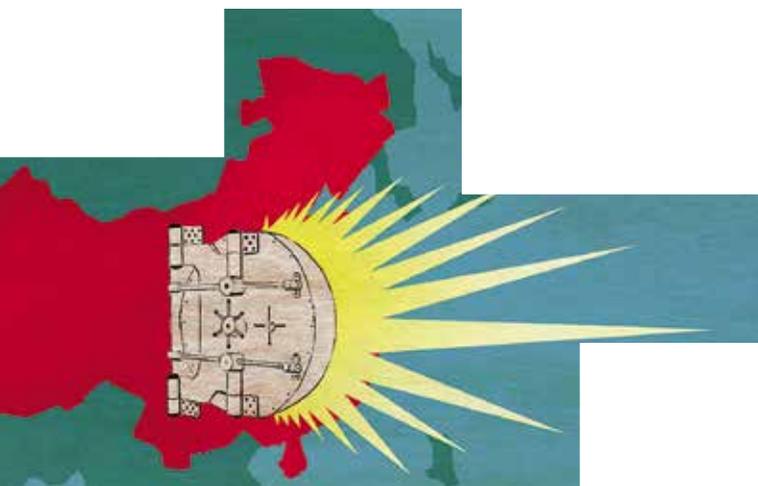
China has defied global trends in cross-border capital flows, which collapsed in 2008 and remain 60 percent below their precrisis peak. For China, by contrast, foreign direct investment, cross-border loans and deposits, and foreign portfolio investments in equities and bonds are up 44 percent over 2007 levels (Exhibit 2). Total foreign investment into China reached \$477 billion at the end of 2011, exceeding the 2007 peak of \$331 billion.³ Foreign companies, eager to establish a presence in China, account for roughly two-thirds of the inflows.

Capital from foreign institutional and individual investors could provide another leg to growth as long-standing restrictions on foreign portfolio investment continue to ease. The number of qualified foreign institutional investors approved by Chinese regulators has grown from 33 in 2005 to 207 in 2012 and will undoubtedly rise further. Regulators are also giving registered foreign funds more latitude to invest their holdings of offshore renminbi in China's domestic capital markets. Both moves have further opened the door to foreign participation in those markets.

Famously, the People's Bank of China, the nation's central bank, has accumulated the world's largest stock of foreign-currency reserves: \$3.3 trillion at the end of 2012. While much of this money is invested in low-risk sovereign debt—for instance, US treasuries, which account for at least \$1.2 trillion of China's reserves—the growth in such investments has slowed considerably. Instead, China is both loosening restrictions on other types of financial outflows and moving to diversify its foreign holdings. That was the impetus behind the 2007 creation of the China Investment Corporation (CIC), one of the world's largest sovereign-wealth funds, with assets of \$482 billion. CIC's holdings include shares in many of the world's blue-chip companies; mining, energy, and infrastructure projects; global real estate; and even a stake in London's Heathrow Airport.

Chinese companies are also stepping up their role in global finance. Foreign direct investment by both state-owned and private-sector Chinese companies grew from just \$1 billion in 2000 to \$101 billion in 2011. At the end of 2011, Chinese companies accounted for \$364 billion of global foreign direct investment, with most of it tied to commodities. About half of these investments went to other emerging markets—a share higher than that for companies in advanced economies.

Much of China's rapidly increasing global lending is tied to foreign-investment deals involving Chinese companies (for instance, financing a mine in Peru, with construction to be undertaken by a Chinese company). Outstanding foreign loans and deposits totaled \$838 billion at the end of 2011. To put this sum in perspective, consider the fact that the total level of loans outstanding from the world's five major multilateral development banks is about \$500 billion. Since 2009,



Chinese loans to Latin America have exceeded those of both the Inter-American Development Bank and the World Bank (Exhibit 3).

Africa is another priority. At the 2012 Forum on China–Africa Cooperation, China pledged an additional \$20 billion in new lending to that continent over the next three years. In March 2013, President Xi Jinping traveled to Africa for his first overseas trip as head of state, reaffirming this lending pledge and signing an agreement to build a multibillion-dollar port and industrial zone in Tanzania.

So far, the returns on many of China's investments at home have been below their cost of capital. There is almost an expectation of low returns—in some cases, negative real returns—on corporate invested

capital, on domestic bank deposits, and even on returns the government earns on its foreign reserves. The returns that will be earned on many of China's recent foreign direct investments and foreign loans remain to be seen. The pace and process of the migration to market-level returns will be a challenge for policy makers.

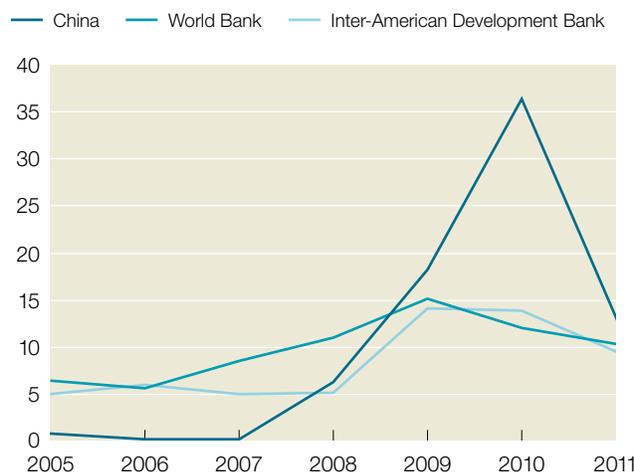
The long road to renminbi convertibility

As China's economy and financial clout continue to grow, so will use of the renminbi. China has aspirations to make it an international currency, perhaps eventually rivaling the US dollar and the euro for global foreign reserves. But realizing these ambitions will require substantial progress on several fronts.⁴ One is developing deep and liquid domestic capital markets for renminbi-denominated financial assets. Despite the progress

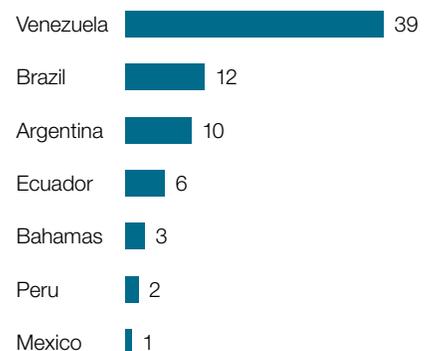
Exhibit 3

China now provides a higher volume of loans to Latin America than the World Bank and the Inter-American Development Bank.

Annual flow of bank loans to Latin America, \$ billion



Recipients of Chinese lending in Latin America, cumulative flows, 2005–11, \$ billion



Source: Heritage Foundation; Inter-American Development Bank; Inter-American Dialogue; World Bank; McKinsey Global Institute analysis

described above, China's financial depth (the total value of its financial assets as a share of GDP) remains less than half that of advanced economies. Developing larger bond markets, as well as derivatives markets to hedge currency and other risks, will be essential.

To take on a greater global role, the renminbi must also become an international medium of exchange. In recent years, China has promoted the use of its currency to settle international trade contracts; for instance, it has created swap lines to supply renminbi to 15 foreign central banks, including those of Australia and Singapore. As a result, the use of the renminbi in China's trade has grown from around just 3 percent several years ago to an estimated 10 percent in 2012. According to a survey by HSBC, Chinese corporations expect one-third of China's trade to be settled in renminbi by 2015.⁵

However, to become a true international currency, the renminbi will have to be fully convertible—meaning that any individual or company must be able to convert it into foreign currencies for any reason and at any bank or foreign-exchange dealer. China's central bank has acknowledged that the time has come to move in this direction and accelerate capital-account liberalization,⁶ and it recently outlined both short- and long-term road maps for this process. Short-term moves could include reducing controls on investment directly related to trade and encouraging Chinese enterprises to further increase outward foreign direct investment. For the longer term, the bank has outlined actions such as opening credit

channels to flow both into and out of China and moving from quantity- to price-based approaches to monetary-policy management. And over time, China will need to build trust in its institutions by developing a set of rules, applying them consistently, and sticking with them.

For now, however, the doors remain only partially open. Achieving the institutional development needed to fully liberalize capital accounts and remove currency controls will take time.



To assume the role of financier to the world, China will have to embrace financial globalization and advance reform more fully, and that won't happen overnight. There is already movement toward greater openness, though, which makes China's recent once-in-a-decade leadership transition a telling moment: if the new economic team picks up the pace of reform, the world financial system could have a very different look in just a decade's time. ○

¹ This article is based on the McKinsey Global Institute report *Financial Globalization: Retreat or Reset?*, mckinsey.com, March 2013.

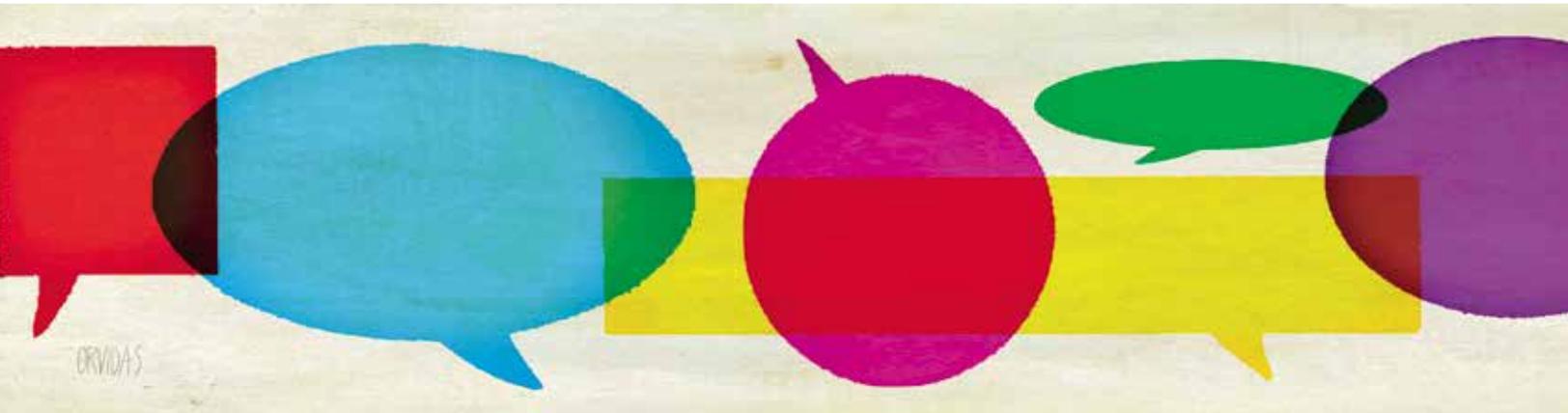
² Compound annual growth rate.

³ The 2011 data on capital inflows and outflows are the latest available from the Chinese government.

⁴ A number of papers have been written about the internationalization of the renminbi. See, for instance, Eswar Prasad and Lei (Sandy) Ye, *The Renminbi's Role in the Global Monetary System*, Brookings Institution, February 2012.

⁵ See "RMB maturing as cross-border usage broadens, says HSBC survey," Hongkong and Shanghai Banking Corporation, hsbc.com.tw, October 24, 2012.

⁶ See the full report, *Accelerating Capital-Account Liberalization* (in Chinese), People's Bank of China, cs.com.cn, February 23, 2012.



Three steps to a more productive earnings call

Traditional earnings calls are painfully unhelpful. Here's how companies and investors alike can get more out of them.

Werner Rehm

As every earnings season comes to an end, it is striking how often executives and investors alike complain that earnings calls are a colossal waste of time. It's no wonder. Even a determined listener would be tested by an executive reading highly scripted texts of revenue, margin, and earnings data that would be better presented in tables. And few analysts or investors work up much enthusiasm for earnings-per-share (EPS)¹ data that heed the generally accepted accounting principles (GAAP)—data that say little about value creation. Clearly, the quarterly earnings call needs an overhaul.

Short of eliminating them entirely, a step many managers are unwilling to contemplate,

what's a CFO to do? There's plenty of room for experimentation with more insightful formats. Beyond the formal and legally required 10-K forms, managers are free to innovate their quarterly (or semiannual) interactions—around both the format and the content of their calls. Most stakeholders would likely be delighted. Three ideas could greatly improve the dialogue.

1. **Ditch the prepared text—and allow more time for thinking**

Today, very little time passes between a written announcement of earnings and the earnings call. Most companies send around a press release minutes before the call or, at best, the evening

before, after the markets close. The call itself often starts with a prerecorded and legalistic review, most often a senior executive reading data from a script, followed by a mundane question-and-answer session in which the company usually selects who asks the questions.

The value of this setup is questionable. Nobody has time to analyze the data before the Q&A session, and the remarks are often a more convoluted way to convey data than simple tables. To improve the dialogue, companies should eliminate the prepared remarks and give investors more time to digest and analyze the data. For example, they could release—a few days in advance of the call—detailed tables and exhibits, as well as a targeted overview in text and perhaps even full quarterly filings.

If investors and analysts have enough time to review the prereleased data prior to the call, companies could likely eliminate the usual prepared remarks and go right to a Q&A session. The advantage of such an approach is obvious—questions are better when the data are clear and understood by the participants. And while executives might worry about volatility in stock price between the release of the data and the earnings call, they should not be. What matters is the longer-term value appreciation, not the day-to-day volatility—and in any case, volatility can be avoided if data are presented clearly in the release and the state of the company is described in a consistent and meaningful way.²

2. Be creative in the way the Q&A is structured

Most Q&A discussions are broken. Sell-side analysts often ask questions—“even bad ones,” as one analyst told us—just so clients can hear their voice on the call or see their name in the

transcript. Managers using sophisticated call-management software often invite questions only from the sell-side analysts they know and like. And buy-side analysts, arguably the most important participants on the call, are reluctant to reveal their thinking, and so are primarily just listening. The result is mediocre at best, routinely requiring numerous follow-up calls, and many questions remain unasked.

We need to start experimenting with systems where more investors can ask more pertinent questions, and perhaps a different way of selecting which ones get answered. New technologies make this fairly easy. If a company sends out data several days in advance of a call, it could, for instance, encourage investors and analysts to submit questions online and then have an online vote on which are the most important. The questions could be posted with the names of the people who sent them in, or perhaps even anonymously, to reduce bias in the vote.

Google, for example, experimented with such an approach in 2009, albeit without sending advanced data.³ Real-estate company Zillow took another tack to encourage real-time questions during its last earnings call. Anybody could ask a question via Twitter, encouraging analysts and investors in “listen only” mode to speak up. While this doesn’t make the poster anonymous, the company “now has less control over who can ask questions and what people can ask, and . . . everyone can see which questions management chose to ignore.”⁴

Some companies might even choose to go further. Expeditors International of Washington, a global logistics company, has a long-standing policy not to have earnings calls at all. Instead, managers respond to written questions in writing in a

Securities and Exchange Commission filing. A 2000 disclosure form explains, “We do not currently plan to host a conference call . . . We . . . believe that investors will benefit from real written answers to thoughtful questions. It’s a little more work for us, but we feel that the quality of the information disclosed will be better with a more formal process.”⁵

3. Stop talking so much about EPS

Given how little investors care about EPS and how far GAAP is away from true operating metrics in many cases, there is still too much emphasis on both in earnings calls, press releases, and announcements, at least with US companies. Managers should leave those numbers to the accountants and lawyers and focus instead on more operating-oriented numbers that make sense for their business. In the simplest form, these would be true pre- or posttax operating-earnings numbers, adjusted for amortization of intangibles, other nonoperating charges like the nonoperating portion of pension costs, and nonrecurring charges.⁶ Investors are likely to react positively to such a shift, and some large companies are indeed already reporting a non-GAAP operating margin.

In extreme cases, however, managers should be even more creative, especially those with business models where GAAP rules significantly distort economics. For example, capital expenditures, operating income, and other consolidated GAAP data do not reflect the underlying economics of one large industrial company, which is forced by GAAP to recognize some revenue as product revenue and some, from similar assets and contracts, as lease revenue. Managers and investors would be better off focusing their dialogue on a restated set of numbers that treats all revenue equally.⁷ Other examples can be found in businesses that combine manufacturing and large projects, where percentage-of-completion accounting, and in extreme cases even real-estate accounting, can significantly distort aggregated data to the point of irrelevance for a value assessment. Here, managers should clearly separate the data for different businesses and focus on non-GAAP metrics to convey the state of the business.

Finally, managers should eliminate the need for the endless clarifying questions that take up the bulk of most earnings calls by releasing more—and more transparent—data. That means full operating-income statements and key

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operating-balance-sheet items for business units, ideally by geography, reconciled to the consolidated statements. A number of companies routinely publish full income statements and balance sheets for their financial businesses, either in their regular filings, like GE, or as a separate full report, like Caterpillar Financial Services. Nonfinancial companies that come closest to the ideal, such as Novartis, often offer a full income statement and capital schedule per business unit, in annual statements. These data are typically available internally, and given the size of larger business units, investors deserve a deeper look into the financials than they are getting from the required disclosure.

For competitive reasons, not every company can be equally transparent. However, most are too conservative. A table with historical volume and price movements by region, for instance, would clarify where growth opportunities are. This kind of transparency allows a clearer, more focused discussion without giving away a strategic position that competitors wouldn't know already. It is hard to imagine why every company can't disclose data more readily unless they're deliberately

being obscure or simply unable to measure the data internally. Either possibility should make investors more skeptical about underlying performance.



Simple actions can greatly improve investor communication. It's time for companies to modernize their approach. ○

¹ Companies in the United States can report data that are not based on the generally accepted accounting principles (GAAP) but need to reconcile to the GAAP information, which has to be presented with equal prominence in the announcement.

² For a deeper discussion, see Tim Koller and S. R. Rajan, "Who's afraid of variable earnings?," *McKinsey on Finance*, Summer 2002, Number 4, pp. 13–17.

³ See Dominic Jones, "Google brings transparency to the earnings call question queue," *irwebreport.com*, October 15, 2009, and "Google announces fourth quarter and fiscal year 2009 results," *investor.google.com*, January 21, 2010.

⁴ See Benjamin Romano, "Zillow takes questions via Twitter in real-time during earnings call," *xconomy.com*, May 8, 2013.

⁵ From a 2000 Form 8-K filing. The policy is still in place.

⁶ See Tim Koller, "Accounting: Now for something completely different," *McKinsey on Finance*, Summer 2003, Number 8, pp. 16–20.

⁷ Unfortunately this might not be allowed, as some publications by accounting authorities in the United States seem to indicate that companies are not allowed to publish a complete set of non-GAAP financials even if reconciled with GAAP financials.

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