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Avoiding the consensus earnings trap

The promise of meeting or beating consensus estimates and the peril of missing them are profoundly overstated.

**Tim Koller,
Rishi Raj, and
Abhishek Saxena**

At most public companies, the pressure to meet or beat consensus earnings estimates is strong. Do so consistently, many executives believe, and investors will reward the company over the longer term with a higher share price. Report earnings below consensus estimates—even by a small amount—and investors will penalize them with a lower share price, they worry. A striking example: in early 2005, eBay reported that it had missed the fourth quarter 2004 consensus estimate by just one penny and saw its share price plunge 22 percent.

As a result, executives often go to some lengths to meet or beat consensus estimates—even acting in ways that could damage the longer-term health

of the business. It's not uncommon, for example, for companies to offer customers steep discounts in the final days of a reporting period in order to stoke sales numbers, in effect borrowing from the next quarter's sales. As other companies have shown, executives may forgo value-creating investments¹ in favor of short-term results, or they might manage earnings inappropriately to create the illusion of stability.²

Yet our analysis of large US companies over the past seven years shows that these fears are unfounded.³ In the near term, falling short of consensus earnings estimates is seldom catastrophic. Even consistently beating or meeting consensus estimates over several years does not matter, once

differences in companies' growth and operating performance are taken into account. In fact, a company's performance relative to consensus earnings seems to matter only when it *consistently misses* earnings estimates over several years.

This doesn't mean that companies should ignore consensus estimates, which can hint at what is on investors' minds and why. For example, how does the industry-growth outlook of investors compare with that of executives? The consensus can also be used to assess how well analysts and investors understand the drivers of a company's performance. Our findings demonstrate that investors consider more indicators of financial health when valuing a company than just whether a company meets its consensus earnings estimates. Thus companies need not go to extremes to meet or beat analysts' expectations if it means damaging the long-term prospects of the company.

The markets shrug

Most executives haven't personally experienced many catastrophic share-price drops after

minor earnings misses, and so they conclude such misses are rare. The mechanics of earnings estimates lend some support to that perception. After all, analysts' estimates are typically overoptimistic at the beginning of the financial year, but by the third quarter, it's reasonable to expect them to fall roughly in line with the eventual reported earnings—a pattern borne out by previous research.⁴ According to standard practice, a company has beaten the consensus estimate if its actual earnings are greater than the last available estimate for the year (almost always projected after the year is over), and as such, one would expect analyst estimates at that stage to be accurate (see sidebar, "Which earnings estimates count?"). Moreover, executives tend to focus on dramatic press accounts of earnings mishaps that are among the most extreme outliers, like the eBay example, where missing the consensus forecast led to a sharp drop in share prices. In addition to believing that missing earnings estimates is rare, they assume that even small misses lead to dramatic share-price declines.

Which earnings estimates count?

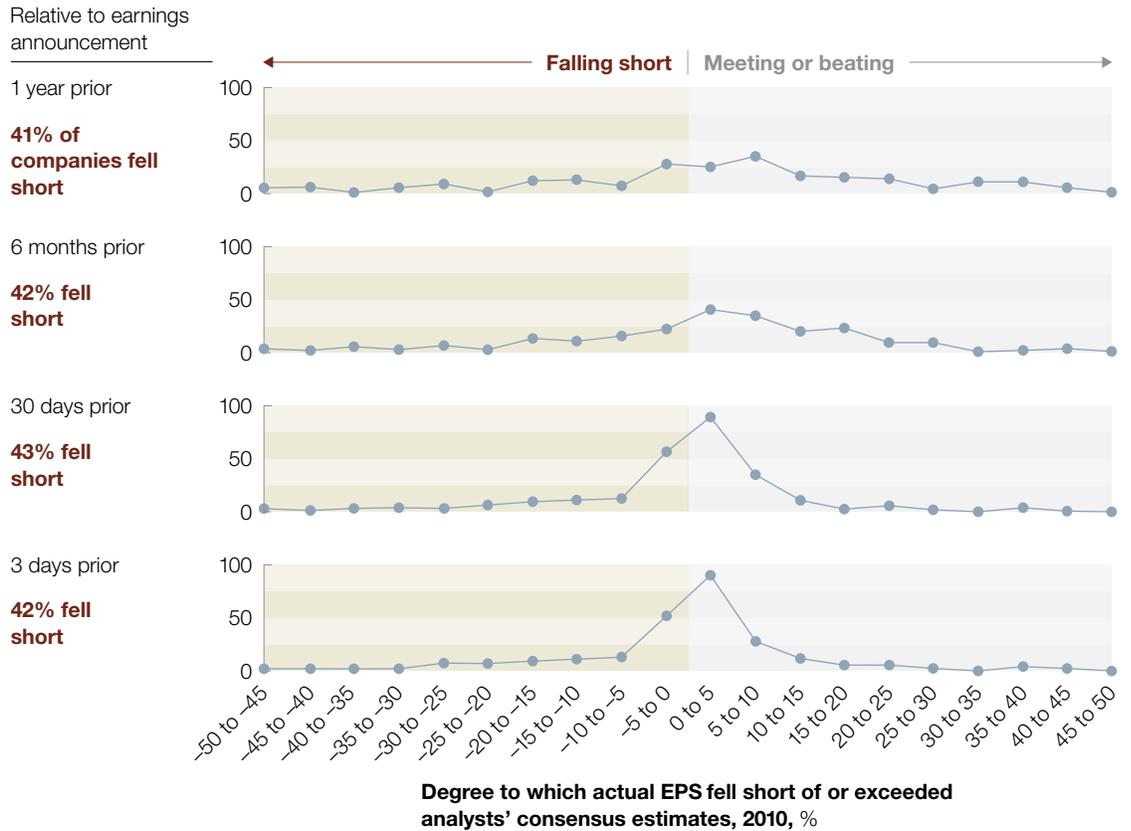
There's a fair amount of confusion around what it means to beat, hit, or miss the consensus earnings estimate. Suppose Company A reports earnings of \$2.00 per share for the year that ended December 31, 2011, on January 15, 2012. On January 1, 2011, at the beginning of the year, the consensus estimate was \$2.10. On January 1, 2012, after the year was over, but before earnings have been released, the

consensus had fallen to \$1.98. Did Company A beat or miss the consensus estimate? According to conventional practice, a company has beaten the consensus estimate if its actual earnings are greater than the last available consensus estimate (which is almost always after the year is over). So Company A has beaten the estimate, even though its earnings were ten cents less than the consensus at the beginning of the year.

Exhibit 1

Companies often fall short of consensus earnings estimates.

Distribution by gap between earnings per share (EPS) and consensus estimates, number of companies¹



¹Analysis of 266 companies, excluding outliers. Total number of companies falling within +/- 50% of consensus estimates: 1 year prior = 209, 6 months prior = 229, 30 days prior = 250, and 3 days prior = 252.

Source: Standard & Poor's Capital IQ; McKinsey analysis

In fact, falling short is common, and the effect is benign. More than 40 percent of companies generate earnings below consensus estimates—whether those estimates are compiled an entire year or just three days before an earnings announcement (Exhibit 1). Although some academics have documented a correlation between the change in a company's share price before and after the

announcement of earnings and the degree to which it meets the consensus earnings estimate, the size of the effect is small. Indeed, our analysis suggests that missing the consensus by 1 percent would lead to a share-price decrease of only two-tenths of a percent in the five days after the announcement. In other words, missing the consensus estimate by a penny or so just doesn't matter.

Executives concerned about their company's performance relative to consensus estimates should also consider that 40 percent of companies saw their share price, adjusted for the market, move in the *opposite* direction of their earnings miss. For example, when PPG Industries, a global supplier of paints, coatings, and chemicals, announced earnings for 2010 that were 4 percent below the consensus, the market reacted positively with an excess return of 7 percent. Why? On digging deeper, investors saw that the long-term outlook had improved. Sales were stronger than expected in nearly all business segments. The CEO also announced some investment initiatives that investors viewed as having the potential to create value in the longer term.

Conversely, when North American brewing company Molson Coors beat the consensus estimate by 2 percent in 2010, the market nevertheless

reacted negatively—with an excess return of –7 percent. Investors saw that the company's sales volume had declined by 2 percent and that margins were also down—it only beat the consensus because of a lower-than-expected tax rate. The market reacted to the fundamental drivers of performance, volume and margin, rather than earnings per share (EPS) itself.

As the Molson Coors example demonstrates, meeting or missing the consensus is less important than how the earnings were reached. That's because investors are continually assessing other news, such as whether the company met the consensus estimate for revenues as well as earnings. They are also able to see through cases where one-off items are responsible for meeting the consensus. Meanwhile, earnings announcements themselves often include information that helps investors reassess a company's long-term performance outlook. Earlier McKinsey research⁵



has shown that the market reaction at the time of an earnings announcement is influenced more by changes in analysts' expectations for longer-term earnings than the most recent results. That research found that a company might fall short of current-year earnings estimates and still see its share price increase if analysts revised their earnings estimates upward for the next two years (Exhibit 2).

Just as critical, the notion that markets reward companies with higher share prices when they consistently beat the earnings consensus turns out to be wrong. Here again, while some researchers⁶ have found this to be true, their analysis doesn't take into consideration the underlying performance of companies as measured by revenue

growth and return on capital. Once adjusted for performance, the apparent effect of consistently beating the consensus, which we define as four or more years out of seven, disappears. Companies with strong growth or return on invested capital had high shareholder returns regardless of whether they consistently beat the consensus. Only those companies that consistently missed it—again, in four years out of seven—showed a statistically significant negative effect from doing so (Exhibit 3).

A needed focus on growth and returns

Two pieces of earlier McKinsey research have shown that companies that provide EPS guidance are not valued higher than those that do not⁷ and that reducing earnings volatility does not drive valuation levels.⁸ Those findings, com-

Exhibit 2

A change in forecast EPS is more important than an earnings surprise.

Analysis of 590 announcements of fiscal-year earnings for 2007 by European companies

If changes in 2-year forward EPS¹ are positive...

... returns are likelier to be higher...

... whether or not consensus estimates are met

	Median excess return, ² %	Actual EPS vs consensus estimates ³
Companies with positive change in 2-year-forward EPS	2.4	Higher
	1.5	Lower
Companies with negative change in 2-year-forward EPS	-0.6	Higher
	-0.5	Lower

¹Earnings per share.

²Excess return over market return.

³Sample size: positive and lower = 127, positive and higher = 203, negative and lower = 118, negative and higher = 142.

Source: Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010; McKinsey analysis

Exhibit 3

A company’s performance on fundamentals is more important than its performance versus consensus estimates.

Median excess return vs sector return,¹ 2005–11, %

	High growth + high ROIC ³	High growth + low ROIC ³	Low growth + high ROIC ³	Low growth + low ROIC ³
Consistently beating²	4	3	0	-2
Inconsistent²	2	0	0	-3
Consistently missing²	0	-5	-5	-6

¹Company’s total returns to shareholders (TRS) minus median TRS of the sector. Sample size is 243 nonfinancial S&P 500 companies with December fiscal year-end.

²Difference between actual earnings per share and consensus estimate 30 days prior to earnings announcement. “Consistently beating” defined as beating expectations by >2% at least 4 out of 7 years, 2005–11. “Consistently missing” defined as missing expectations by >2% at least 4 out of 7 years. Companies consistently meeting expectations (by +/- 2% at least 4 out of 7 years) are not shown due to small sample size.

³ROIC = return on invested capital (2005–11); growth = compound annual growth rate of revenue (2004–11). Companies categorized as high ROIC or high growth exceeded the absolute reference points of 15% for ROIC and 7% for growth or the median of the respective sector in the sample.

Source: Standard & Poor’s Capital IQ; McKinsey analysis

combined with our current analysis, suggest that companies are spending too much time trying to manage their earnings without seeing any benefit to their share price.

While we realize it would be unrealistic for companies to ignore consensus earnings estimates, we believe that there are practices that companies should avoid:

- At the beginning of the year, managers shouldn’t shape their earnings targets or budgets just to meet consensus estimates. We’ve seen companies do that, typically by reducing spending on

product development, sales and marketing, or other costs associated with long-term growth. In doing so, they essentially are handicapping long-term performance for the appearance of short-term strength. Managers know much more than investors about what is happening inside their company and in their markets and about what the long-term growth opportunities are.

- As the year progresses, managers should likewise avoid costly, shortsighted actions to meet the consensus. As mentioned earlier, we’ve seen companies offering customers end-of-year discounts to boost their current-year sales with

next year's orders—or even cutting the travel budgets of the sales force, effectively borrowing from future sales to meet this year's consensus estimates.

- At year-end, never resort to using cosmetic quick wins to meet estimates, such as creative accounting with accruals. Investors recognize these for what they are. Instead, focus on the company's underlying fundamentals and on communicating those to investors. That's what is most important for your share price.



Executives commonly believe that missing consensus earnings forecasts will penalize their share price. We have found that is not the case, and executives should not take extreme measures to meet or beat estimates. Doing so may damage business health over the longer term. Rather, leaders should keep their focus on creating value, since that is the only reliable way of creating durable shareholder returns. ○

¹ See John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 2005, which found that a majority of CFOs would “avoid initiating a positive-NPV project if it meant falling short of the current quarter’s consensus earnings.”

² See Peggy Hsieh, Tim Koller, and S. R. Rajan, “The misguided practice of earnings guidance,” *mckinseyquarterly.com*, March 2006.

³ We analyzed Fortune 500 companies, excluding financial companies and those with a fiscal year-end other than December 31, ultimately considering a total of 266 companies.

⁴ See Marc Goedhart, Brendan Russell, and Zane Williams, “Prophets and profits,” *mckinseyquarterly.com*, October 2001.

⁵ See Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010.

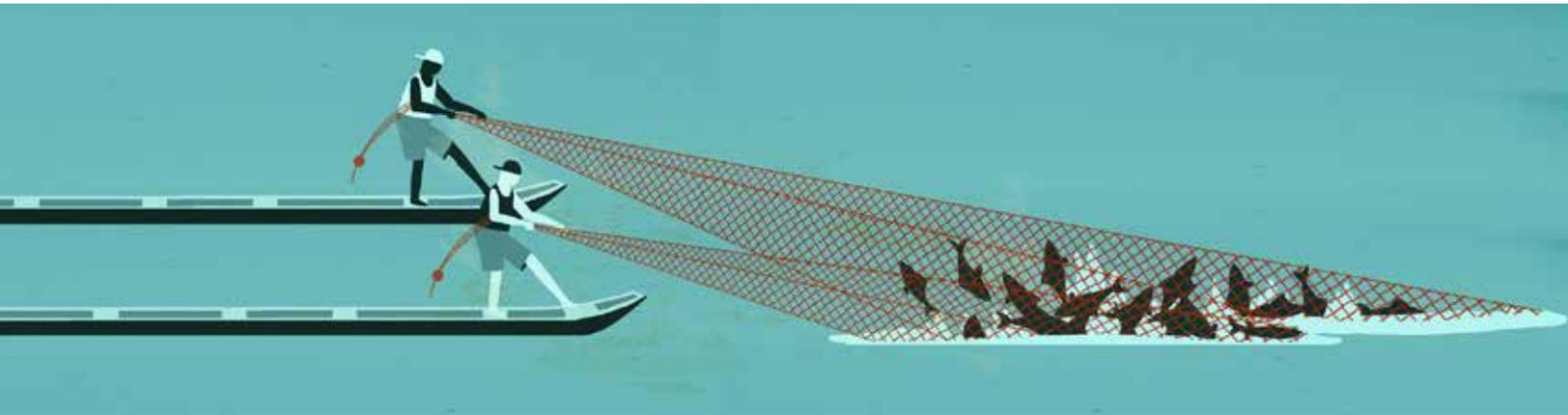
⁶ See, for example, Ron Kasznik and Maureen E. McNichols, “Does meeting earnings expectations matter? Evidence from analyst forecast revisions and share prices,” *Journal of Accounting Research*, Volume 40, Number 3, June 2002.

⁷ See Peggy Hsieh, Tim Koller, and S. R. Rajan, “The misguided practice of earnings guidance,” *mckinseyquarterly.com*, March 2006.

⁸ See Bin Jiang and Tim Koller, “The myth of smooth earnings,” *mckinseyquarterly.com*, February 2011.

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Modernizing the board's role in M&A

Active involvement can help companies capture more value—and develop a competitive advantage in deal making.

**Chinta Bhagat and
Bill Huyett**

In many conversations with senior executives and corporate directors, we've heard variations on the theme that deep board involvement in M&A encroaches on the line that separates governance from management. While we wouldn't argue with the importance of such a line, our experience suggests that when it comes to M&A, many boards and management teams are drawing it in the wrong place.

Consider the stakes: many large corporations depend on M&A¹ for growth, and by executing it well they can significantly boost the value those deals create. But poorly executed M&A can saddle investors with weak returns on capital for decades and little hope for recovery. What's

more, the margin between success and failure is slim. In most transactions, the net value creation to the buyer is usually a small fraction of the deal's value and therefore easy to wipe out with indifferent execution or ill-informed economic assumptions.²

Many boards, reluctant to cross the line between governance and management, miss opportunities to help senior executives win at M&A. Boards are well placed to take a long-term view of a deal's value: the CEO or the business unit leader may have tenures shorter than the time needed to realize it fully. Boards are also well positioned to challenge the biases that often cloud M&A decision making and goal setting. Furthermore, the

A board cannot substitute for an effective management team. Yet it can play roles that go beyond the legal, regulatory, and fiduciary obligations that virtually every board fulfills on M&A.

diverse experiences of board members with long leadership careers in different corporate settings can shed useful light on common organizational risks in deals. Finally, boards can embolden senior management to pursue promising deals that may seem unfashionable or are initially unpopular with investors.

Of course, a board cannot substitute for an effective management team. Yet it can play roles that go beyond the legal, regulatory, and fiduciary obligations that virtually every board fulfills on M&A—thereby helping executive teams to pursue deals and manage the associated risks in ways that create more value. In this article, we describe three such roles: challenging value-creation possibilities, testing merger-integration plans, and helping managers to create a corporate competitive advantage in M&A.

This final role is crucial because M&A is central to the strategy of many value-creating companies. Active M&A programs offer a window on the external world—product innovations, talent, new business models—and a way to bring fresh skills and ideas to the development of new products and geographies. They also help leaders keep corporate portfolios vibrant by training resources on the most attractive businesses and avoiding inertia in the allocation of cash and talent. In short, the benefits of M&A often transcend those of

individual deals, making boards that engage with it better able to fulfill their broader stewardship functions.

Challenging value-creation potential

To understand how boards can help create value, consider the example of one we know that's created a subcommittee to challenge the thinking of the CEO and deal managers on potential transactions. That subcommittee is in constant touch with the company's M&A strategy, the pipeline of potential targets, and emerging deals. Its involvement allows the full board to feel more confident about (and to move much faster than other possible buyers on) large-scale transactions—even company-shaping ones, with all their accompanying risks—because the board is always current on how specific deals create value. This approach isn't common, but it's the right idea, and the company has been particularly successful in generating both growth and returns through M&A.

Providing such a challenge lies at the heart of the value boards can offer in M&A: helping managers to exploit M&A's impact on performance while avoiding its traps. Why the board? Because without its input, ways of working that serve corporations well for ongoing business operations can work against consistent value creation through M&A. The board's independence from daily operations and its long-term perspective enable it to

challenge the tendency of management to emphasize income statements over balance sheets; to adhere, sometimes slavishly, to budget targets understating the potential of transactions; or to behave in risk-averse ways³ that inhibit the consideration of aggressive deals and prevent managers from discussing any but the most certain synergies. Specifically, boards can enhance decision making in M&A by closely challenging the following.

The strategic fit

While opportunistic transactions can succeed, recent analysis by our McKinsey colleagues has underscored the importance of strategic fit: deals driven by strategy succeed more often when they are part of a stream of similar transactions supporting that strategy.⁴ Boards should push to clarify the relationship between a potential transaction and corporate strategy: how the deal will support organic growth efforts in target markets and provide complementary sources of value creation, for example. Above all, why is the company a “better owner” than competing buyers?

The pro forma

In reviewing pro forma financial statements prepared for a transaction, a board should test the assumptions used to justify a deal, not just give a quick approval based on estimates of net present value or internal rates of return. Many boards place too much emphasis on, for example, whether a transaction is accretive or dilutive of the acquirer's earnings per share or on basing the outlay for deals on price-to-earnings multiples. Instead, they should demand clarity—using discounted-cash-flow methods—about the value created by various growth, asset, and cost synergies compared with the value-creation potential other bidders would bring to the deal.

Effective value-creation challenges probe deeply. Are the forecast growth rates and estimates of return on invested capital consistent with industry norms and the long-run tendency of these metrics to converge? What business-model or product disruptions may lie on the horizon? Does the pro forma account for a competitive response? Are its price assumptions consistent with its assumptions about market-share capture? Is there enough new year-one spending to support growth projections?

The risks and rewards

Frequently, best-case/worst-case risk analyses that a board sees reflect a heavily negotiated pro forma that barely meets the minimum financial threshold to secure approval for a deal. These analyses may fail to highlight important risks or upside opportunities. Boards must clearly indicate that it's OK to acknowledge uncertainties in pro formas; what matters is management's ability to assess both those risks and the upside realistically and to develop plans that address them. For example, boards should explore the correlation between different types of risks inherent in a transaction and understand the impact they might have on future growth or returns. Similarly, boards shouldn't miss a chance to push companies to capture cost or revenue synergies more quickly. Setting high expectations for management—and rewarding it accordingly—boosts the odds of creating value.

Testing the merger-integration plan

Important as it is to scrutinize a deal's value-creation potential, one board we know has decided that oversight of postmerger integration (PMI), not a challenge to a deal's pro forma, represents its primary opportunity to add value to M&A. In that company's industry, acquirers must typically rationalize costs and accelerate

growth in the new entity—a tricky combination—to create value through deals. The board pressure-tests the PMI plan's specifics against stretch-growth and cost goals before and after a deal's announcement.

Boards should examine a transaction's PMI plan in as much detail as they do pro forma statements. While this might seem to verge on meddling in management, our experience suggests otherwise. We see more variation in the quality of post-merger plans than in the financial analysis and pricing of transactions. We've also seen effective PMI plans boost net value creation for the buyer by as much as two to three times the net value created through ineffective PMI plans. Boards can help realize these opportunities without micromanaging, by asking questions such as the following:

• *Is the PMI designed to capture maximum value?*

A surprising number of PMIs and associated management incentives are designed, implicitly, just to integrate transactions smoothly and to meet, not beat, the value-creation pro forma approved by boards. Unfortunately, PMIs are inherently messy; the priority should be finding and exploiting every source of value, not merely keeping things orderly. The PMI plan also must be adaptable enough to accommodate new value-creation opportunities and risks uncovered in the early weeks of integration.

• *Is the PMI leader well equipped to realize the deal's value?* Particularly for large transactions, it's often important to appoint fairly senior integration managers. In a world of scarce senior talent, a board should make sure that when a complex transaction is under consideration, PMI leadership is on the table. Given competing priorities, will a company find a senior leader

with the skill and independence to manage what is often a tricky and high-stakes role?

• *Can we launch the PMI on the day the deal is announced and complete it rapidly?* If

the answer is no, value leakage is inevitable. Our experience suggests that lost value is difficult to recover—and is rarely captured at all if a board accepts a strategy of “we'll integrate the business later.”

Creating a competitive advantage in M&A

The third arena of board involvement is unrelated to a transaction's deadline; it is the decision to create a competitive advantage through M&A skills—a corporate asset that can be difficult for competitors to copy. Boards can help management build such a competitive advantage along three dimensions.

M&A strategy

As part of a board's corporate-strategy oversight, the board and management must agree on the role M&A plays in creating value for shareholders—how material is that role, which of course varies across companies, and what critical sources of value can M&A provide? The dialogue between management and the board about sources of value must be quite specific, and the board should know how those sources fit in with the prospective deal pipeline, whose size, flow, and quality help determine the performance of M&A. While active involvement in the pipeline by the full board is rarely feasible or desirable, the board should periodically review it.

M&A leadership

Even if a company doesn't appoint a single executive to oversee the three stages of M&A—building a healthy pipeline linked to strategy, closing value-creating deals, and ensuring timely, effective

integration—it must have clear organizational-structure and process linkages between those stages. The board can help the CEO and the CFO become more explicit about the roles of the corporate center and business units in M&A and the ideal scale and scope of a permanent M&A organization. Moreover, the executives leading various elements of M&A can significantly affect the creation of value, positively or negatively. It's often harder to provide mentorship for these roles and to develop in them than it is for a standard line position, but they deserve the same attention from the board as do, for example, business unit leadership roles.

M&A processes

Board directors should read and challenge their company's M&A playbook—its how-to guide for the different types of deals it pursues. The playbook typically covers topics ranging from capturing cost synergies to integrating IT to jump-starting growth, and translates a corporation's M&A strategy into specifics for delivering value. With the playbook in mind, a board can also help to make risk-fraught M&A decision making more effective. The board should ensure that the company structures each phase of decision making to counter these risks explicitly, from risk aversion in the early stages to biases in financial analysis to deal advocacy in the final stages. Finally, once a deal is complete, boards can ensure that

the deal's performance in creating value is transparent. Incentives should be tied to the realization of a deal's full value, ideally informed by stretch targets.



This level of engagement is bound to be outside the comfort zone for some executives and board directors—but it need not cause friction between them. In fact, it can align the board and management on the need for bolder transactions with more upside value potential. The nature of the risks will be clearer all around, while management will be able to focus on capturing value instead of simply securing the board's approval. Above all, a higher level of engagement can convert what is typically a sequence of discrete deals into a set of ongoing deal processes and dialogues that deliver value from M&A. ○

¹ In this article, M&A refers to mergers, acquisitions, joint ventures, and divestitures; it does not include sales of companies, leveraged buyouts, or other recapitalization events.

² See Richard Dobbs, Bill Huyett, and Tim Koller, "The CEO's guide to corporate finance," *mckinseyquarterly.com*, November 2010.

³ Tim Koller, Dan Lovallo, and Zane Williams, "Overcoming a bias against risk," *mckinseyquarterly.com*, August 2012.

⁴ Werner Rehm, Robert Uhlener, and Andy West, "Taking a longer-term look at M&A value creation," *mckinseyquarterly.com*, January 2012.

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Profitably parting ways:

Getting more value from divestitures

Companies often struggle to capture the full value of a separation. Here's how to do better.

**David Fubini,
Michael Park, and
Kim Thomas**

Most divestitures start with a strategic decision that a company is no longer the best owner of one of its businesses. It's a natural move for executives who see value in actively managing their portfolio of business units—recognizing that to grow, they sometimes have to shrink first—to deploy capital into a business with higher returns, for example, or to reshape the company's strategy. Indeed, past McKinsey research has shown that companies that more frequently reallocate capital generate higher returns than their peers.¹

But once a company decides to sell, problems can arise. Managers devote their attention to finding a buyer but seldom scope deals from a potential buyer's point of view, even as they

struggle to figure out exactly what should be included in the sale, apart from the productive assets that are its centerpiece. They often think about the separation process only secondarily, assuming they can separate a business and worry about stranded costs later. And they neglect the reality of internal competition for resources that can flare up between the managers who are staying and those who are leaving. Management and the board can get so caught up in the sale that the core business begins to suffer from neglect. All in all, divestiture turns out to be no panacea: sellers can take up to three years to recover from the experience (exhibit). Indeed, some companies are so wary of these pitfalls that they decide to muddle through with businesses of which they



are not the natural owners—another unsatisfactory result, as research suggests that these sales can produce significant returns for both the parent company and the divested or spun-off business.²

In our experience, even highly complex divestitures can work well, provided companies follow proven practices, especially in three areas: scoping the deal in detail, addressing the so-called stranded costs left behind when the revenue-generating assets are sold, and managing the expectations and concerns of employees.

These are not discrete goals—in fact, they are mutually reinforcing. Setting clear boundaries for the deal will enable managers to understand the implications of any subsequent adjustments

to the scope and accordingly help them maximize value. Clear boundaries will also help the seller understand the costs that are likely to be stranded; knowing these early is essential, as they often require some time to wind down. And the process of defining the deal’s potential boundaries lets companies be more transparent with employees about the deal process, its progress, and where they’re likely to end up. Getting started on these activities quickly, in parallel with the search for a buyer, can unlock enormous value for buyer and seller alike.

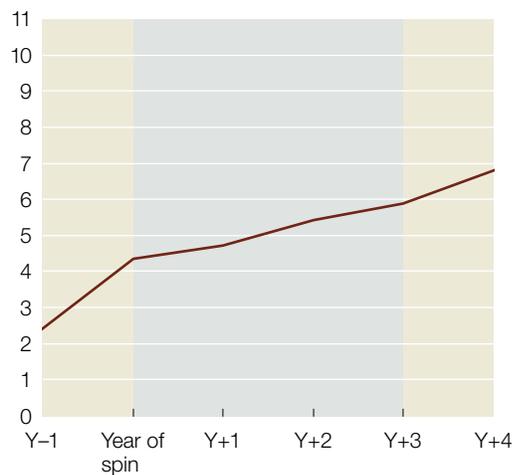
Taking the buyer’s point of view

Few companies adequately study the likely boundaries of a deal before they start searching for buyers, preferring to start with a simple high-level

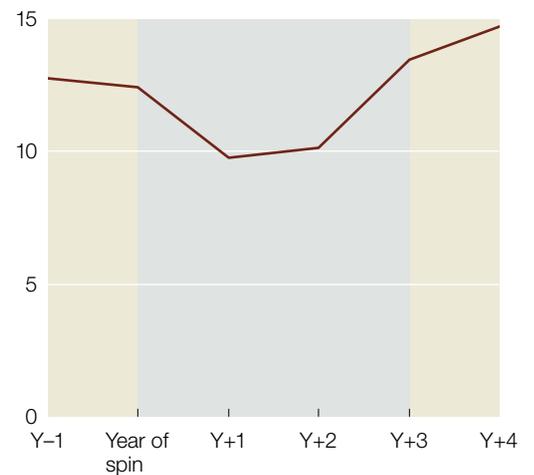
Exhibit

Parent companies can take one to three years to recover after a divestiture.

Parent year-on-year revenue growth,¹ %



Parent EBITA margin,¹ %



¹Our analysis covered all 144 spin-offs valued over \$1 billion globally between 1990 and March 2011; we excluded deals that did not have data on earnings before interest, taxes, and amortization (EBITA) margins 1 year before to 4 years after the spin, where the parent was acquired, or where EBITA is not a meaningful measure; n = 57 for revenue, n = 53 for EBITA.

Source: Standard & Poor’s Capital IQ; McKinsey divestitures transaction database

definition rather than dig into the details. Admittedly, it's a bit impractical to define exact deal boundaries before the identity of the buyer and its preferences are known.

To get around that problem, smart sellers define a number of different deal packages—of assets, people, and services—configured to attract interest from a broad spectrum of buyers. These packages not only broaden the field of potential buyers, often in ways that companies cannot envision at the outset, but also help the company cope with the tough questions that buyers inevitably have about what's in scope, how to separate, the transitional services they can count on, and the financials of the business. Sellers that haven't begun to define the deal will be unable to provide good answers—delaying the sales process and losing their competitive position, as well as leaving buyers to factor more risk into their valuation models and lowering the value they see in the deal.

When one European private-equity firm, for example, didn't get all the answers it sought about a company it was negotiating to acquire, it raised

the level of assumed risk in its valuation model, suppressing the value of the deal and lowering the price it was willing to pay. To prevent such problems, a US industrial company divesting a subsidiary conducted a detailed analysis of its true sales, general, and administrative costs and, by clearly defining which activities were attributable to the business being sold, found them to be tens of millions of dollars lower than current allocations. That exercise provided detailed information for potential buyers, increased the profit of the business being sold, and helped get a higher price for the deal.

Sellers can construct sale packages for a range of buyers. Each buyer is unique and will have more or less need for infrastructure, capabilities, and a geographic presence where the assets for sale are located. To prepare for the wide range of needs, most sellers will want to develop basic packages for at least three types of bidder: a strategic buyer with a local presence, a strategic buyer from another region, and a private-equity firm seeking a stand-alone entity. Bundles for strategic buyers with no local infrastructure and for private-equity buyers typically include more support services

Smart sellers define a number of different deal packages that not only broaden the field of potential buyers but also help the company cope with the tough questions that buyers inevitably have.

than those designed for local strategic investors, which may only want the operational and market-facing parts of the business.

These packages represent two ends of the spectrum; in between, there are many possible configurations of support services to package with the assets. And there may also be buyers interested in cherry-picking parts of the core business instead of taking all of it—which, while probably not ideal, should not be discounted out of hand. Sale packages include pro forma financial statements tailored to represent the package being offered to each buyer or class of buyer that highlight the true value of the business, separation and transition plans, and details on proposed management and talent assignments.

When a large industrial company was looking to divest one of its business units in the late 2000s, its managers' first instinct was to sell to a large strategic buyer. But by conducting a form of due diligence on its prospective buyers (often known as a “reverse due diligence”)—including some private-equity firms—the company was able to understand all the potential synergies each would gain by buying the business. That enabled managers to design a specific value proposition for each potential buyer. Eventually, they were able to attract—and sell the business to—a much smaller player that hadn't even come up in their initial scan for potential buyers. Even better, the company got a price 20 percent higher than first expected. In fact, all the bids exceeded expectations; the final list of bidders included a private-equity consortium and a few other unanticipated interests.

Rooting out stranded costs

One of the most challenging aspects of a major divestiture is that even sellers that control

expenses well are inevitably left with some corporate costs associated with the business but not sold with it. Without the revenues to support them, these stranded costs are a direct threat to the bottom line. Stranded costs essentially can be any type of cost that does not automatically disappear with the transaction, from costs related to shared services, such as marketing and investor relations, to IT infrastructure. Some of these are fixed, such as the IT system, and cannot be readily reduced regardless of the size of the divestiture. Others are more variable and can contract, for example, with a lower head count—but they can still take years to unwind unless explicitly planned as part of the divestiture. As noted, sellers often take up to three years to recover from a divestiture.

Sellers whose cost management is weak are all the more challenged by stranded costs and are often surprised by how much overhead they have. The divestiture typically reveals unsuspected layers of complexity or outright duplication within centralized functions.

We see three strong practices to reduce overhead. First, as we have discussed, defining the precise boundaries of potential deal packages early in the deal brings to light the full extent of the subsidiary's sales, general, and administrative costs. The parent company can make a better attribution of resources to the parent and the subsidiary. That benefits both companies.

Second, successful sellers often use the momentum generated by the divestiture as a catalyst to reduce stranded costs—and to improve the performance of any bloated or inefficient corporate-center activities revealed by the divestiture. (This mirrors a similar effect of transformational acquisitions, in which buyers take advantage of

the circumstances of an acquisition as a catalyst to restructure costs more broadly.³⁾ Companies can seize the impetus of the divestiture to reexamine their entire cost base using benchmarking analysis to highlight potential inefficiency or even zero-based budgeting to encourage a radical rethinking of the corporate infrastructure.

Rooting out stranded costs takes a separation manager with the foresight to rethink the parent company's cost base and the authority to make it happen—the third good practice.

One industrial organization had divested a few units over the years, but it had not followed suit with its corporate functions, which were still sized for their earlier duties. When it came time to shape another big divestiture, representing about 10 percent of revenues, the company conducted a thorough search for the stranded costs that lay within individual support functions, as well as costs that cut across functions such as real estate. All told, these added up to hundreds of millions of dollars. That proved to be a catalyst for an even broader cost restructuring.

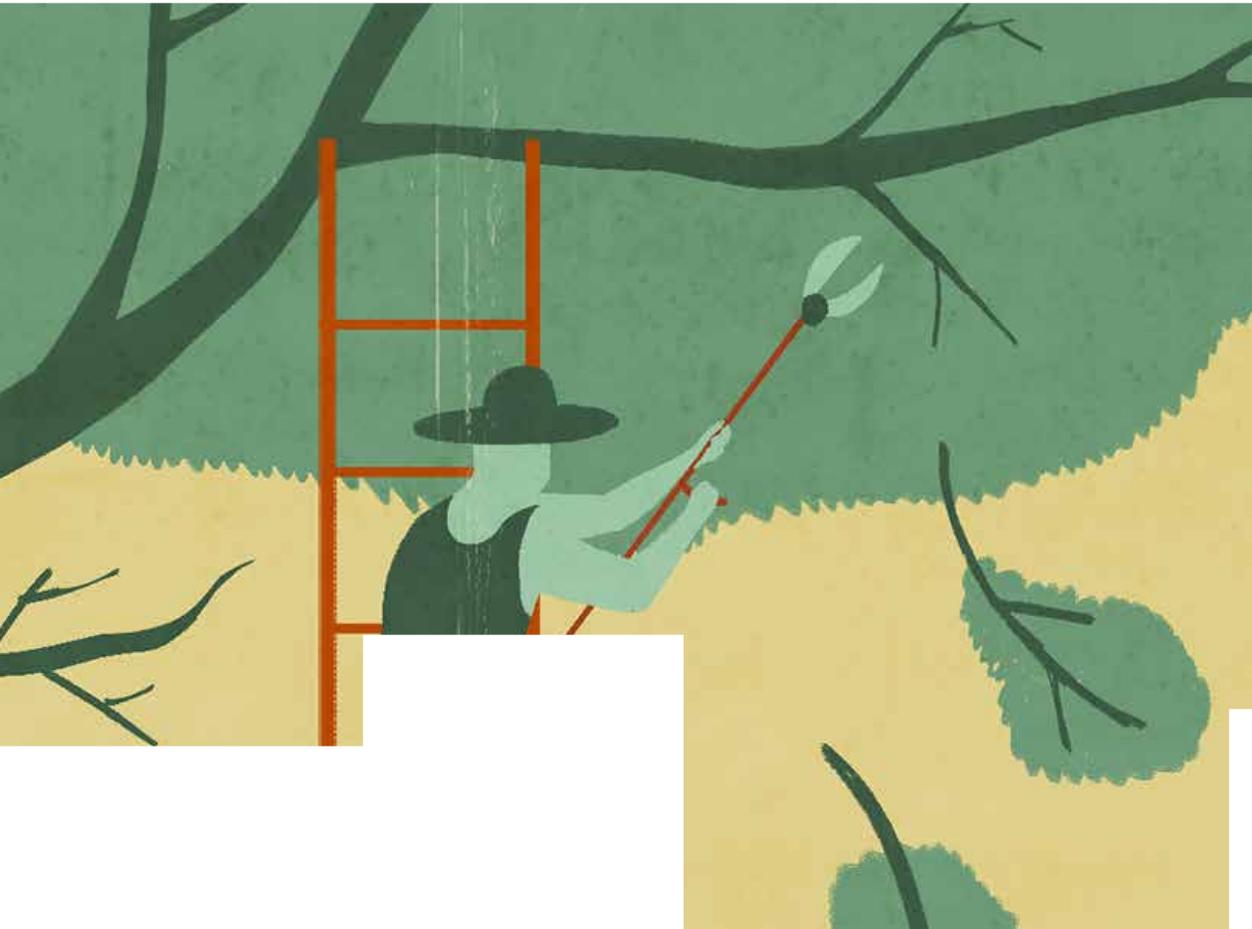
Companies of this size often face a special problem in rooting out stranded costs. For many large multinational companies organized by matrix, the only pragmatic method is for senior management to lead a cross-functional initiative to tackle cross-cutting opportunities such as shared-service and outsourcing operations, as well as the change programs required to support the cost transformations.

Managing employee expectations

The challenges of talent management in a divestiture start at the moment companies begin defining the boundaries of different sale packages and continue right through to the close of the

deal. First and foremost, managers struggle to figure out what to say to the people involved. Most choose to say nothing at first, reflecting the genuine uncertainty about what will happen. Sometimes company leaders will choose to keep plans for the deal confidential up until signing—as one global CEO and seasoned divestiture veteran told us, “I just deny everything until the deal is signed. It's easier that way.” This may be true, but it creates a communication challenge. Many employees inevitably will know about the deal because of the massive preparation work that is impossible to conceal. But if management officially denies the reports, it becomes very





difficult to put in place communication plans and other measures to minimize the concerns that always arise in such situations—all employees want to know, “What happens to me?”

Some form of short announcement is essential. Once managers make an announcement, they should clearly define and communicate the selection process to keep employees motivated while they wait for news of their fate. That can, of course, be challenging in situations where the deal boundaries are unclear until late in the process. Ideally, the communication plan should be part of a compelling story that shows

not only employees but also investors, analysts, and customers why the divestiture will leave both buyer and seller better off.

Once the word is out, other challenges begin. In almost every divestiture we’ve worked on, tension has arisen from the moment it becomes clear who is staying and who is going. Given the role the exiting managers will play in communicating the business’s value to potential buyers, delay in informing them is undesirable. But once they are informed, they immediately become another party at the negotiating table, bargaining for the talent, assets, and contracts they feel they’ll

It is important to define and implement a set of performance measures and rewards aligned with value maximization, and to use these with all key people involved in the divestiture process.

need to be successful and trying to avoid the ones they don't want.

Failing to manage the tension between the two groups can be damaging. When a global industrial company divested a multibillion-dollar division, for example, it began to receive a lot of applications for transfers from the entity to be divested back into the parent company—so many, indeed, that the company was at risk of visibly depleting the divested company of talent and experienced leadership, potentially affecting its value. To discourage the transfers, it aligned the incentives of people in the departing unit to the characteristics of the sale. It decided to reward managers based on earnings before interest, taxes, depreciation, and amortization (EBITDA)—a critical negotiating point with the private-equity firm that ultimately bought it. The emphasis on EBITDA motivated exiting managers to minimize the overhead they took with them; it also reduced transfer requests.

This approach did leave more overhead for parent-company managers to deal with, just as they too were striving to reduce overhead costs. But they made a conscious choice to accept this, believing that the right way to deal with broader cost issues was, as we discussed above, as part of a thorough change process in the wake of the divestiture.

Parent-company managers often lack the incentives that would compel them to take care of the departing entity. If they do not feel responsible for the unit's success, they may stop investing in value-creating projects, caring for employees and customers, or watching costs. In our experience, it is important to define and implement a set of performance measures and rewards aligned with value maximization, and to use these with all key people involved in the divestiture process. The most obvious rewards are monetary, but research shows that other incentives (such as recognition and promotions) can be equally if not more important determinants of performance.

Negotiations over talent are particularly sensitive. The first inclination of parent-company managers is to keep the best performers and send the rest with the divested business. That's not practical, in the end, because regardless of the type of buyer, the divestor has a moral obligation—and in some places a legal one—to make sure the business is a going concern. Furthermore, sellers who intend to divest multiple businesses in the future do not want to be perceived by the market as selling bad businesses stripped of key talent, as this will of course affect their ability to make future deals. At the same time, the parent company must retain critical resources, and quite often, the exiting managers have the very skills they need. Thus, successful divestors will address the issue of

talent early in the process and start building or acquiring the skills needed in both the parent organization and the business to be sold.



Much of the value of a divestiture depends on the effectiveness of the separation process. Defining the right deal, managing talent uncertainty, and rooting out stranded costs can make the difference between a deal that succeeds and one that destroys value. And skill in divestiture is comparatively rare; doing it well can help companies get a competitive edge. ○

¹ Stephen Hall, Dan Lovallo, and Reinier Musters, “How to put your money where your strategy is,” mckinseyquarterly.com, March 2012.

² Bill Huyett and Tim Koller, “Finding the courage to shrink,” mckinseyquarterly.com, August 2011.

³ Marc Goedhart, Tim Koller, and David Wessels, “The five types of successful acquisitions,” mckinseyquarterly.com, July 2010.



Today's CFO: Which profile best suits your company?

Profiles of today's CFO show how the role is evolving and raise important questions for boards about talent and leadership development.

**Ankur Agrawal,
John Goldie, and
Bill Huyett**

Most readers are well aware that the role of the CFO generally has broadened over the past decade. Beyond the core responsibilities of financial reporting, audit and compliance, planning, treasury, and capital structure, many CFOs are playing a stronger role in corporate portfolio management and capital allocation. Others have become prominent as the voice of the company in investor relations and in communications to the board, as leaders in performance management, and as exporters of finance-experienced personnel to the rest of the organization.

Where does it end? It's unproductive to stretch the role too far and unreasonable to expect a CFO to be good at everything. How can the CEO and the

board—through the audit committee—shape a manageable profile for the position? It's an important question, both for companies hiring a new CFO and for existing CFOs who see their roles expanding without a broad perspective.

To get a more detailed picture of how the role continues to evolve, we analyzed the experience, credentials, and backgrounds of CFOs of the top 100 global companies by market capitalization.¹ Our review, while not definitive, suggests that companies are shaping the role to meet their current needs. Indeed, we identified four distinct profiles of the role defined by the breadth of the current CFO's experience in finance or in nonfinance functions; his or her professional focus,



whether it's an internal focus on operations or an external focus on strategy; and the sources of the CFO's expertise, whether from years of experience at the current company or another one, for example, or whether it includes a traditional accounting degree or some other.

The four profiles include what we would characterize as the finance expert (or numbers guru), the generalist, the performance leader, and the growth champion. And while there is no single CFO profile that will fit the needs of every company—each must target candidates with competencies that best fit their strategy, the composition of the rest of the company's top team, and current finance-function capabilities—these profiles do offer a glimpse into how the role is evolving and where peers are looking for talented and innovative CFOs. They also raise important questions for board audit committees thinking about CFO development or the profile of the person they'd like to hire, as well as for executives seeking to shape their current role or considering new ones.

Four profiles of today's CFO

Management roles vary by organization, depending on a company's history, the characteristics of its industry, and the demands of investors. And although fitting CFOs into a clear-cut typology may seem artificial, we found it useful to understand how companies are filling the role to get a clearer picture of how it's changing. Based on our research, we categorize CFOs into four general profiles.

The finance expert. Typically internal hires, these CFOs have years of experience rotating through multiple roles within the finance function—controlling, treasury, audit, financial planning and analysis, or business unit finance. They tend

to have intricate working knowledge of the company and are often experts in relevant finance and accounting issues, such as financial regulation, international accounting, or capital structure. Many have advanced accounting degrees or experience at an auditing firm.

This type of CFO is particularly well suited to highly decentralized companies with stand-alone businesses or early-stage ones scaling up and professionalizing the finance function. Their strong finance-function knowledge across a broad spectrum of activities is critical to effective compliance and standardization of processes. The finance-expert profile may also be best for any company whose top team otherwise lacks strong finance leadership—or whose finance department is inefficient or in disarray.

The generalist. Companies in highly capital-intensive industries, such as basic materials, oil and gas, and telecommunications, put a high premium on operational capabilities. So they naturally look for executives with broad experience—including CFOs who have spent time outside the finance organization—in operations, strategy, marketing, or general management. Indeed, among the 51 CFOs in our sample who were hired since 2009, 31 of them have such experience, up from 17 of those hired prior to 2009. Among all the CFOs in our sample, 62 have MBAs or other advanced degrees, compared with only 28 with advanced accounting degrees—reflecting a premium for management and communication skills over deep technical expertise.

CFOs that fit this description tend to engage heavily in business operations and strategy and often bring strong industry and competitive insights. They're often found in companies in

mature sectors, such as financial institutions, where operational similarities across business units provide a good platform to rotate managers among businesses and eventually into functional leadership roles; most are internally hired and already fill an executive function, often being groomed for a CEO role. These rotations give managers insights about different businesses that they need to support tightly run operations, allocate resources, and influence peers—which, regardless of industry or strategy, make them ideal for companies where personal influence is needed to get things done.

The performance leader. CFOs with strong track records in transformations both within the finance function and throughout the organization are what we've dubbed performance leaders. They tend to focus on cost management, promote the use of metrics and scorecards, and work to standardize data and systems. They are often hired externally, and many have previous experience as CFOs. Most have worked internationally—explaining in part why, among the 51 CFOs in our sample hired in the past three years, 30 have significant experience in multiple geographies, up from 21 of those with longer tenures.

Companies employing these types of CFOs are often highly diversified companies requiring rigorous analytics to compare performance across

businesses, companies with aggressive growth or cost targets that must be met in the near term, or companies with scarce resources that must be carefully allocated.

The growth champion. Externally hired professionals are the least common type of CFOs, but they have risen to account for nearly 25 percent of new CFO hires. They are most common in industries with frequent disruptions that require dramatic changes in resource allocation—and in companies that plan to grow considerably or reshape their portfolio of businesses through aggressive M&A or divestiture programs. Such moves make external hires especially valued for their significant experience in M&A, as well as for their external networks, independent thinking, and strategic insight, often gleaned through working as a CFO or serving for years in professional-services firms. Many growth champions are among the nearly a third of new CFOs who have spent a sizable portion of their career in investment banking, consulting, or private equity, up from a fifth with a similar background prior to 2009.

Aligning the role with the company

These profiles are obviously not prescriptive; it would be simplistic to suggest definitive rules prescribing a specific CFO profile for general categories of company. That said, with the profile

In addition to industry context, companies must consider how certain CFO characteristics might best support their own strategic plans.

characteristics in hand, companies can more explicitly weigh them against the skills and capabilities they expect to require from the CFO as they shape, refine, and implement their strategy for the future. Whether this means selecting a new CFO or rebalancing the role of an existing one, they'll need a candid assessment of their current corporate strategy, the skills and temperament of the CEO, the composition of the senior-management team, the current capabilities of the finance function, and organizational and reporting structures. We propose four questions (by order of importance) that CFOs should answer when planning their own career-development plans—or that CEOs and boards should answer when beginning the search for a new CFO.

1. What are your corporate strategy and aspirations—especially considering the nature of your industry?

While there are certain trends in the hiring of new CFOs generally, CFO profiles often reflect the structure, conduct, and performance of a company's industry. Stable sectors with large global footprints and extensive supply chains—such as oil and gas and consumer packaged goods—are more insular in their CFO selections. Only 4 of 28 CFOs in our sample in these industries were hired externally, and only 2 had significant experience outside the sector. However, international experience is very important, with 9 of 13 CFOs in oil and gas and 10 of 15 in consumer packaged goods having worked in multiple geographies. At the other end of the spectrum are industries with rapidly changing technology and significant R&D, such as pharmaceuticals and medical products (PMP) and technology. Companies in these industries tend to have CFOs with more experience in strategy and transactions, and they

are much more likely to select CFOs from outside the company or the sector. For example, of the 14 PMP CFOs, 8 were hired externally, 6 had consulting or investment-banking backgrounds, and 9 had general-management backgrounds. Over half of CFOs in both the PMP and technology industries have experience outside their sector.

In addition to industry context, companies must consider how certain CFO characteristics might best support their own strategic plans. Leadership teams of companies following inorganic (M&A) growth strategies require a higher degree of market insight and strategic orientation. Senior executives of companies following organic growth strategies, meanwhile, exhibit a high competency in people and organizational leadership. So regardless of industry characteristics—and as long as candidates meet the threshold of finance expertise and performance-management skills—a company embarking on an ambitious M&A program, for example, would want to give a strong preference to those with significant transaction experience and industry insight, more akin to a growth champion. A company lagging in profitability or undergoing significant industry consolidation may require a CFO more similar to the performance leader—strong in performance management and cost containment.

2. What is the composition of your top-management team?

The selection of a CFO cannot be made in isolation; companies must consider the strengths of the rest of the top team, paying specific attention to its blind spots and missing capabilities. Recent research has found that the top teams of high-performing companies score higher on all

measures of leadership competencies—including thought leadership, people and organizational leadership, and business leadership—than those of low-performing companies.² Finding the right set of leaders is clearly an important determinant of corporate performance.³ This means that the specific profile of your CFO may need to be different from that for other companies—even those in the same industry or those that have similar strategic goals—in order to create a robust top team.

Companies with a disproportionate share of leaders with a few areas of deep expertise—so-called spiky leaders—tend to outperform those whose leaders have a broad range of more general skills. This requires members of the top-management team to build on one another's strengths and compensate for one another's shortfalls. A company with a visionary CEO may require a CFO with a firm grasp of the economics of the business and enough influence capital inside the organization to provide a counterbalance against potentially risky moves. Or a company that recently hired a CEO from outside the organization may require a CFO with deep company expertise and a firm grasp of the numbers, such as a person who fits the finance-expert or generalist profile.

The downside of mistakes in selecting the top team, and the CFO in particular, is significant. Myopic top teams can undertake risky or costly acquisitions, fall behind on innovations in the market, or fail to retain key talent. High-performing CFOs must have the integrity and conviction to challenge the CEO and other members of the top team on key strategic and financial decisions and hence steer the company to a higher performance trajectory.

3. What is the current level of capability in your finance function?

As long as a CFO's profile fits with a company's strategy and complements the top team, further considerations are more tactical. The current level of capability of the finance function is the most important of these, since the CFO's primary responsibility is to ensure the execution of core functions of the finance group, especially strong compliance and controls, accurate data, and systems integration. If a company struggles with efficiently performing the basic finance functions (relative to peers), then it may be necessary to promote candidates for CFO with considerable experience in a variety of finance roles and a track record of performance improvement.

However, if strong capabilities are already present in the finance organization, a company may consider candidates with other competencies, such as broader management experience or strategic insight. Companies that do so typically pair such a CFO with a senior finance executive who manages accounting and other traditional finance roles.

4. What is the organizational and reporting structure of your company? Which areas report to the CFO?

It is also important to consider the company's reporting structure—that is, does it have solid or dotted-line reporting to the CFO—and the breadth of formal CFO responsibilities. For example, a CFO in a global company with a complex matrix structure and only dotted-line reporting must be able to exert a considerable amount of personal influence to be successful. In this situation, it may help to hire a CFO

internally—regardless of which general profile he or she fits—who has the networks and institutional knowledge necessary to drive change. It is also important to define the areas of responsibility that may lie beyond traditional finance areas, such as IT, procurement, and transformation, which demand day-to-day hands-on management and people skills typically seen in the generalist CFO profile.



The right fit between a company and its CFO involves a complex set of trade-offs reflecting its strategy, the skills and abilities of top management and the finance function, and a given individual's ability to drive change. Understanding how the role is evolving can prompt useful conversations that shape the CFO's role at your company in the future. ◯

¹ From the top 146 largest companies by market capitalization, we excluded Asian companies and 14 others with insufficient public data, for a total sample size of 100 companies. We then compared CFOs hired prior to 2009 with those hired after. Note that the pre-2009 sample includes only CFOs who are still in that role.

² See *Return on Leadership—Competencies that Generate Growth*, Egon Zehnder International and McKinsey & Company, February 2011.

³ See Katharina Herrmann, Asmus Komm, and Sven Smit, “Do you have the right leaders for your growth strategies?,” *mckinseyquarterly.com*, July 2011.



Delivering large-scale IT projects on time, on budget, and on value

Large IT efforts often cost much more than planned; some can put the whole organization in jeopardy. The companies that defy these odds are the ones that master key dimensions that align IT and business value.

**Michael Bloch,
Sven Blumberg, and
Jürgen Laartz**

As IT systems become an important competitive element in many industries, technology projects are getting larger, touching more parts of the organization, and posing a risk to the company if something goes wrong. Unfortunately, things often do go wrong. Our research conducted in collaboration with the University of Oxford suggests that half of all large IT projects—defined as those with initial price tags exceeding \$15 million—massively blow their budget. On average, large IT projects run 45 percent over budget and 7 percent over time while delivering 56 percent less value than predicted. Software projects run the highest risk of cost and schedule overruns¹ (Exhibit 1).

These findings—consistent across industries—emerged from research recently conducted on more than 5,400 IT projects² by McKinsey and the BT Centre for Major Programme Management at the University of Oxford. After comparing budgets, schedules, and predicted performance benefits with the actual costs and results, we found that these IT projects, in total, had a cost overrun of \$66 billion, more than the GDP of Luxembourg. We also found that the longer a project is scheduled to last, the more likely it is that it will run over time and budget, with every additional year spent on the project increasing cost overruns by 15 percent.



Staggering as these findings are, most companies survive the pain of cost and schedule overruns. However, 17 percent of IT projects go so bad that they can threaten the very existence of the company. These unpredictable high-impact events—“black swans” in popular risk parlance—occur significantly more often than would be expected under a normal distribution. Large IT projects that turn into black swans are defined as those with budget overruns of more than 200 percent (and up to 400 percent at the extreme end of the spectrum). Such overruns match or surpass those experienced by black swans among complex construction projects such as tunnels and bridges.

One large retailer started a \$1.4 billion effort to modernize its IT systems, but the project was eventually abandoned. As the company fell behind its competitors, it initiated another project—a new system for supply-chain management—to the tune of \$600 million. When that effort failed, too, the retailer had to file for bankruptcy.

Four ways to improve project performance

So how do companies maximize the chances that their IT projects deliver the expected value on time and within budget? Our surveys of IT executives indicate that the key to success lies in mastering four broad dimensions, which combined make up a methodology for large-scale IT projects that we call “value assurance.” The following elements make up this approach:

- focusing on managing strategy and stakeholders instead of exclusively concentrating on budget and scheduling
- mastering technology and project content by securing critical internal and external talent
- building effective teams by aligning their incentives with the overall goals of the project
- excelling at core project-management practices, such as short delivery cycles and rigorous quality checks

Exhibit 1

The performance of different types of IT projects varies significantly.

%, projects >\$15 million, in 2010 dollars

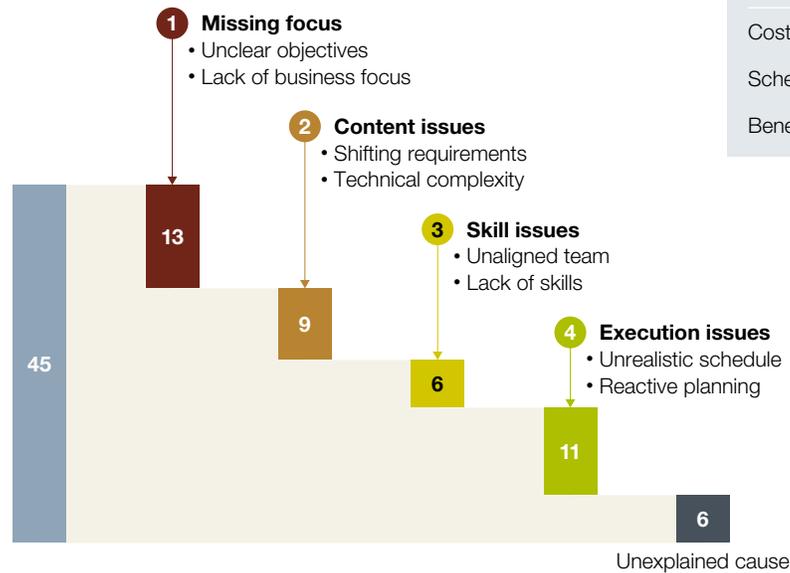
Project type	Average cost overrun	Average schedule overrun	Average benefits shortfall
Software	66	33	17
Nonsoftware	43	3.6	133
Total	45	7	56

Source: McKinsey-Oxford study on reference-class forecasting for IT projects

Exhibit 2

IT executives identify four groups of issues that cause most project failures.

Rough cost-overrun disaggregation, %



IT projects >\$15 million¹

Cost overrun ²	45%
Schedule overrun	7%
Benefits shortfall	-56%

¹With cost overrun, in 2010 dollars.

²Cost increase over regular cost.

Source: McKinsey-Oxford study on reference-class forecasting for IT projects

According to survey responses, the inability to master the first two dimensions typically causes about half of all cost overruns, while poor performance on the second two dimensions accounts for another 40 percent of overspending (Exhibit 2).

Managing strategy and stakeholders

IT initiatives too often pay little heed to strategy and stakeholders and manage projects purely according to budget and schedule targets. The perils are illustrated by one bank's transformation effort, in which its finance department became involved only a few months before the system was due to go live. This led to several complex changes in the accounting modules due to a recently

introduced performance-management system. Coming so late in the day, the changes delayed the launch by more than three months, at a cost of more than \$8 million.

Top-performing projects, on the other hand, establish a clear view of the initiative's strategic value—one that goes beyond the technical content. By building a robust business case and maintaining focus on business objectives along the whole project timeline, successful teams can avoid cost overruns. They can also, for example, ensure faster customer response times, obtain higher-quality data for the marketing organization, or reduce the number of required manual processes.

High-performing project teams also improve the ways in which the company manages its internal and external stakeholders, such as business and IT executives, vendors, partners, and regulators. They make sure the project aligns with the company's overarching business strategy and undertake detailed analyses of stakeholder positions. Project leaders continually engage with all business unit and functional heads to ensure genuine alignment between business needs and the IT solutions being developed.

Good stakeholder management involves foresight when it comes to selecting vendors and negotiating contracts with them. Company negotiators should proactively identify potential risks and, for instance, expand their focus beyond unit price and seek to establish "win-win" agreements. Doing so can help ensure that the company has preferential access to the vendor's best talent for an extended period of time.

Some companies have learned this the hard way. A bank in the Middle East negotiated hard for price with a vendor and later suffered at the hands of an inexperienced vendor team. Another bank scored well on unit price with a software-package provider for the project phase of a trading-system implementation but encountered high costs for changes and support after the system was introduced and the bank was locked into the new technology.

Mastering technology and content

Drawing on expert help as needed, high-performing teams orchestrate all technical aspects of the project, including IT architecture and infrastructure, functionality trade-offs, quality assurance, migration and rollout plans, and project scope. The right team will understand both business and technical concerns, which is why

companies must assign a few high-performing and experienced experts for the length of the program. We estimate that the appropriate experts can raise performance by as much as 100 percent through their judgment and ability to interpret data patterns.

One common pitfall occurs when teams focus disproportionately on technology issues and targets. A bank wanted to create a central data warehouse to overcome inconsistencies that occurred among its business unit finance data, centralized finance data, and risk data. However, the project team focused purely on developing the IT architecture solution for the data warehouse instead of addressing the end goal, which was to handle information inconsistencies. As a result, the project budget ballooned as the team pursued architectural "perfection," which involved the inclusion of unneeded data from other systems. This added huge amounts of unnecessary complexity. With milestones and launch dates constantly being pushed back and investments totaling almost \$10 million, the bank stopped the project after 18 months.

In contrast, one public-sector institution was able to rescope and simplify its IT project's technical requirements even though most stakeholders believed doing so was impossible. To eliminate waste and to focus on the items that represented the greatest business value, the team introduced lean³ techniques. At the same time, it established rigorous testing and rollout plans to ensure quality and introduced clearly defined stage gates. Through these and other actions, the team was able to check 95 percent of all test cases, fix critical defects, and verify the fixes before continuing from the unit test phase to integration testing.

To achieve effective project management, there's no substitute for tested practices.

Building effective teams

Large projects can take on a life of their own in an organization. To be effective and efficient, project teams need a common vision, shared team processes, and a high-performance culture. To build a solid team, members should have a common incentive structure that is aligned with the overall project goal in contrast to individual work-stream goals. A business-to-technology team that is financially aligned with the value-delivery targets will also ensure that all the critical change-management steps are taken and that, for example, communications with the rest of the organization are clear, timely, and precise.

To ensure the smooth start-up of new front-end and core systems that more than 8,000 people would use, one company team launched a massive—and successful—change-management program. The program included a regular newsletter, desktop calendars that highlighted key changes and milestones, and quarterly town-hall meetings with the CEO. The team made sure all top business unit leaders were involved during the user-acceptance phase. The company included at least one change agent on each team. These agents received training that instilled a clear understanding of the benefits of the IT change. The actions helped the company to verify that it had the required business capabilities in place to make full use of the technology being implemented and that it could deliver the business value expected in the overall project business case.

Excelling at core project-management practices

To achieve effective project management, there's no substitute for tested practices. These include having a strategic and disciplined project-management office and establishing rigorous processes for managing requirements engineering and change requests. The project office should establish a few strong stage gates to ensure high-quality end products. At the same time, it needs to strive for a short delivery life cycle to avoid creating waste in the development process.

One public-sector organization established strong project control by defining the initiative's scope in an initial six-month phase and making sure all stakeholders signed off on the plan. Beyond this phase, the organization's board had to approve all change requests, and the project was given a pre-defined cost-overflow buffer of less than \$2 million. Another organization, a high-tech company, established clear quality criteria for the project master plan, which mandated that teams break down all activities so that they required fewer than 20 person-days to complete and took no longer than four weeks.

In yet another case, instead of following a “water-fall”⁴ or linear approach, a company created integrated business and IT teams that worked on an end-to-end basis in their respective work streams. In other words, the teams participated from the beginning of the project to its completion—from defining requirements to testing. This approach helps to avoid misunderstandings

during stage transitions and ensures clear responsibility and ownership. It also promotes efficiency gains and fast delivery.

Assessing the black-swan risk

The high rate of failure makes it wise to analyze prospects before starting a large IT project.

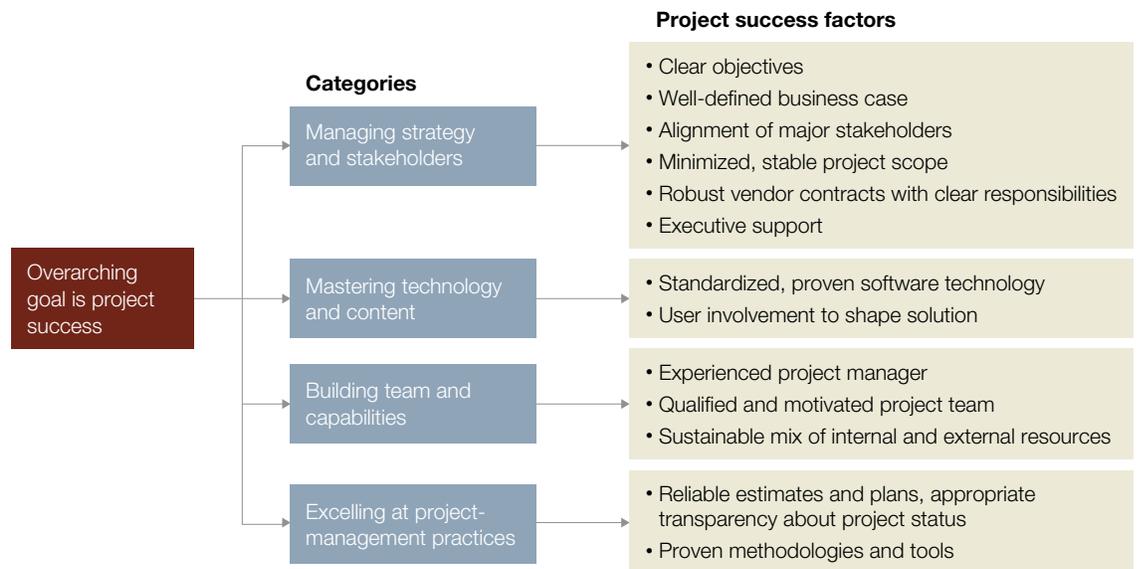
Companies usually begin with a diagnostic to determine the status of their key projects and programs—both finalized and existing projects (to understand company-specific problems) and planned projects (to estimate their true cost and duration). This diagnostic determines two conditions: the health of a project from the standpoint of the four dimensions of the value-assurance methodology (Exhibit 3) and its relative prospects when compared with the outcomes of a reference class⁵ of similar projects. Teams can

measure the latter by making a comparative assessment against the 5,400 IT projects in our proprietary database, developed jointly with the University of Oxford. This resource provides comparative data on the scope, cost, duration, and performance characteristics of many projects. Despite differences in project subject and geography, the database can be used to forecast project risk, adding much needed accuracy to up-front investment decision making. The overall assessment takes about three weeks and is supported by Web surveys and other tools. Depending on the findings, companies can attach greater reliability to investment decisions and deploy the optimal management structure for the project.

This comparative assessment may have helped a health care provider avoid disaster. The provider

Exhibit 3

A ‘value assurance’ assessment indicates how a project is doing against four groups of success factors.



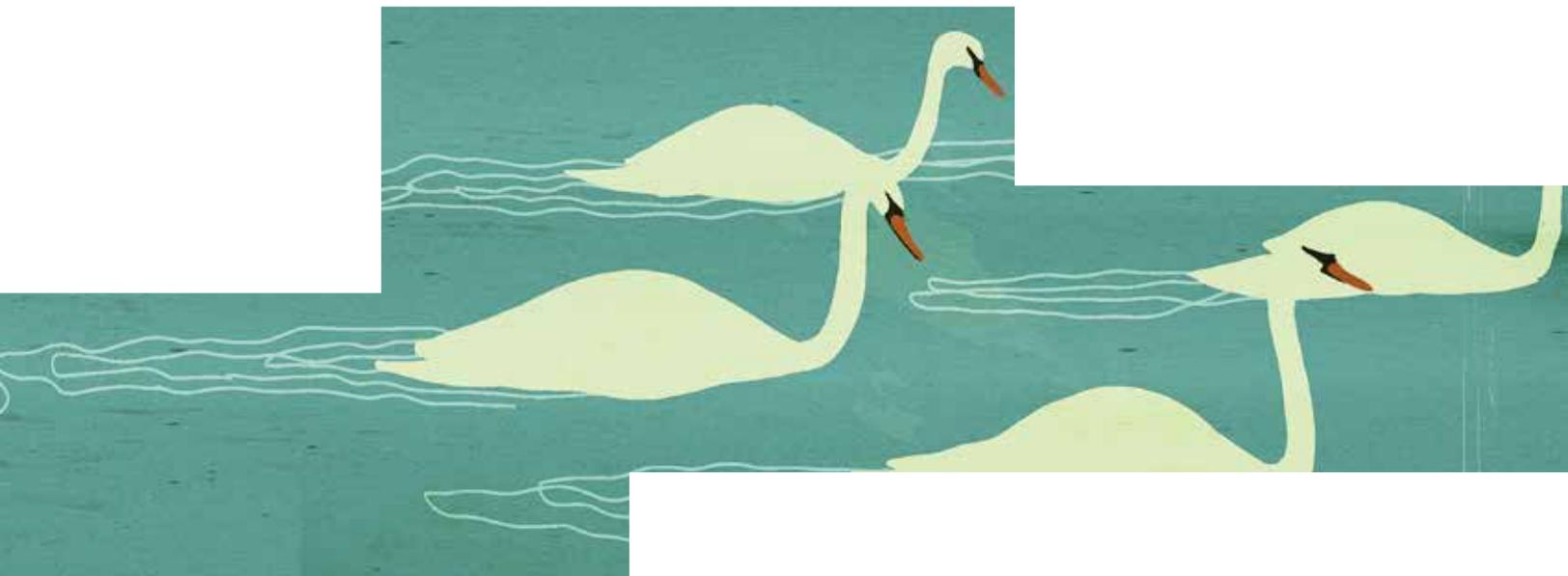
was about to spend about \$1 billion over eight years to replace its health care management system—an amount twice as large and a duration twice as long as any comparable IT project in the database. Given that the black-swan risk is largely driven by how long the project takes before it goes live, top management stopped the initiative at the green-light stage and asked the team to revise the plan. Leaders also charged the team with planning for intermediate checkpoints. The latest estimate is now in line with comparable projects in the database, and it still delivers the desired scope.

In another case, an organization used a broader and more interview-driven diagnostic approach to identify critical improvement areas. The organization had recently experienced failures that led it to make a commitment to reform IT and drive fundamental improvement in IT project delivery. The diagnostic helped it realize that the major hurdle to creating a well-defined business

case was the limited availability of funding during the prestudy phase. The study also revealed that the organization's inability to arrive at a stable and accurate project scope resulted from the infrequent communication between project managers and stakeholders about issues such as new requirements and change requests, which led to deviations from the original scope.

The value-assurance approach has a solid track record. One large public-sector organization, for example, replaced about 50 legacy IT systems with a standard system for enterprise resource planning over the course of three years—within budget and on schedule—even though analysis of projects of this size and duration had indicated an expected budget overrun in the range of \$80 million to \$100 million.

Similarly, a global insurance company used the approach to consolidate its IT infrastructure over 18 months, delivering the project on time



and within budget and realizing savings of about \$800 million a year.



Large-scale IT projects are prone to take too long, are usually more expensive than expected, and, crucially, fail to deliver the expected benefits. This need not be the case. Companies can achieve successful outcomes through an approach that helps IT and business join forces in a commitment to deliver value. Despite the disasters, large organizations can engineer IT projects to defy the odds. ◯

¹ For another cut of the data—one focused on all IT projects in the database (not just the large ones)—see Alexander Budzier and Bent Flyvbjerg, “Why your IT project may be riskier than you think,” *Harvard Business Review*, September 2011.

² IT projects are continually added to the database. This round of research is based on the more than 5,400 projects that were in the database as of June 2012.

³ For more on lean techniques in IT, see Nicklas Ilebrand, Tor Mesøy, and Remco Vlemmix, “Using IT to enable a lean transformation,” *mckinseyquarterly.com*, February 2010.

⁴ The waterfall model is a sequential software-development process in which progress is seen as flowing steadily downward—like a waterfall—through the phases of conception, initiation, analysis, design, construction, testing, and maintenance.

⁵ Reference-class forecasting predicts the outcome of a planned action based on actual outcomes in a reference class of actions similar to that being forecast. The theories behind reference-class forecasting were developed by Daniel Kahneman and Amos Tversky and helped Kahneman win the Nobel Prize in Economics. Today reference-class forecasting is practiced in both public- and private-sector policy and management.

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