

McKinsey on Finance

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Whither the US equity markets?

The underlying drivers of performance suggest that over the long term, a dramatic decline in equity returns is unlikely.

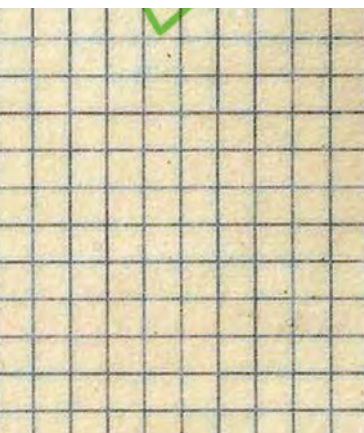
**Bing Cao, Bin Jiang,
and Tim Koller**

US equity markets stretched once again into record territory in March, setting new highs on both the Dow and the S&P 500 indexes. That's good news for investors—it wasn't that long ago when the market was headed in the other direction. The question on everyone's mind, though, is where the market is headed next.

In the short term, of course, there's no telling what will happen—and speculation is risky. Investors and companies alike are notoriously weak at timing their investments to the market. But those are short-term questions; what really matters from a corporate-strategy perspective is the long

term, and what really counts in the long term is the market's relationship to the real economy.

In fact, much of the equity market's performance in the United States, as we've seen over at least the past 50 years, is clearly linked to the performance of the real economy, including GDP growth, corporate profits, interest rates, and inflation—in spite of short-term volatility. And in the absence of some disruption of that link, the market should continue to thrive. In a nutshell, if GDP were to grow at rates comparable to the 2 to 3 percent annual real growth of the past 50 years and inflation is kept in check, investors



should be able to expect annual stock-market returns of 5 to 7 percent in real dollars over the next 10 to 20 years.¹

Of course, it's worth remembering the old saw about economists predicting nine of the past four recessions: in economics, it's often easier to predict the long term than the short term. The same applies to the stock market. So while we'd never attempt to forecast periods as short as even five years—affected as they are by volatile shifts in investor expectations—today's fundamentals make us relatively sanguine about the market's performance over the longer term. Indeed, it would take catastrophic changes in real economic performance spread over multiple decades in the real economy or a fundamental shift in investor behavior—unlike anything we've seen in more than a century—to reduce long-term equity returns to below around 5 percent in developed markets. In this article, we'll first examine the connection between equities and the real economy and then consider the likely causes of breaks in that connection over specific periods of time.

Stock-market performance and the real economy

Over the past century, stocks have earned about 9 to 10 percent per year. Adjusted for inflation, that means investors have earned annual real returns on US common stocks of about 6 percent per year.²

That 6 percent is no random number—and understanding where it has come from in the past tells us something about how likely it is to continue in the future. In fact, that number is a natural consequence of economic forces derived from the

long-term performance of companies and industries in aggregate and from the relationships among economic growth, corporate profits, and returns on capital—and how they convert into shareholder returns (TRS). Once these relationships are made clear, the connection between the stock market and the real economy becomes apparent, and historical returns make sense: that is, share-price appreciation combined with cash yield³ has resulted in about 6 percent real TRS—depending on the precise measuring period. Here's how it works, using the last 50 years of the S&P 500 index as an example.

Share-price appreciation. From the end of 1962 through the end of 2012, real share prices grew at 2.7 percent per year, roughly the same rate as real profit growth and real GDP growth. Share prices and real profit tend to grow at the same rate because the P/E ratio tends to revert to a normal level of around 15 times earnings—as long as the economy, inflation, and interest rates are in a “normal” range of stable longer-term levels. In fact, both theory and the data show that a P/E ratio of 15 is consistent with average returns on equity of 13 percent, a real cost of capital of about 7 percent, inflation of 2 percent, and long-term profit growth of 2.5 percent.⁴

Cash yield. Over the 50-year period, investors earned another 3.1 percent per year in dividends and share repurchases, as companies paid out around 55 to 65 percent of their profits to shareholders. That payout ratio, combined with an average P/E ratio of 15, results in a cash yield on stocks between 3 and 4 percent per year. Payout levels may be volatile over the short term, but over the longer term, dividend and share-repurchase payouts are driven by company cash flows—the

profits a company earns less the portion of these profits it must reinvest to grow. Anything left over must eventually be paid back to shareholders, even among companies that sit on their cash for years.⁵

Combined, that level of share-price appreciation and dividend yield results in a total real return of 5.8 percent per year, slightly lower than the 100-year average due to recessions and high inflation in the 1970s. It's not inconceivable that fundamental economic forces might tilt the balance and undermine the equity markets. Radical shifts in investor risk preferences, for example, could permanently shift the long-term

P/E ratio from 15 to some other number. So could extreme changes in the performance of the economy, such as substantially higher or lower long-term GDP growth or a large change in the ratio of corporate profits to GDP, bigger than the one that has taken place in recent years.⁶

But such things haven't happened thus far, and as long as they don't, shareholder returns are unlikely to deviate much from the 6 percent real long-term return. In fact, even with relatively extreme assumptions about long-term earnings growth, it is difficult to foresee real long-term shareholder returns of less than about 5 percent (Exhibit 1). (Readers can explore the

Exhibit 1

Absent radical shifts, returns are unlikely to deviate much from the long-term norm.

Potential long-term real returns to shareholders, %

		Today's share prices relative to "normal"				
		-20	-10	0	10	20
Long-term earnings growth	2.0	8.5	7.6	6.6	5.6	4.4
	2.5	8.7	7.8	6.9	5.8	4.7
	3.0	8.9	8.1	7.1	6.1	4.9
	3.5	9.2	8.3	7.3	6.3	5.1
	4.0	9.4	8.5	7.6	6.5	5.4

- Assumes return on capital is constant at 13% and inflation at 2%¹
- Each percentage-point increase in inflation reduces TRS by about 0.5% (assuming companies cannot increase their return on capital)
- Each percentage-point increase in return on capital increases TRS by about 0.2%

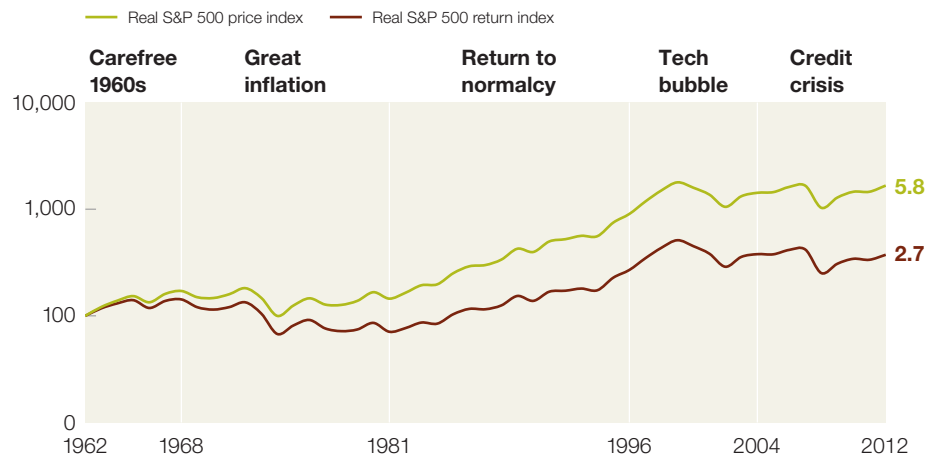
¹The 13% return-on-capital constant is a historical average. Inflation of 2% is widely accepted as the ideal, long-term sustainable level.

Exhibit 2

Five eras illustrate the market’s connection to the real economy.

S&P 500 TRS index

LOG SCALE/GDP DEFLATOR



	1962–68	1968–81	1981–96	1996–2004	2004–12	1962–2012 ¹
Real TRS (%)	9.4	-1.3	13.0	5.9	1.9	5.8
Real corporate-profit growth (%)	5.2	0.9	2.6	5.9	2.9	3.0
12-month forward P/E	15.3	17.0	8.9	18.7	16.3	15.3
Inflation (%)	1.1	4.3	9.4	1.9	2.8	3.7
10-year Treasury note yield (%)	4.0	5.6	13.9	6.4	4.2	6.6

¹1962–2012 TRS, profit growth, and inflation in compound annual growth rate; inflation using GDP deflator.

Source: Bloomberg; US Bureau of Labor Statistics; McKinsey analysis

likely impact on shareholder returns of a range of assumptions on earnings growth and on the value of today’s share prices relative to historical norms using an interactive calculator at mckinsey.com/insights.)

Stock-market eras, 1962–2012

It would be hard to argue that the market’s movements can be explained by anything other

than a random process over periods as short as a day, a week, or even several years. There are simply too many moving parts. Shifts are often as much about changes in expectations as they are about actual performance. Market observers like to focus on trough-to-peak periods, like the 13 percent real returns from 1983 to the market’s peak in 2000. But linking the market to the real economy does let us tease out the

Linking the market to the real economy lets us tease out the impact of different fundamental forces behind its performance over longer periods.

impact of different fundamental forces behind its performance over longer periods. By understanding what shaped past events, we are in a better position to explain where we are today and what the future might look like.

To better understand why the market has deviated from its long-term trajectory in the past, it helps to look at its performance through the lens of underlying economic trends rather than the usual approach of examining calendar decades or peak-to-trough cycles. We defined five eras in the past 50 years, distinguished by key events in the real economy—inflation, interest rates, and corporate-profit growth (Exhibit 2).

The era from 1962 to 1968 was a robust period, with a fast-growing economy and low, stable inflation and interest rates. Not surprisingly, then, the real return to shareholders was 9.4 percent, above the long-term average.

Contrast that fairly short period of calm to the years 1968 to 1996, when real returns fell below the long-term average to about 5 percent. During the first era of this much longer period, from 1968 to 1981, inflation (and the resulting high interest rates) slowed the real economy and the stock market and led to low P/E ratios. As most economics observers understand, when inflation is high, companies are unable to increase their returns on

capital enough to make up for it. This leads to higher investment and lower cash flows for a given level of growth, and therefore lower P/E ratios. Inflation also depresses P/E levels because investors discount expected cash flows at a higher cost of capital. Indeed, high inflation and interest rates drove down the P/E ratio from 17 in 1968 to about 9 in 1981, when inflation was 9.4 percent and interest rates were nearly 14 percent. That decline in P/E ratios, plus the negative effects on economic growth, resulted in real returns to shareholders of –1.3 percent per year.

As inflation was brought under control in the early 1980s, P/E ratios and economic growth returned to normal levels. Real returns to shareholders were 13 percent per year. While commentators have held those returns up almost as a golden age of stocks, the reality was more mundane; it was just a return to normalcy.

The years 1996 to 2004 appear very different depending on whether you look at the total return over the entire period or only at what happened in the middle. From beginning to end, real returns to shareholders were about 6 percent. What everyone remembers, though, is what happened in the middle. The S&P 500 index went from 741 at the beginning of 1997 to a peak of 1,527 in mid-2000 before falling back to 1,212 at the end of 2004.

This movement was caused not by a market-wide bubble but by a very large sector bubble in technology and megacap stocks, whose P/E ratios ballooned in 1999–2000 to twice those of rest of the index.⁷ The S&P 500 index is weighted by the value of its stocks—and while the range of P/Es is typically fairly narrow, movements in a handful of the largest stocks can shape the entire index. The collapse of the bubble in 2000 led to a convergence of P/Es and a return to normal over the next four years.

Similar circumstances define the period from 2004 to 2012. This time around, it was unusually high corporate profits, not a high P/E ratio, that drove the S&P 500 up to a new high of 1,565 in October 2007. These profits, however, were concentrated in the energy sector, with oil prices reaching \$145 per barrel, and in the banking sector, with overoptimistic assumptions about the value of loans and unsustainable speculative activities. In their initial panic over the credit crisis, investors drove the S&P 500 index briefly as low as 676 in March 2009. That lasted just a couple of months, however, as investors realized that as bad as the recession might be, the long-term outlook couldn't be so bleak. For the rest of the period (2010 to 2012), corporate profits and P/E ratios began to return to normal. At the end of 2012, corporate profits and GDP had not yet returned to long-term trend levels, leading to subpar real shareholder returns of about 2 percent for the 2004–12 period.

By early March 2013, as the S&P 500 again neared record-high levels, the forward P/E multiple

stood at around 16. However, at this writing, there is still great uncertainty about the trend in corporate profits and whether GDP and corporate profits will return to long-term trends in 2013 or 2014.



Unlike the market for fine art or exotic cars, where value is determined by changing investor tastes and fads, the stock market is underpinned by companies that generate real profits and cash flows. Most of the time, its performance can be explained by those profits, cash flows, and the behavior of inflation and interest rates. Deviations from those linkages, as in the tech bubble in 1999–2000 or the panic in 2009, tend to be short-lived. ○

¹ Numbers in this article are in real, not nominal, terms, unless otherwise noted.

² See Elroy Dimson et al., *Credit Suisse Global Investment Returns Yearbook 2012*, February 2012 (credit-suisse.com).

³ Cash yield equals the cash-payout ratio divided by P/E. Note that it is important to include both dividends and share repurchases, as companies have shifted the way they return cash, from almost all dividends to about half dividends and half share repurchases.

⁴ See Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, New Jersey: John Wiley & Sons, 2010.

⁵ A company growing at 4.5 percent (2.5 percent real, plus 2 percent inflation) and earning a 13 percent return on capital will need to reinvest 35 percent of its income to sustain that growth rate. This means that 65 percent of earnings will be available for distribution to shareholders—and the payout rate would only change significantly if growth rates or returns on capital also changed significantly.

⁶ There is some evidence that corporate profits have increased as a percent of GDP in the last eight years, but once they stabilize at a new level, overall returns should again revert to normal.

⁷ Marc Goedhart, Bin Jiang, and Timothy Koller, “Market fundamentals: 2000 versus 2007,” mckinseyquarterly.com, September 2007.



How to attract long-term investors:

An interview with M&G's Aled Smith

The award-winning fund manager discusses what he looks for in a company when he's making investment decisions.

**Marc Goedhart
and Tim Koller**

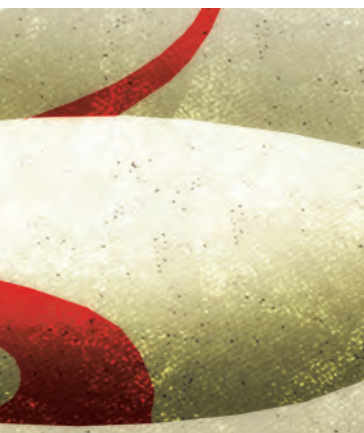
Executives overburdened by the demands of their companies' short-term investors may yearn for a more supportive crowd that might be less skittish about volatility. Such investors would base their decisions on a deeper understanding of a company's strategy, performance, and potential to create long-term value—and would not pressure a company for short-term gains at the expense of greater long-term growth.¹

Attracting such investors can prove something of a challenge. Certainly, executives are often highly coached when they talk about their strategy and objectives, and have extensive information about potential investors and their style and approach to investing. Too often, though, those

messaging cues come from sell-side analysts, who may have a shorter-term agenda. So says Aled Smith, who manages the Global Leaders Fund and the American Fund at M&G Investments, based in London.²

Smith recently joined Marc Goedhart and Tim Koller in McKinsey's London office for this wide-ranging interview on what he looks for in potential investments for his portfolios.

McKinsey on Finance: *In a world where investors and analysts often focus on short-term returns, how do you differentiate your approach? What characteristics do you look for in the companies you consider for your portfolio?*



Aled Smith: My strategy is based on the observation that a lot of companies are making good long-term investments that may hurt short-term cash flow. Investors often overlook these companies because they shun earnings and cash-flow volatility. Today this aversion is extreme—they aren't prepared to admit that the world will still exist in five years, so they want to get their money back sooner, and volatility works against that. Eventually, the markets will see earnings and cash-flow volatility as a good thing again because it's being priced so attractively. In the meantime, that's what I look for—especially the volatility resulting from corporate restructuring and change.

Let me put that into context. When I started investing in the early 1990s, information was imperfect and not freely available. Having a valuation framework was a competitive advantage; having sensible inputs into it was even more so. Today, those things are available off the shelf, and it's rare for one investor to know something others don't.

Since the information-gathering component of outperformance is basically gone, the role of the analyst now is to understand an industry rather than just a company. If you can do that and take a longer-term, bigger-picture view of disruptions in the industry—the big shifts that might take five or six years to play out—then all that conventional analysis can still offer an advantage.

McKinsey on Finance: *What kinds of clues do you look for that might promise long-term growth?*

Aled Smith: The key is not to explicitly look for growth, as the chances are it will be priced in. So we have two strategies. One of them is to look

for quality businesses you can trust to make good decisions—and the clue is in the company's performance on dividends. This is the Global Dividend Fund strategy. The best companies have an element of capital scarcity in their culture. Rather than just growing an asset for the sake of growth, these companies prune bits of the business and cultivate continuous improvement. And the first thing the board does every year is raise the dividend, which keeps the list of strategic moves short and focused and allows less money for silly things to happen.

The second strategy is to look for growth before it is recognized, that is, in companies where any potential growth surprise is not considered possible. This is the M&G Global Leaders strategy. The clues we look for are subtle ones in changing asset-allocation policy, measurement, and incentives. Most low-valued companies are valued low for a good reason. We identify those among them that are making positive internal changes—and then we can call these companies cheap.

We don't want sprinters; we want healthy long-distance runners and great runners that are recovering from injuries and have been written off.

McKinsey on Finance: *How does your dividend fund react to the trend, particularly in the United States, of companies using share purchases to distribute cash flow instead of dividends?*

Aled Smith: The evidence suggests that CFOs are not good at timing share purchases, so we prefer the board to focus on dividends, thereby signaling a healthy underlying culture with a lower risk of derailing and doing something wrong.

Companies that are among the dividend achievers likely have a certain kind of business model,

and the good ones also tend to do buybacks in a dividend-like manner. The challenge, then, is more about whether a CFO can commit to a strategy—and that commitment becomes a statement to the market, like a dividend. What we'd like to see in buybacks is the share count meaningfully going down over time. Over the past decade, there were probably only seven or eight companies in the S&P 500 that reduced the share count every single year. Those companies, although statistically a very small sample, have performed quite well.

Ultimately, what we're talking about is an agency risk that the market responds to. So, if you can say to the market, "We've got a great business model, we're going to grow your dividend and income every year, and you can trust us," then you

get rewarded for it. The challenge is how to make that statement to the market and gain the trust of your shareholders. For example, we know that great companies make acquisitions as part of their growth strategy. Building trust there requires showing shareholders both how a deal has created value and how it's been audited. The same goes for R&D and other capital investments.

McKinsey on Finance: *How do you decide whether management is trustworthy?*

Aled Smith: Ultimately, you have to just track what decisions are made. What matters to us is that companies can explain their strategy. At the risk of sounding corny, it's a bit like an episode of South Park called "Gnomes."³ The story was that these gnomes came up with

Aled Smith



Education

Graduated from Lincoln College, Oxford, with a BA in mathematics and is a CFA charterholder

Career highlights

M&G
(2000–present)
Joined in December 2000 as a global equity-fund manager

JPMorgan Asset Management

(1992–2000)
Senior analyst for the media sector

Coopers & Lybrand, 1989–1992

(1989–92)
Actuarial consultant

Fast facts

Winner of 3 Sauren Golden Awards in 2011, including 2 for US equities and 1 for global equities

a business idea of stealing underpants. And when someone came along and asked them to explain it, they responded with what they called a three-point strategy: point one is to steal underpants and point three is to make lots of money—but point two is missing. And unfortunately, probably 80 percent of corporate presentations fall into the same trap, confusing strategy with objectives or aims with ambitions. Their explanations are like those of the South Park gnomes: “We’re going to build this great platform, and then we’re going to monetize it and make lots of money.” The steps in between are not well laid out.

When we’re trying to decide if management is trustworthy, we want to understand its strategy over the long run, whether it involves the reallocation of capital or the need to be more efficient and rethink the supply chain and so on. When we sit down with management, we want to be seen as investors who talk like the board of directors. We want to know how management makes decisions. What are the executives good at? How do they know they’re good at it? Why is their business a better business today than it was five years ago? And we might buy into that vision if we can see the pieces. If a company’s management tells us that it’s doing some short-term fixes, it’s telling me that there is no point two in the strategy.

What’s frustrating is that managers often have all of the pieces, but their communication is poor because it’s targeted to sell-side analysts. Such analysts shouldn’t be the audience in the first place, because all they want are the earnings-per-share numbers over the next two years so they can fit them into their spreadsheets. That leads to one of the most amusing and depressing charts of all time, which is what we call the walk down to beatable earnings. Every year, the earnings

estimate starts high on the left of the chart, but by the end of the year, it’s down there on the right—and the company is, guess what, beating it. We’d rather see the communication and the metrics that the board is talking to management about; we’d much rather have management tell us, “This is how we want to be measured.”

McKinsey on Finance: *Do you find that companies often take too long to decide to make the kind of change you’re looking for?*

Aled Smith: Sometimes we see that alongside a fixation on perfection. That is to say, we often find managers who are paralyzed by too many options. We often hear sad tales of executives saying, “We were holding out for the last euro and now we’re selling it at half the price it would have gotten three years ago.” The point is they made the decision to sell the business because the capital could be redeployed but underestimated the compounding value of the redeployment.

I would wager that since 2007—when the recent risk aversion started—companies have not been rewarded for the reallocation of capital, precisely because what’s being rewarded has been short-term cash-flow generation, not long-term value creation. So if a company has put capital in the ground and depressed short-term cash flow, I would bet that on average its share price has not performed particularly well—even though it’s created value. And that’s the kind of company we would be interested in.

McKinsey on Finance: *Earlier, you mentioned that you like to talk to managers as if you were the board of directors as opposed to just sitting through the typical selling pitch. What’s that dialogue like when it’s successful?*

Aled Smith: The best company meetings for us, the ones where the light bulbs go on, are those where managers are able to explain the history of the business, its capital decisions, and the key events in the corporate life cycle—to explain why they believe the company is moving in a different direction. Sometimes it also includes a mea culpa: “Here’s what we got wrong, here’s what we learned, and here’s what we’re trying to do differently.” That helps us see in our terms whether the company has a business model that’s not being appreciated by the market—whether there’s a real disconnect between the boardroom and the stock market.

I think the biggest message that I would like to give to CFOs is, “Tell us about your business model. Can you, for example, take a big A3 sheet of paper and draw the value drivers of your

business?” I’d guess that eight out of ten CFOs can’t—and the ones who can, who maybe couldn’t three years ago, those are the ones I want to hear from. To me, that’s the step-two point in the underpants-gnomes piece.

McKinsey on Finance: *How should companies think about what sort of earnings guidance they give investors?*

Aled Smith: If companies tell us how they want to be measured, then I’ll take a view if that’s appropriate for me or interesting. But if their long-term key performance metrics mean they have some volatility—if a big order came this quarter, for example, instead of next quarter—they shouldn’t be beholden to it, and they shouldn’t listen to the sell side just because analysts can tell clients the company beat or missed a quarterly



number. Because the sell side has a job to do (which increasingly is being paid for by hedge funds), which is to shift inventory.

Instead, companies have to be strong enough to say, “This is how we run our business,” and not hide from it—and they have to be transparent about how they’re being incentivized. There’s a big problem with incentives in the world today.

McKinsey on Finance: *Can you tell us more about the problem with incentives?*

Aled Smith: Whenever we see strange behavior, it’s usually because someone’s wrongly incentivized. If I am a board director and I understand what you, the management, are doing to create value, then I should set the incentive systems to be aligned with it.

But we find about 70 to 80 percent of incentive systems don’t take account of the balance sheet. Managers are incentivized on earnings, on revenue, and on growth, but they are not held accountable for the cost of simple things, such as goodwill on an acquisition. Consequently, their behavior is aligned to their pay, and unfortunately a lot of them get very high pay with no penalty for failure; therefore, we get suboptimal allocation of capital. Managers are being rewarded, but not for creating value. ○

¹ Robert N. Palter, Werner Rehm, and Jonathan Shih, “Communicating with the right investors,” *mckinseyquarterly.com*, April 2008.

² With around 375,000 investors and more than £215 billion (€259.9 billion; \$346.6 billion) under management, M&G is one of Europe’s leading active asset managers.

³ *South Park*, episode 30, first broadcast December 16, 1998, on Comedy Central, directed by Trey Parker and written by Pam Brady, Trey Parker, and Matt Stone.



Due diligence in China: Art, science, and self-defense

Widespread delisting of Chinese companies has investors rethinking due diligence and looking harder for subtle clues that something is amiss.

David Cogman

It's not often that the credibility of an entire class of companies is called into question at once. The aggregate market capitalization of US-listed Chinese companies¹ fell in 2011 and 2012 by 72 percent—and around one in five was delisted²—even as the Nasdaq rose by 12 percent (exhibit). Nor is delisting of Chinese companies purely a US phenomenon: since 2008, around one in ten Chinese companies listed in Singapore has also been delisted or suspended.

The extent of the damage to investor confidence is hard to gauge. The broad decline in market capitalization suggests investors may be tarring even the most transparent and upstanding Chinese companies with the same brush. Now-familiar

cases like Longtop Financial Technologies, the China-based software company charged with fraud in 2011, or Sino-Forest, the erstwhile forest-plantation operator that announced plans to liquidate itself last year after allegations of fraud, have left investors with fundamental concerns. These companies had, after all, followed required listing procedures, yet they somehow slipped through the regulatory requirements of the IPO and statutory-reporting processes that might have identified deficiencies. In many cases, the problem was fraud, and often involved false or misleading documentation that would not have been discovered by a regular audit—since such audits primarily rely on documentation supplied by the company itself. Indeed, almost



all the companies involved were audited by Big Four firms; most were brought to the market through IPO or reverse takeover by major US investment banks. Past examples have shown that private-equity and strategic investors can miss accounting fraud despite conducting a detailed, professional diligence. Investigative, forensic diligence is important in catching these cases, but it is costly and time-consuming, and not necessarily foolproof.

The problem is surely not limited to Chinese companies, though they are at the center of investor concerns today given the importance

of that country’s growth and stability to the world economy. It also extends to other countries where transparency is lacking and audit quality is inconsistent. Overcoming investor concerns may mean going back to some investing basics. Diligence is, after all, as much about developing a sense of trust in a company and exercising judgment as it is about finding and checking facts. Financial, portfolio, and corporate investors alike need to revive the habit of looking beyond the usual statutory and regulatory disclosures for less direct indicators of trouble in areas such as the ones discussed in this article: governance, management, financing, market context, and

Exhibit

In recent years, the aggregate market capitalization of US-listed Chinese companies fell dramatically.

TRS index: value on Dec 31, 2010 = 100¹



¹TRS index based on median monthly TRS movements for 440 companies from Dec 31, 2010, to Jan 31, 2013. Source: Bloomberg; Datastream; McKinsey analysis

partnerships. Such indicators are neither conclusive in themselves nor a replacement for other aspects of diligence: exercising judgment isn't just about following a gut feeling. But it can lead to valuable clues that something unpleasant is hiding under the surface, even when everything looks healthy on paper. That makes it especially useful as part of a systematic checklist that investors keep in mind when reviewing diligence results and reflecting on interactions with investee management.

Governance

Corporate governance merits serious attention for a variety of reasons. To start, when it's weak, the floodgates open for unscrupulous management teams. Blatant misappropriation of company resources may be less common than it once was, but it was a factor in some of the companies delisted in the United States recently: in one case, for example, the board chairman transferred ownership of company assets to himself just prior to raising funds from US investors and conspired with the CEO to avoid disclosure.

Governance arrangements also reveal how the top team thinks about its rights and responsibilities. Senior management demonstrates its understanding of them in myriad small and large ways that sometimes serve as early-warning signs. Consider, for example, the many private Chinese companies where a single minority shareholder plays a de facto controlling role. This is not necessarily a problem, but it pays to look closely at how such shareholders view their relationship with the company. Minor things, such as small transactions between the company and the controlling shareholder, can reveal much about shareholders' attitudes toward the company. Do they see it as something to which

they have a duty of trust or as an extension of their personal property? Do they understand and respect basic boundaries between company and personal business? Have they gone out of their way to treat minority shareholders fairly during corporate restructurings—something that is easy to avoid doing?

When Chinese companies list their shares on foreign exchanges, particularly in the United States, they need to make sure their corporate-governance infrastructure complies with exchange regulations. The choices made in this process say a lot about management's motivation and about whether there is real intent to improve the company's governance. Have managers made a serious attempt to upgrade their controls and decision-making process? Have there been concrete changes in how top management works and in how it is overseen by the board, or have managers simply made token changes to comply with regulations? Halfhearted governance-compliance efforts may be a leading indicator of deeper problems—even outlandish ones, such as the questions that arose about the very existence of an oil and gas exploration company's operations after it was listed.

Management

A number of delistings of Chinese companies in the United States involved accusations of falsified transaction documents provided for audits. In some cases, the fraud was happening well below top management and even without its direct knowledge, as was alleged at one energy company. The only way to catch these issues directly is through a forensic audit. But investors also need to keep a lookout for warning signs about management that extend beyond the top team and its compliance with governance standards.

How can that be done? A first step for many investors should be examining the bench strength of a company's professional management. It is relatively easy to assemble a senior team that will leave a good impression in a road show. As part of their IPO process, in fact, a number of Chinese midcap companies have fielded compelling leadership teams that included several figureheads brought in recently to add credibility. It's much harder, especially in a market like China where talent is expensive, for executives to build a strong pipeline of competent operational managers with long tenure in the company: that can often take years to develop. Depth of management talent is an indicator of a company that's being built to last—and its absence could signal that a company may have deeper problems.

A mismatch between a company's management capabilities and its growth plans is another potential red flag. If the CFO plans to upgrade the company's financial planning, investors

should confirm that the finance team has the size and experience to follow through. If the company plans to expand manufacturing capacity, does it have enough plant managers to run existing facilities as it ramps up new ones? If the company plans to locate manufacturing overseas, does it have general managers who can work in a foreign-language environment? These questions may seem obvious, but too often they go unasked.

The quality of operational management is another area where on-the-ground scrutiny is worthwhile. Good plant discipline is hard to develop and harder to fake, and its absence is typically visible to the trained eye on a single site visit. Even a one-hour walk-through, if used carefully, can provide validation of staffing levels, inventory levels and age, and plant utilization. If a company resists a walk-through, that should sound alarm bells. How good are the company's manufacturing or service operations? Are there good visual-



management systems? Is there evidence of strong health, safety, and environmental and quality systems? Are testing labs in constant use, or does a layer of dust cover the desks? Affirmative answers to questions like these don't necessarily mean a company is trustworthy, but negative ones should be cause for concern.

Financing

Financial management is, in China at least, one of the greatest risk factors. Although proper evaluation is only possible in the context of a full diligence, a company's commercial-banking relationships can offer some indications of whether the conditions exist to facilitate fraud—and these indicators can be assessed quickly and easily through frank discussion with managers. Among the companies delisted in the United States were several that colluded with banks to falsify audit documents, others that took on excessive leverage through sweetheart loans that circumvented banking regulations, and still others that borrowed unnecessarily and then moved the cash out of the company. Investors should ask several questions. Does the company have relationships with multiple banks, or is it reliant on a single one? Are its critical financial relationships with major, well-regarded national banks or smaller, less well-known provincial or municipal ones? How important is the company's business to the bank branch or branches that it works with? None of these factors would prove the existence of financial malfeasance, but they would make malfeasance a lot easier.

Similarly, much can be inferred from the way a company structures and times its loans. Investors should examine whether a company has structured loan facilities and projects to get around restrictions (for instance,

breaking a project into sections that are within a loan officer's approval limit). Has capital raising occurred when there were no clear needs—for example, has the company borrowed money when it had ample reported cash on its balance sheet and no major investments under way? Do current patterns of capital raising clearly match its investment plans?

Discovering fraud in these areas through regular audits can be a long process. Well-run Chinese companies are usually keen to provide transparency to investors; reticence is in itself a warning sign. In either case, closer observation of transactional banking relationships and capital raising can give an early indication that something is wrong, without definitively showing what.

Market context

Several of the companies delisted in the United States operated in opaque and protected markets, such as reselling advertising, importing specific fuel or agricultural products into concentrated and highly regulated markets, or operating logistics infrastructure in specific geographies. From an investor's perspective, these episodes reinforce something more fundamental: companies that have competed effectively in open markets are intrinsically more credible than those that function in closed ecosystems.

Of course, many companies operating in protected sectors are reliable and trustworthy and deserving of capital. It can be challenging for investors to reassure themselves of that, though. Further complicating matters is the role that low-cost financing from Chinese banks is alleged to play in some sectors; companies that on the surface seem to be competing vigorously actually may be floating on artificially cheap capital.

For skeptical investors, the other indicators covered in this article can help. Moreover, many Chinese companies are already making the transition to more open competition: consider the country's telecommunications-equipment providers, which have moved from dominating the domestic market to succeeding in international markets, where they must stand on their own without government support. Others, including both private and state-owned enterprises, still face limited natural competition in their domestic market. This is often due to regulation aimed at creating a stable industry structure that government can more easily manage. When policy support is a factor in a company's performance (as was the case in solar-panel manufacturing, where it led to overcapacity), it is usually obvious—and rarely sustainable.

Partnerships

A final reliable sign of corporate trustworthiness is a company's track record with partners. It's reasonable for investors to conclude that a company involved in multiple joint ventures with the same leading multinational partner has survived several rounds of close-up diligence from an experienced operator. It may still have issues, but it was reliable enough to motivate the multinational company to form additional joint ventures rather than turn to other potential partners.

This is not foolproof logic, however. In China, investment restrictions force multinational companies in many industries to work with local joint-venture partners—and some multinationals

have clearly gotten partnership decisions wrong. In the infamous high-speed-rail cases, for example, partnerships that multinational companies hoped would help them address the local market turned into disputes over local partners' development of their own technology platforms.



The spate of delistings in the past two years may, in retrospect, have had some beneficial effects. It has forced many corporate and private-equity investors to increase the depth and detail of their formal due-diligence efforts. It has spurred the growth of what could be termed forensic equity research—conducted by analysts who specialize in reviewing listed companies for potential fraud. Although often disliked by their targets, such analysts provide a valuable balance to traditional equity research. Delistings are also forcing the US Securities and Exchange Commission to look hard at the reliability and acceptability of certain audits, which will most likely result in better standards of practice. Finally, we hope that it will leave investors more cautious about the information on which they rely and more thoughtful and circumspect about how they interpret it. ○

¹ Based on the 518 companies listed in the United States before January 2012 that were either domiciled in China or domiciled in Hong Kong, with a significant portion of their revenues derived directly from China.

² In all, 106 of these companies were delisted over the past two years. More may be implicated by the ongoing US Securities and Exchange Commission investigation into accounting practices.

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M&A in 2012: Picking up the pace

Merger activity increased during the second half of the year, in spite of high deal premiums. Here's a look at how the markets reacted.

André Annema

After a slow start last year, M&A activity in 2012 picked up during the second half of 2012, bringing the total value of activity to a level just 1 percent below 2011. The continuing economic uncertainty in Europe reduced European deal volume further, although activity there showed a remarkable rebound in the fourth quarter. Deal volume in Asia declined as well. In the Americas, however, deal volume notched up, leading the global M&A market with 48 percent of volume.

Deal premiums remained high. Although global stock-market valuations recovered materially during the year, with the S&P 500 index increasing by more than 10 percent, the average premium

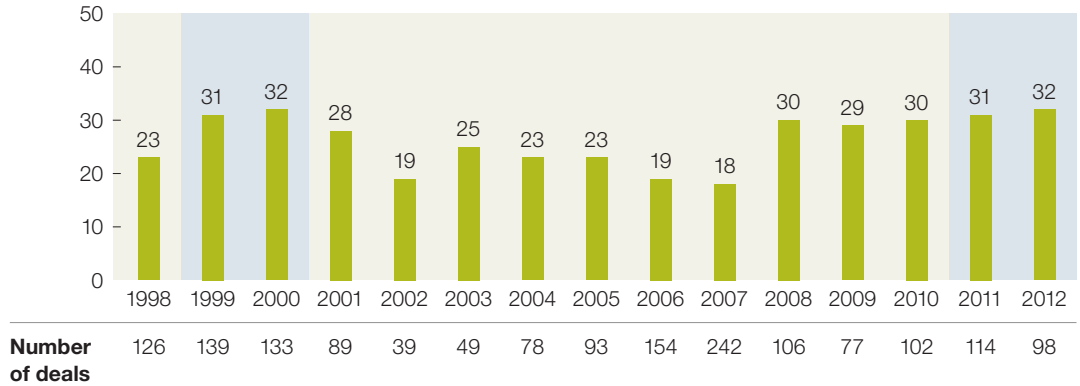
paid by acquirers hovered around historic levels—comparable even to the average paid during the M&A boom driven by the high-tech industry at the turn of the century (Exhibit 1).

There is, however, a distinct difference in investor perception about current M&A deal activity compared with that of the high-tech boom. At that time, investors were skeptical about many of the deals announced, and they heavily penalized acquirers for the lack of credible value-creation potential from those deals. Our deal-value-added (DVA) index suggests that investors were more sanguine about deals announced in 2012, in spite of the lingering global economic malaise.

Exhibit 1

Deal premiums hover near historic highs.

Median 1-week premium,¹ %



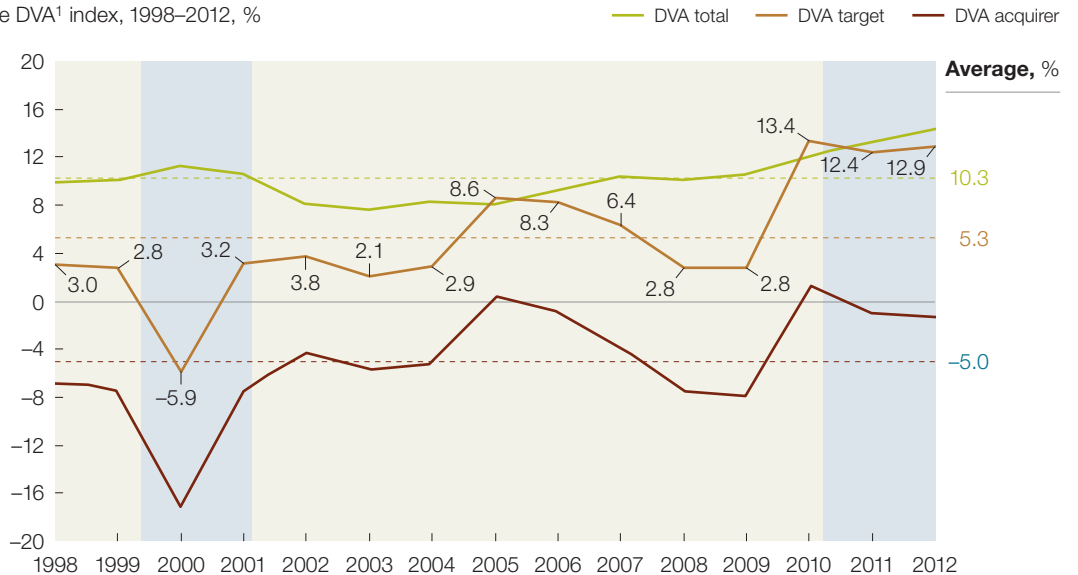
¹For M&A deals >\$25 million involving publicly traded companies, 1-week premium = price offered per share vs. target company's share price 1 week before announcement.

Source: Datastream; Dealogic; McKinsey analysis

Exhibit 2

Investors have a more positive outlook than the last time premiums were at a high level.

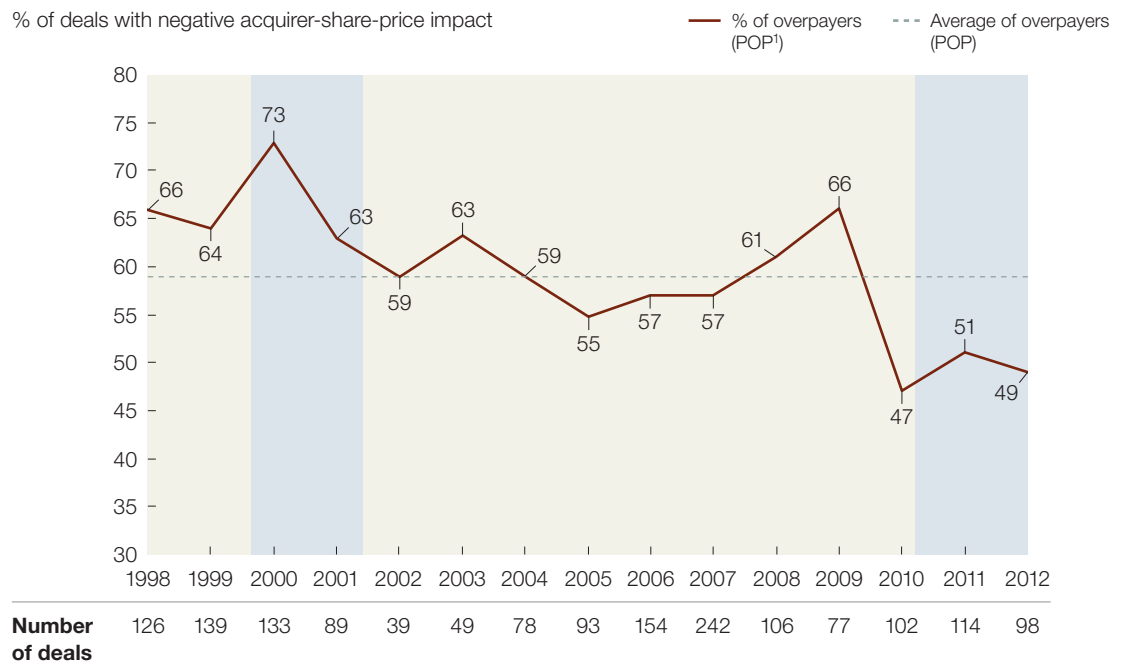
Average DVA¹ index, 1998–2012, %



¹Deal value added; for M&A deals >\$25 million involving publicly traded companies, this is 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: Datastream; Dealogic; McKinsey analysis

Exhibit 3

The number of overpayers has edged close to historic lows.

¹ Public-offering price; defined as the 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 for M&A deals >\$25 million involving publicly traded companies. Source: Datastream; Dealogic; McKinsey analysis

The DVA that investors currently perceive at deal announcement continues to be high (Exhibit 2), and the share of acquirers that face a negative investor reaction to the deal announcement continues to be at a historically low level (Exhibit 3). Readers can explore the deal value added and percentage of overpayers for deals by industry, geography, and source of funding in an interactive exhibit at mckinsey.com/insights.

These results imply that even in this uncertain period, investors recognize M&A as a pivotal element of corporate strategy. Whether companies can meet or beat the expectations suggested by announcement effects, of course, depends on whether they can excel at integration and value capture. Executives who want to do so will need to build and sustain a strong corporate M&A capability. ○



Managing the people side of risk

Companies can create a powerful risk culture without turning the organization upside down.

**Alexis Krivkovich
and Cindy Levy**

Most executives take managing risk quite seriously, the better to avoid the kinds of crises that can destroy value, ruin reputations, and even bring a company down. Especially in the wake of the global financial crisis, many have strived to put in place more thorough risk-related processes and oversight structures in order to detect and correct fraud, safety breaches, operational errors, and overleveraging long before they become full-blown disasters.

Yet processes and oversight structures, albeit essential, are only part of the story. Some organizations have found that crises can continue to emerge when they neglect to manage the frontline attitudes and behaviors that are their

first line of defense against risk. This so-called risk culture¹ is the milieu within which the human decisions that govern the day-to-day activities of every organization are made; even decisions that are small and seemingly innocuous can be critical. Having a strong risk culture does not necessarily mean taking less risk. Companies with the most effective risk cultures might, in fact, take a lot of risk, acquiring new businesses, entering new markets, and investing in organic growth. Those with an ineffective risk culture might be taking too little.

Of course, it is unlikely that any program will completely safeguard a company against unforeseen events or bad actors. But we believe it

is possible to create a culture that makes it harder for an outlier, be it an event or an offender, to put the company at risk. In our risk-culture-profiling work with 30 global companies, supported by 20 detailed case studies, we have found that the most effective managers of risk exhibit certain traits—which enable them to respond quickly, whether by avoiding risks or taking advantage of them. We have also observed companies that take concrete steps to begin building an effective risk culture—often starting with data they already have.

Traits of strong risk cultures

The most effective risk managers we have observed act quickly to move risk issues up the chain of command as they emerge, breaking through rigid governance mechanisms to get the right experts involved whether or not, for example, they sit on a formal risk-management committee. They can respond to risk adroitly because they have fostered a culture that acknowledges risks for what they are, for better or for worse; they have encouraged transparency, making early signs of unexpected events more visible; and they have reinforced respect for internal controls, both in designing them and in adhering to them.

Acknowledging risk

It takes a certain confidence among managers to acknowledge risks. Doing so—especially to the point of discussing them internally, as well as with shareholders or even regulators—requires that managers rely on their own policies and procedures to work through issues that could lead to crisis, embarrassment, or loss.

The cultural differences between companies that acknowledge risk and those that do not are quite stark. Consider, for example, two global

financial institutions that take similar risks and share a similar appetite for risk. The first has built a culture, at all levels of the organization, that prizes staying ahead of the trend. This might mean convening a group of executive peers to discuss issues faced by the entire industry or responding to regulatory trends early—for example, on capital and liquidity requirements or compensation practices. The stance it takes is, “If we see it, identify it, and size it, then even if it’s horrible, we’ll be able to manage it.” Where risks cannot be sized, they are at least discussed in qualitative terms. The institution’s candor and its plans to rectify cultural issues in response to a number of risk incidents has won it the respect of regulators and built credibility with investors.

The second institution, in contrast, has a reactive and back-footed culture—one focused more on staying out of trouble, ensuring regulatory compliance, and making sure all the boxes are ticked. Its managers are generally content to move with the pack on risk issues, preferring to wait for regulatory criticism or reprimand before upgrading subpar practices. They are afraid of knowing what they don’t know, and they fear the reaction of the board, regulators, and investors. Many would rather ignore undesirable behaviors because they don’t know how to manage them and because managing them would demand time and might affect their cost base. This organization’s stance is, “Let’s wait until we really need to deal with these unpleasant things, because they’re anomalies that may turn out to be nothing at all.”

A separate institution had such a mind-set during the mortgage crisis. Managers did not trust their own models, which accurately predicted the severity of the issues to come. They knew that if the models were correct, they would be in more trouble than they knew how to handle, and so

In the best of cases, respect for rules can be a powerful source of competitive advantage.

they found it easier to assume that the models were wrong—or to hope that the risk would crest and fall before the model's estimates came true. Whether from fear or hubris, managers convinced themselves that they were safer than they really were. Even as the crisis developed, they were confident that they would not experience the mishaps befalling similar companies. In the end, the company's refusal to acknowledge and address risk left it far more vulnerable than managers expected, and it was hit particularly hard.

Encouraging transparency

Managers who are confident that their organizational policies and controls can handle—and even benefit from—openness about risk are more likely to share the kinds of information that signal risk events and allow the institution to resolve emerging issues long before they become crises. This means they spot a risk issue developing and mobilize the organization to analyze and remedy it—at the board level if needed, and often within a few working days. In one situation, a division of an energy-services company was operating a contract in an emerging country in which it had not previously worked. There, the division discovered employment practices among subcontractors that ran counter to its own policies and practices. The operating leadership swiftly escalated the issue to the company's global management board to decide whether specific contractors were acceptable. It was able to reallocate project tasks among contractors, manage timeline slippage and the budget, and consequently

reduce the company's employment-practices risk and safeguard project returns.

Companies with a culture that discourages such discussions—as well as those in which overconfidence leads to denial—are prone to ignoring or failing to recognize risks. In some cases, employees fear telling the boss bad news because they worry about the financial downside of slowing commercial progress, they know the boss doesn't want to hear it, or they fear being blamed. As a result, they alert managers to risks only when further delay is impossible.

In other cases, companies promote practices that unintentionally reduce transparency regarding risk. For example, at one global pharmaceutical company, the culture thrives on competitive teams. Competitiveness is so strong that product-development teams use subtly different risk classifications so that their respective projects can't be directly compared. To the teams, it can feel like good management to deal with issues close to home rather than raise them to higher levels—especially since revealing their true risks might place them at a disadvantage in the next planning round. For the company, though, this practice has obscured risks that were identified by one unit but went unnoticed by others, which continued to make errors that had been resolved elsewhere.

The best cultures actively seek information about and insight into risk by making it everyone's responsibility to flag potential issues. For example, managers at one global oil-exploration company

explicitly begin every meeting and interaction with a discussion about safety. Participants know they must be able to make an observation or raise a concern if called on randomly, which keeps them on the lookout for safety issues at all times. Most of the issues they raise are minor and easily addressed. But bigger questions often lead to longer conversations and inquiries from leadership, which clarify the problem and identify by name those responsible for resolving the issue.

Ensuring respect for risk

Most executives understand the need for controls that alert them to trends and behaviors they should monitor, the better to mobilize in response to an evolving risk situation. And while managers are unlikely to approve of skirting the very guidelines and controls they have put in place, some unintentionally promote situations and behaviors that undermine them. For example, while too few controls can obviously leave companies in the dark as a situation builds, too many can be even more problematic. Managers in such cases mistake more controls for tighter management of risk, though they may be inadvertently encouraging undesired behaviors. In one large hospital system, managers had implemented so many guidelines and controls for ward

procedures that the staff saw them as impractical. As a result, they routinely circumvented them, and the culture became increasingly dismissive of all guidelines—not just the less practical ones—to the detriment of patients.

Even companies with the right number of controls in place encounter difficulty if managers do not monitor related trends and behaviors. Companies often unconsciously celebrate a “beat the system” mind-set, rewarding people who create new businesses, launch projects, or obtain approvals for things others cannot—even if it means working around control functions in order to get credit lines or capital allocations, for example.

In the best of cases, respect for rules can be a powerful source of competitive advantage. A global investment company had a comprehensive due-diligence process and sign-off requirements for investments. Once these requirements were fulfilled, however, the board was prepared to make large, early investments in asset classes or companies with the collective support of the senior-executive team, which was ultimately accountable for performance. Company-wide confidence in proceeding resulted from an exhaustive risk



debate that reduced fear of failure and encouraged greater boldness relative to competitors. Confidence also stemmed from an appropriately gauged set of risk controls and an understanding that if these controls were followed, failure would not be regarded as a matter of poor decision making.

Building an effective risk culture

Companies that want to reshape their risk culture should be aware that patience and tenacity are crucial. Changing the operating environment of a large organization takes at least two to three years, as individuals come up against specific processes—such as policy decisions, project approvals, or even personnel reviews—that have changed in line with new risk-culture principles. In our observation, companies wrestle with two challenges: building consensus among senior executives and sustaining vigilance over time.

Finding consensus on culture

Improving a company's risk culture is a group exercise. No one executive—or even a dozen—can sufficiently address the challenge. In most global organizations, CEOs and CFOs who want to initiate the process must build a broad consensus among the company's top 50 or 60 leaders about the current culture's weaknesses. Then they must agree on and clearly define the kind of culture they want to build. This is no small task, typically requiring agreement on four or five core statements of values about the desired culture that imply clear process changes. For example, in one organization, managers often adopted new products or took on new customers without considering whether the company's infrastructure could support them. Often, it could not; this ran up costs and created huge operational risks. When leaders gathered to define the risk culture they wanted to see, one of their statements was, "We will always

understand the infrastructure implications of the risk decisions we make."

The consequence of committing to such statements is that the company will need to change the way it approves activities, whether those are transactions at banks, capital projects in heavy industry, or even surgical procedures at hospitals. It cannot let them proceed if the risk infrastructure does not support them—and business-unit COOs must be held accountable for risk events related to infrastructure in their areas. To make aspirations for the culture operational, managers must translate them into as many as 20 specific process changes around the organization, deliberately intervening where it will make a difference in order to signal the right behavior. In some companies, this has meant changing the way governance committees function or modifying people processes, such as training, compensation, and accountability. And while fine-tuning some of these areas may take a fair number of cycles, even a few symbolic changes in the first cycle can have a profound impact on the culture.

For example, in one global organization, a simple announcement that certain risk-related data would be incorporated into one round of promotions radiated through the organization almost overnight, encouraging some behaviors and discouraging others. In the next round of promotions, managers created reports using the data so that every staff member had tangible risk indicators next to his or her name. At that point, the new approach to risk started to become part of the infrastructure—sending loud signals to the organization about what would be celebrated and what would not. Although these were big changes, they were accomplished without turning the organization upside down.

Sustaining vigilance

Since cultures are dynamic by definition, sustaining the right attitudes and behaviors over time requires continuing effort. An ongoing risk committee might start off by keeping on top of key issues but become stale and mechanical as people lose energy over time. Or a discontinuity—new leadership or a new set of market pressures, for instance—could send the culture in a different direction. To monitor for such shifts and make sure things continue moving in the right direction, managers at one pharmaceutical company conduct spot checks every year on employee attitudes and minor risk infractions.

The responsibility for maintaining the new risk culture extends to boards of directors, which should demand periodic reviews of the overall company and individual businesses to identify areas that merit a deeper look. This need not be complicated. Indeed, most companies can aggregate existing data: a people survey, which most companies conduct, can provide one set of indicators; a summary of operational incidents, information on financial performance, and even

customer complaints can also be useful. Combined, these data could be displayed in a dashboard of indicators relevant to the company's desired risk culture and values. Such a review process should become part of the annual risk strategy on which the board signs off.



Obviously, a shortage of risk consciousness will lead to trouble. But it is all too easy to assume that a thorough set of risk-related processes and oversight structures is sufficient to avert a crisis. Companies cannot assume that a healthy risk culture will be a natural result. Rather, leadership teams must tackle risk culture just as thoroughly as any business problem, demanding evidence about the underlying attitudes that pervade day-to-day risk decisions. ○

¹ The concept of risk culture featured prominently in a 2008 report by the Institute of International Finance on the failings that led to the credit and liquidity crisis among global banks and the consequent bank collapses and losses. See *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*, Institute of International Finance, July 2008.



The CFO's role in the pursuit of growth

As CFOs play a bigger role in strategy, their influence may bring renewed focus on organic growth.

**Ankur Agrawal,
Kaustubh Joshi,
and Ishaan Seth**

The more CFOs contribute to strategy, the more relevant their perceptions of growth may become. That's a key finding from a recent McKinsey Global Survey,¹ which asked C-level and senior managers to identify their companies' biggest strategic challenges—and how effective their CFOs are at driving growth.

Respondents largely agree that achieving sustainable growth is the most pressing strategic challenge their companies face (Exhibit 1). Among CFOs, 86 percent report finding new sources of growth (both organic and inorganic) is a challenge, while 77 percent cite balancing long-term growth with short-term investor pressures as a challenge. Other executives agree:

77 percent and 72 percent of them cite these, respectively, as their companies' strategic challenges. When asked what the most important drivers of this growth might be over the next five years, the largest share of CFOs (45 percent) cite organic growth, compared with 36 percent of non-CFO respondents; CFOs are also less likely to see shifting of resources within the portfolio as the most important driver. These results indicate no real consensus on a single best path to growth or on the actual value of organic growth relative to M&A. They do, however, characterize the perception of CFOs relative to other executives at a time when CFOs' influence may increase along with their role in strategy. The differences among them suggest at least the

Exhibit 1

Sustainable growth is a pressing challenge.% of respondents¹

■ CFOs, n = 72 ■ All others, n = 552

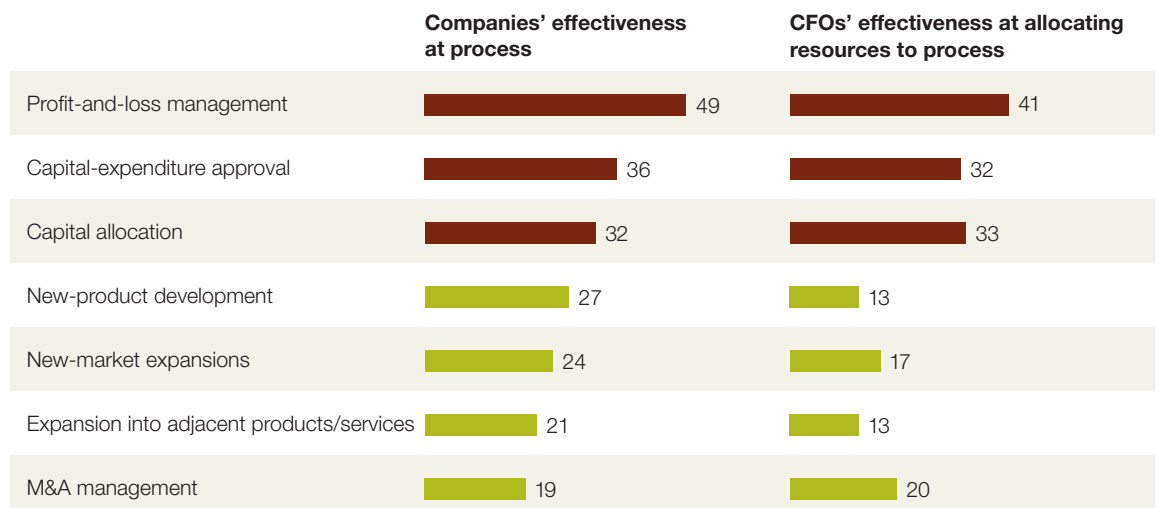
Strategic challenges for respondents' companies¹ Respondents who answered "don't know" are not shown.

Exhibit 2

Companies and CFOs are most effective at managing the portfolio.

% of respondents who say "extremely" or "very," n = 624

■ Portfolio-management activities



likelihood of healthy debate on the sources and sustainability of growth.

Regardless of which sources of growth their companies pursue, the results indicate that, in the coming years, CFOs will need to up their game in a wide range of growth-related activities. Among several processes linked to these growth drivers, executives are most likely to say they are extremely or very satisfied with their companies' effectiveness—and their CFOs' resource-allocation role—in processes related to portfolio management, including capital allocation, capital-expenditure approval, and profit-and-loss management (Exhibit 2).

Yet nearly half of non-CFO executives report less satisfaction with their companies' effectiveness at processes that drive M&A, as well as expansion into new markets and organic growth (such as new-product development and expansion to adjacent products and services). Not surprisingly, these are the same areas where non-CFO respondents think CFOs could more effectively spend their time. ○

¹ The online survey was in the field from October 23 to November 2, 2012, and was refiled from December 3 to December 10, 2012. In total, it received responses from 72 CFOs, 204 other finance executives, and 348 other C-level and senior executives representing the full range of regions and industries. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

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