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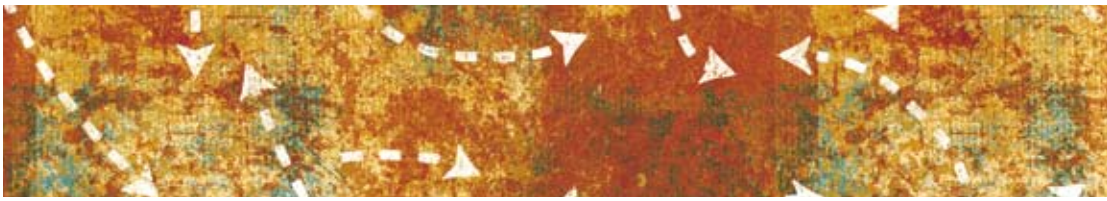

How to improve **strategic planning**

It can be a frustrating exercise, but there are ways to increase its value.

Renée Dye and Olivier Sibony

In conference rooms everywhere, corporate planners are in the midst of the annual strategic-planning process. For the better part of a year, they collect financial and operational data, make forecasts, and prepare lengthy presentations with the CEO and other senior managers about the future direction of the business. But at the end of this expensive and time-consuming process, many participants say they are frustrated by its lack of impact on either their own actions or the strategic direction of the company.

This sense of disappointment was captured in a recent *McKinsey Quarterly* survey of nearly 800 executives: just 45 percent of the respondents said they were satisfied with the strategic-planning process.[1] Moreover, only 23 percent indicated that major strategic decisions were made within its confines. Given these results, managers might well be tempted to jettison the planning process altogether.

But for those working in the overwhelming majority of corporations, the annual planning process plays an essential role. In addition to formulating at least some elements of a company's strategy, the process results in a budget, which establishes the resource allocation map for the coming 12 to 18 months; sets financial and operating targets, often used to determine compensation metrics and to provide guidance for financial markets; and aligns the management team on its strategic priorities. The operative question for chief executives is how to make the planning process more effective—not whether it is the sole mechanism used to design strategy. CEOs know that strategy is often formulated through ad hoc meetings or brand reviews, or as a result of decisions about mergers and acquisitions.

Our research shows that formal strategic-planning processes play an important role in improving overall satisfaction with strategy development. That role can be

[1] "Improving strategic planning: A McKinsey Survey," *The McKinsey Quarterly*, Web exclusive, September 2006. The survey, conducted in late July and early August 2006, received 796 responses from a panel of executives from around the world. All panelists have mostly financial or strategic responsibilities and work in a wide range of industries for organizations with revenues of at least $500 million.

seen in the responses of the 79 percent of managers who claimed that the formal planning process played a significant role in developing strategies and were satisfied with the approach of their companies, compared with only 21 percent of the respondents who felt that the process did not play a significant role. Looked at another way, 51 percent of the respondents whose companies had no formal process were dissatisfied with their approach to the development of strategy, against only 20 percent of those at companies with a formal process.

So what can managers do to improve the process? There are many ways to conduct strategic planning, but determining the ideal method goes beyond the scope of this article. Instead we offer, from our research, five emergent ideas that executives can employ immediately to make existing processes run better. The changes we discuss here (such as a focus on important strategic issues or a connection to core-management processes) are the elements most linked with the satisfaction of employees and their perceptions of the significance of the process. These steps cannot guarantee that the right strategic decisions will be made or that strategy will be better executed, but by enhancing the planning process—and thus increasing satisfaction with the development of strategy—they will improve the odds for success.

Start with the issues

Ask CEOs what they think strategic planning should involve and they will talk about anticipating big challenges and spotting important trends. At many companies, however, this noble purpose has taken a backseat to rigid, data-driven processes dominated by the production of budgets and financial forecasts. If the calendar-based process is to play a more valuable role in a company's overall strategy efforts, it must complement budgeting with a focus on strategic issues. In our experience, the first liberating change managers can make to improve the quality of the planning process is to begin it by deliberately and thoughtfully identifying and discussing the strategic issues that will have the greatest impact on future business performance.

Granted, an approach based on issues will not necessarily yield better strategic results. The music business, for instance, has discussed the threat posed by digital-file sharing for years without finding an effective way of dealing with the problem. But as a first step, identifying the key issues will ensure that management does not waste time and energy on less important topics.

We found a variety of practical ways in which companies can impose a fresh strategic perspective. For instance, the CEO of one large health care company asks the leaders of each business unit to imagine how a set of specific economic, social, and business trends will affect their businesses, as well as ways to capture the opportunities—or counter the threats—that these trends pose. Only after such an analysis and discussion do the leaders settle into the more typical planning exercises of financial forecasting and identifying strategic initiatives.

One consumer goods organization takes a more directed approach. The CEO, supported by the corporate-strategy function, compiles a list of three to six priorities for the coming year. Distributed to the managers responsible for functions, geographies, and brands, the list then becomes

the basis for an offsite strategy-alignment meeting, where managers debate the implications of the priorities for their particular organizations. The corporate-strategy function summarizes the results, adds appropriate corporate targets, and shares them with the organization in the form of a strategy memo, which serves as the basis for more detailed strategic planning at the division and business unit levels.

A packaged-goods company offers an even more tailored example. Every December the corporate senior-management team produces a list of ten strategic questions tailored to each of the three business units. The leaders of these businesses have six months to explore and debate the questions internally and to come up with answers. In June each unit convenes with the senior-management team in a one-day meeting to discuss proposed actions and reach decisions.

Some companies prefer to use a bottom-up rather than a top-down process. We recently worked with a sales company to design a strategic-planning process that begins with in-depth interviews (involving all of the senior managers and selected corporate and business executives) to generate a list of the most important strategic issues facing the company. The senior-management team prioritizes the list and assigns managers to explore each issue and report back in four to six weeks. Such an approach can be especially valuable in companies where internal consensus building is an imperative.

Bring together the right people

An issues-based approach won't do much good unless the most relevant people are involved in the debate. We found that survey respondents who were satisfied with the strategic-planning process rated it highly on dimensions such as including the most knowledgeable and influential participants, stimulating and challenging the participants' thinking, and having honest, open discussions about difficult issues. In contrast, 27 percent of the dissatisfied respondents reported that their company's strategic planning had not a single one of these virtues. Such results suggest that too many companies focus on the data-gathering and packaging elements of strategic planning and neglect the crucial interactive components.

Strategic conversations will have little impact if they involve only strategic planners from both the business unit and the corporate levels. One of our core beliefs is that those who carry out strategy should also develop it. The key strategy conversation should take place among corporate decision makers, business unit leaders, and people with expertise essential to the discussion. In addition to leading the corporate review, the CEO, aided by members of the executive team, should as a rule lead the strategy review for business units as well. The head of a business unit, supported by four to six people, should direct the discussion from its side of the table (see sidebar, "Things to ask in any business unit review").

One pharmaceutical company invites business unit leaders to take part in the strategy reviews of their peers in other units. This approach can help build a better understanding of the entire company and, especially, of the issues that span business units. The risk is that such interactions might constrain the honesty and vigor of the dialogue and put executives at the focus of the discussion on the defensive.

Things to ask in any business unit review

1. Are major trends and changes in your business unit's environment affecting your strategic plan? Specifically, what potential developments in customer demand, technology, or the regulatory environment could have enough impact on the industry to change the entire plan?
2. How and why is this plan different from last year's?
3. What were your forecasts for market growth, sales, and profitability last year, two years ago, and three years ago? How right or wrong were they? What did the business unit learn from those experiences?
4. What would it take to double your business unit's growth rate and profits? Where will growth come from: expansion or gains in market share?
5. If your business unit plans to take market share from competitors, how will it do so, and how will they respond? Are you counting on a strategic advantage or superior execution?
6. What are your business unit's distinctive competitive strengths, and how does the plan build on them?
7. How different is the strategy from those of competitors, and why? Is that a good or a bad thing?
8. Beyond the immediate planning cycle, what are the key issues, risks, and opportunities that we should discuss today?
9. What would a private-equity owner do with this business?
10. How will the business unit monitor the execution of this strategy?

Corporate senior-management teams can dedicate only a few hours or at most a few days to a business unit under review. So team members should spend this time in challenging yet collaborative discussions with business unit leaders rather than trying to absorb many facts during the review itself. To provide some context for the discussion, best-practice companies disseminate important operational and financial information to the corporate review team well in advance of such sessions. This reading material should also tee up the most important issues facing the business and outline the proposed strategy, ensuring that the review team is prepared with well-thought-out questions. In our experience, the right 10 pages provide ample fuel to fire a vigorous discussion, but more than 25 pages will likely douse the level of energy or engagement in the room.

Adapt planning cycles to the needs of each business

Managers are justifiably concerned about the resources and time required to implement an issues-based strategic-planning approach. One easy—yet rarely adopted—solution is to free business units from the need to conduct this rigorous process every single year. In all but the most volatile, high-velocity industries, it is hard to imagine that a major strategic redirection will be necessary every planning cycle. In fact, forcing businesses to undertake this exercise annually is distracting and may even be detrimental. Managers need to focus on executing the last plan's major initiatives, many of which can take 18 to 36 months to implement fully.

Some companies alternate the business units that undergo the complete strategic-planning

process (as opposed to abbreviated annual updates of the existing plan). One media company, for example, requires individual business units to undertake strategic planning only every two or three years. This cadence enables the corporate senior-management team and its strategy group to devote more energy to the business units that are "at bat." More important, it frees the corporate-strategy group to work directly with the senior team on critical issues that affect the entire company—issues such as developing an integrated digitization strategy and addressing unforeseen changes in the fast-moving digital-media landscape.

Other companies use trigger mechanisms to decide which business units will undergo a full strategic-planning exercise in a given year. One industrial company assigns each business unit a color-coded grade—green, yellow, or red—based on the unit's success in executing the existing strategic plan. "Code red," for example, would slate a business unit for a strategy review. Although many of the metrics that determine the grade are financial, some may be operational to provide a more complete assessment of the unit's performance.

Freeing business units from participating in the strategic-planning process every year raises a caveat, however. When important changes in the external environment occur, senior managers must be able to engage with business units that are not under review and make major strategic decisions on an ad hoc basis. For instance, a major merger in any industry would prompt competitors in it to revisit their strategies. Indeed, one advantage of a tailored planning cycle is that it builds slack into the strategic-review system, enabling management to address unforeseen but pressing strategic issues as they arise.

Implement a strategic-performance-management system

In the end, many companies fail to execute the chosen strategy. More than a quarter of our survey respondents said that their companies had plans but no execution path. Forty-five percent reported that planning processes failed to track the execution of strategic initiatives. All this suggests that putting in place a system to measure and monitor their progress can greatly enhance the impact of the planning process.

Most companies believe that their existing control systems and performance-management processes (including budgets and operating reviews) are the sole way to monitor progress on strategy. As a result, managers attempt to translate the decisions made during the planning process into budget targets or other financial goals. Although this practice is sensible and necessary, it is not enough. We estimate that a significant portion of the strategic decisions we recommend to companies can't be tracked solely through financial targets. A company undertaking a major strategic initiative to enhance its innovation and product-development capabilities, for example, should measure a variety of input metrics, such as the quality of available talent and the number of ideas and projects at each stage in development, in addition to pure output metrics such as revenues from new-product sales. One information technology company, for instance, carefully tracks the number and skill levels of people posted to important strategic projects.

More on strategic planning

In a *Quarterly* interview, Richard Rumelt, a professor at UCLA's Anderson School of Management, discusses the misperceptions some executives have about strategic planning:

"Most corporate 'strategic plans' have little to do with strategy. They are simply three-year or five-year rolling resource budgets and some sort of market share projection. Calling it 'strategic planning' creates false expectations that the exercise will somehow produce a coherent strategy."

Read the full interview, "Strategy's strategist: An interview with Richard Rumelt," on mckinseyquarterly.com.

Strategic-performance-management systems, which should assign accountability for initiatives and make their progress more transparent, can take many forms. One industrial corporation tracks major strategic initiatives that will have the greatest impact, across a portfolio of a dozen businesses, on its financial and strategic goals. Transparency is achieved through regular reviews and the use of financial as well as nonfinancial metrics. The corporate-strategy team assumes responsibility for reviews (chaired by the CEO and involving the relevant business unit leaders) that use an array of milestones and metrics to assess the top ten initiatives. One to expand operations in China and India, for example, would entail regular reviews of interim metrics such as the quality and number of local employees recruited and the pace at which alliances are formed with channel partners or suppliers. Each business unit, in turn, is accountable for adopting the same performance-management approach for its own lower-tier top-ten list of initiatives.

When designed well, strategic-performance-management systems can give an early warning of problems with strategic initiatives, whereas financial targets alone at best provide lagging indicators. An effective system enables management to step in and correct, redirect, or even abandon an initiative that is failing to perform as expected. The strategy of a pharmaceutical company that embarked on a major expansion of its sales force to drive revenue growth, for example, presupposed that rapid growth in the number of sales representatives would lead to a corresponding increase in revenues. The company also recognized, however, that expansion was in turn contingent on several factors, including the ability to recruit and train the right people. It therefore put in place a regular review of the key strategic metrics against its actual performance to alert managers to any emerging problems.

Integrate human-resources systems into the strategic plan

Simply monitoring the execution of strategic initiatives is not sufficient: their successful implementation also depends on how managers are evaluated and compensated. Yet only 36 percent of the executives we surveyed said that their companies' strategic-planning processes were integrated with HR processes. One way to create a more valuable strategic-planning process would be to tie the evaluation and compensation of managers to the progress of new initiatives.

Although the development of strategy is ostensibly a long-term endeavor, companies traditionally emphasize short-term, purely financial targets—such as annual revenue growth or improved margins—as the sole metrics to gauge the performance of managers and employees. This approach is gradually changing. Deferred-compensation models for boards, CEOs, and some senior managers are now widely used. What's more, several companies have added longer-term performance targets to complement the short-term ones. A major pharmaceutical company, for example, recently revamped its managerial-compensation structure to include a basket of short-term financial and operating targets as well as longer-term, innovation-based growth targets.

Although these changes help persuade managers to adopt both short- and long-term approaches to the development of strategy, they don't address the need to link evaluation and compensation to specific strategic initiatives. One way of doing so is

to craft a mix of performance targets that more appropriately reflect a company's strategy. For example, one North American services business that launched strategic initiatives to improve its customer retention and increase sales also adjusted the evaluation and compensation targets for its managers. Rather than measuring senior managers only by revenue and margin targets, as it had done before, it tied 20 percent of their compensation to achieving its retention and cross-selling goals. By introducing metrics for these specific initiatives and linking their success closely to bonus packages, the company motivated managers to make the strategy succeed.

An advantage of this approach is that it motivates managers to flag any problems early in the implementation of a strategic initiative (which determines the size of bonuses) so that the company can solve them. Otherwise, managers all too often sweep the debris of a failing strategy under the operating rug until the spring-cleaning ritual of next year's annual planning process.

Some business leaders have found ways to give strategic planning a more valuable role in the formulation as well as the execution of strategy. Companies that emulate their methods might find satisfaction instead of frustration at the end of the annual process. **MoF**

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Market fundamentals:

2000 versus 2007

Whither the S&P 500? Comparing the market's recent turmoil with its decline at the end of the dot-com boom can help investors assess what might come next.

Marc Goedhart, Bin Jiang, and Timothy Koller

Talk about summertime blues. After peaking above 1,500 this July, the S&P 500 suffered an abrupt 10 percent correction before ending the month of August at 1,475. As *McKinsey on Finance* goes to press, the broad market has rebounded following interest rate cuts by the US Federal Reserve Bank in mid-September. But stocks remain buffeted by volatility in the credit market and by concerns that current high price levels might succumb to the same economic forces that caused the markets to plunge more than 40 percent in the three years after the last peak, in 2000.

As central bankers warily eye credit markets and ponder further interest rate cuts, no one can really anticipate what might happen next in a market wracked by volatility and skittish investors. Nonetheless, a comparison of the fundamentals underpinning the S&P's recent performance and those at the time of the 2000 peak offers insights about the parallels and divergences between the two periods. These insights can give investors a better feel for where the market is now—and where it might head next.

First, the similarities. At one level, during both the run-up to the recent peak and the earlier dot-com market surge, most of the growth in market values was concentrated in a few sectors. Performance during the subsequent decline also varied by sector.

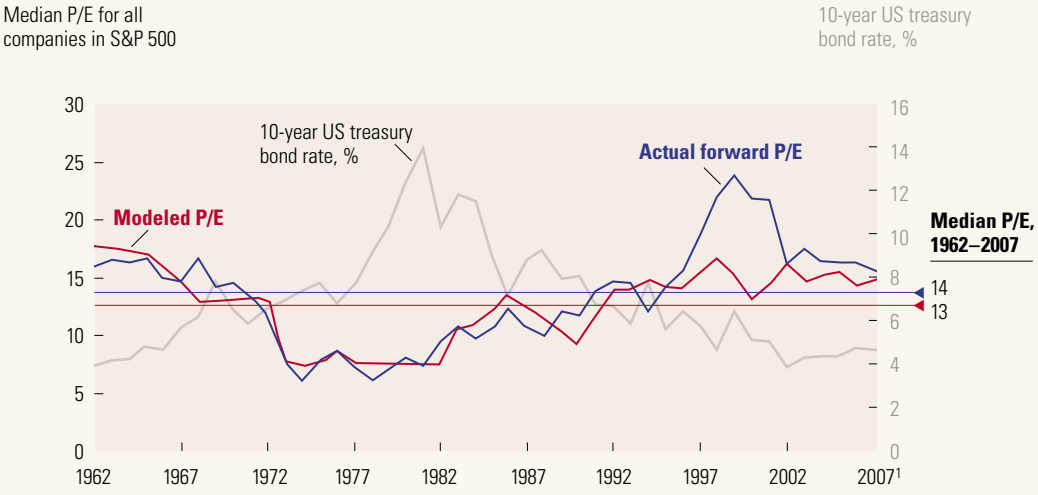
However, the peak in 2007 differed considerably from the one in 2000. During the 1990s investor euphoria and a highly speculative atmosphere overtook the market, raising P/E ratios to heights that made valuations unsustainable. In contrast, this year the market rode to its July peak on the back of exceptional corporate earnings, healthy GDP growth, a fast-paced M&A boom, and amazing consumer resilience despite a slump in the US housing market.

To get a better look at what exactly was driving the broad market during these

Exhibit 1

Reasonable valuations

Market valuations have declined to levels seen in the 1960s.



[1]As of Aug 31, 2007.

periods, we analyzed two components of the market value of companies in the S&P 500—earnings and P/E ratios—assessing the performance of both over the past four decades at the market and the industry level.

As a first step, we analyzed recent P/E levels. In an earlier article we described our simple P/E model,[1] driven by a few fundamental factors that explain these ratios: long-term returns on capital, long-term real growth, the cost of capital, and expectations of inflation (Exhibit 1). Our model does a good job of explaining aggregate-market P/E ratios over the past 45 years—except during the speculative period around 2000. In that year overoptimism about the prospects of the technology, media, and telecom sectors and of megacompany stocks led the overall market P/E ratio to unsustainably high levels disconnected from the fundamental value creation potential of companies. The earlier article also shows that interest rates (and investors' expectations of inflation) are inversely related to P/E ratios and have driven most of their fluctuations over the past 45 years.

The current market P/E, in 2007,[2] is about 35 percent lower than it was in 2000 and in line with our modeled P/E. In other words, the current ratio is consistent with current levels of interest rates, inflation, and long-term growth. Note that the current P/E also resembles the P/Es of the 1960s, when inflation and interest rates were low, as they are now. If today's corporate earnings can be sustained, and interest and inflation rates stay low, the current P/E level is reasonable.

Since today's P/E is in line with economic conditions, it is reasonable to conclude that exceptionally strong corporate earnings must have been responsible for this year's peak in the S&P 500. Indeed, the ratio of total profits[3] to GDP soared in 2006, to an unprecedented 5.7 percent—much higher than the historical average, about

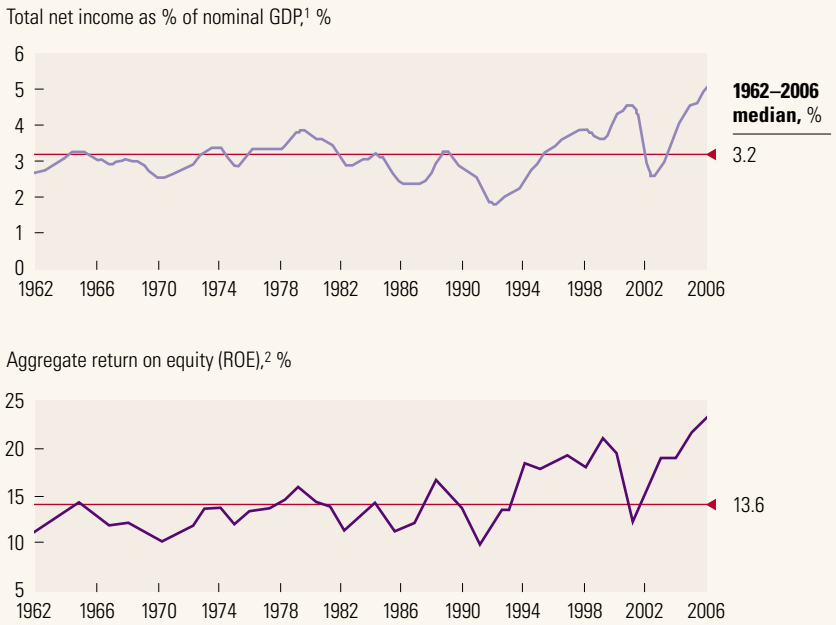
[1]For more on our simple model of market valuation, see Marc H. Goedhart, Bin Jiang, and Timothy Koller, "The irrational component of your stock price," *McKinsey on Finance*, Summer 2006, pp. 17–20.
[2]Median forward P/E as of the end of August 2007.
[3]Defined for the companies on the S&P 500 index as total net income before extraordinary items.

Exhibit 2

New heights for corporate earnings

Returns on equity are strong.

For all companies in S&P 500

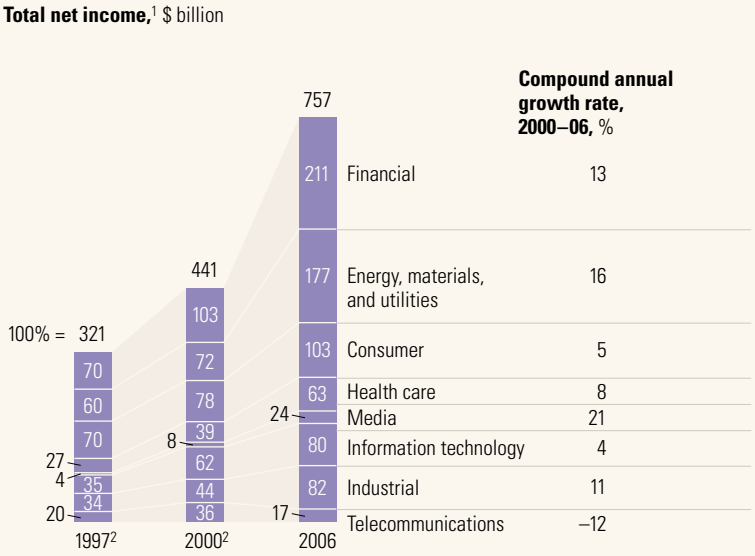


[1]Before extraordinary items; adjusted for goodwill impairment.
[2]Adjusted for goodwill and goodwill impairment.

Exhibit 3

A concentrated improvement

Recent growth has been concentrated in fewer sectors.



[1]Before extraordinary items and adjusted for goodwill impairment.
[2]Figures do not sum to total, because of rounding.

3.2 percent,[4] and easily surpassing the previous record of 4.5 percent, set in 2000. This level of performance isn't limited to S&P 500 companies, though they might have benefited disproportionately from a weakening dollar. The analysis of all publicly listed US companies shows a strikingly similar pattern of record high profits.

What's more, returns on equity (ROE) are strong (Exhibit 2). Aggregate S&P 500 earnings grew at a compounded annual rate of 9.5 percent from 2000 to 2006, though total productive capital grew by only 5 percent each year. As a result, the aggregate ROE shot up to 23 percent, from 20 percent, for the same period—well above the 13.6 percent median ROE from 1962 to 2006.

Can such extraordinary earnings last? For indications, look at whether the current earnings strength is broadly based. Such advances tend to prove more sustainable than those driven only by individual sectors, since it is easier for weakness from one or a few sectors to be offset by enduring strength in others. A sector-specific analysis[5] of the S&P 500 index finds that while for most sectors earnings growth from 2000 to 2006 resembled its growth during the entire past decade, two broadly defined sectors grew much more quickly during the past six years, the period from peak to peak: the financial sector and the energy, utilities, and materials sector (Exhibit 3). Higher oil and gas prices clearly drove earnings in the latter, low interest rates and loose credit drove the former. The sharp increase in these two sectors elevated their share of total S&P earnings from 41 percent in 1997 to 51 percent in 2006. In contrast, earnings growth from 1997 to 2000—the run-up to the previous peak—was more balanced across a number of sectors.

In the end, whether or not the S&P 500's current level is sustainable depends entirely on corporate earnings, particularly in the energy and financial sectors. If these two sustain their level of profits, the current peak in the S&P 500 could be the new base level for future growth. However, if corporate earnings as a whole revert to their historical relationship with GDP, a return to the recent peak of the S&P 500 may take some time. MoF

[4] In addition, we have examined similar ratios of the profits of top European companies (FTSE 300) to the total GDP of all Western European economies. The pattern is similar, with a more pronounced upward trend. For the US economy, we have also used the corporate-profit measures published by the US Bureau of Economic Analysis (BEA) and found a pattern similar to that of the S&P 500.

[5] Aggregated using the Global Industry Classification Standard (GICS), developed by Standard & Poor's and Morgan Stanley Capital International. The financial sector includes banks, diversified financials, insurance, and real-estate industry groups. The energy, materials, and telecom sector includes the energy, materials, and utilities industries. The consumer sector includes automobiles; consumer durables; apparel; consumer services; retailing; the retailing of food and staples; foods, beverages, and tobacco; and household and personal products. The health care sector includes health care equipment and products, as well as pharmaceuticals, biotechnology, and life sciences. The IT sector includes technology hardware and equipment, as well as semiconductors and semiconductor equipment. The industrial sector consists of capital goods, transportation, and commercial supplies and services.

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When to break up a conglomerate: An interview with Tyco International's CFO

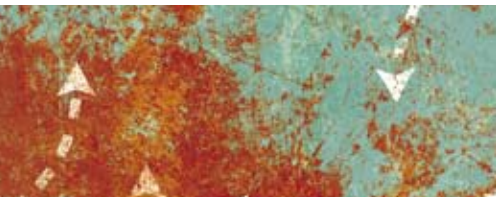
Chris Coughlin explains how spinning off some of the company's largest businesses was the key to ensuring its long-term growth.

Laura Corb and Timothy Koller

When Chris Coughlin stepped into the CFO role at Tyco International in March 2005, the conglomerate had already put its scandal-scarred history under former CEO Dennis Kozlowski behind it. The new CEO, Ed Breen, had orchestrated the departure of the entire board of directors, replacing them with new members eager to turn things around. Indeed, the company was in the midst of a rebound, with solid earnings, moderate growth, a strong capital structure, and a share price hovering just under $30—up from a low of $8.25 during the crisis several years earlier.

Investors were reassured, but Coughlin was joining a management team pondering the best way to deliver growth to the company's widely diverse businesses over the longer term. Their conclusion, announced in January 2006, was as bold as it was unexpected: spin off Tyco's health care business, now called Covidien, the world's second-biggest maker of disposable-medical products (behind Johnson & Johnson), as well as Tyco Electronics, the world's largest manufacturer of electronic connectors. Over the following 18 months, Breen and Coughlin extricated overlapping functions, contracts, and procurement agreements, appointed two new senior-management teams, addressed securities regulations, and recruited new boards of directors. The result: parent Tyco International is today a $20 billion company, half its former size, but more focused and still the world's biggest provider of security and fire protection products and services, as well as the largest maker of industrial valves.

Coughlin, 54, came to Tyco well prepared to orchestrate large transactions. He had honed his skills as CFO of Pharmacia during that company's 2000 acquisition of Monsanto, the spin-off of the Monsanto



agricultural business two years later, and Pharmacia's subsequent sale to Pfizer. At Nabisco and Interpublic, Coughlin served in both operating and CFO roles, developing perspectives on operational management that dovetailed well with the challenges at Tyco.

He recently sat down in his Princeton, New Jersey, office with McKinsey's Laura Corb and Timothy Koller to discuss the value of multi-industry companies, the strategy behind the Tyco breakup, and the challenges of conducting such large transactions simultaneously.

McKinsey on Finance: *What was behind the decision to split up Tyco into the three businesses—Tyco International, Tyco Healthcare, and Tyco Electronics?*

Chris Coughlin: By 2005 the crisis precipitated by the whole sordid history of Tyco and everything that happened in 2002 was over. The company was about where we wanted it to be in terms of corporate debt, and the businesses were thriving. At that point, we started going through our strategic-planning exercises and talking about the businesses and what it would take to really be successful over the next five to ten years and how we could grow the value of the corporation.

Early indications became apparent out of our discussions with investors. Between

Christopher J. Coughlin

Vital statistics

Born in Paterson, New Jersey; 55 years old

Married with 3 children

Education

Graduated in 1974 with BS in accounting from Boston College, Massachusetts

Career highlights

Tyco International
- Executive vice president and CFO (2005–present)

Interpublic
- Chief operating officer, member of board of directors (2003–05)

Pharmacia
- Executive vice president and CFO (postmerger of Pharmacia & Upjohn with Monsanto) (2000–03)

Pharmacia & Upjohn
- Executive vice president and CFO (1998–2000)

Nabisco (1996–98)
- President of Nabisco International (1997–98)
- Executive vice president and CFO (1996–97)

Fast facts

Serves on board of directors of Covidien and D&B

Serves on board of trustees of Delbarton School, in Morristown, New Jersey

2004 and 2005, their questions were all about the electronics business, because investors were looking at what could move within Tyco's diverse portfolio that would make earnings go up or down in a particular period. There were few questions about health care, our largest business. Investors seemed to view it simply as a solid generator of profits and cash flow.

Investors were also asking about the long-term capital structure of the company. And while we felt that the health care business needed to be an A-rated kind of company, given the nature of the business, it needed that flexibility to gain access to the capital markets to make deals and to fund new technologies. So we were driving the capital structure of all of Tyco on the basis of what a company in the health care industry needed, but health care was only a quarter of our revenues. The other businesses clearly did not require that kind of a capital structure.

So in 2005, as we looked at what it was going to take to grow the health care business, we eventually concluded that it may be better off on its own. In addition to being a large group, with about $10 billion in annual revenues, it was well organized, it had integrated many of its acquired businesses, and it had a seasoned management team. And once we had reached that conclusion with the health care business, we started to look at the rest of the portfolio. Given our shareholder base, we concluded that it probably made sense to pull apart the electronics business as well, enabling that business to invest more effectively during the down cycle, which might be more difficult as a part of a multi-industry player.

McKinsey on Finance: *How did the board of directors respond to your proposal?*

Chris Coughlin: I think it surprised the board that we were thinking of something so significant so soon. The good news is they had great pride in the organization and in everything we'd achieved in bringing the company out of crisis. But I think they understood the need to look at the company's portfolio, and we put together a process to consider the proposal in greater detail. After some lively discussions, the board agreed that that strategy made sense, and in the end it was a healthy exercise.

McKinsey on Finance: *Outside of the board, did investors or anyone in management object to the split?*

Chris Coughlin: There was some initial skepticism. Some felt that we had built this great company, it was doing very well, the stock was performing very well, so why pull it apart when the profits were growing and cash flow was strong?

What surprised us was that, from the moment we announced the proposal to when we actually separated, we had virtually no shareholders express the belief that the separation was a bad idea. You know, we had some who might have been a little bit agnostic, but none of them really said, "This just doesn't make sense to us." There was concern and some confusion about how long the process would take, and some didn't fully appreciate the complexities of a spin-off on this scale. But once they saw the filings that were required—which were just massive—and the SEC review process, people started to understand how truly complex it was.

McKinsey on Finance: *In some cases, companies have done sort of an equity carve-out first to create a stock that traded before doing the final spin-out. Tyco went straight to the final spin-out. Any particular reason why? Any pros and cons?*

Chris Coughlin: We looked at a number of alternatives before we decided on just a straight dividend of shares. Obviously, one of the key drivers was size. If you look at other spin-offs that have taken place over time, most are smaller pieces of businesses. At Tyco we were divesting very large businesses, and we wanted to make sure they had the appropriate capital structures in place. We also wanted to ensure that the remaining Tyco, which was actually the smallest piece in terms of profitability, didn't need additional cash. We had very solid cash-generating businesses; we could put together a capital structure and a debt structure that were appropriate. And we didn't think that we needed to establish a market by putting out 15 percent or 20 percent in advance. We could set up the appropriate capital structures that would best support the three companies without having to move a lot of the money around.

McKinsey on Finance: *Was there any concern that once investors had shares in three different companies, they might decide they liked one and not the other two and start trading based on that?*

Chris Coughlin: Well, yes. But I had been involved in the fairly significant spin-off of the Monsanto agricultural business at Pharmacia. It was a different set of circumstances but similar in that there was a very large pharmaceutical company holding a large agriculture business. The investors were clearly pharmaceutical investors—they always wanted to be pharmaceutical investors and they didn't like this agriculture business anyway. That transaction has been just enormously successful: shares trade at $80 now, compared with $10 when Monsanto first spun off, in 2002. Clearly, in that case, the agriculture business was competing internally for funds against the pharmaceutical company that was run by pharmaceutical people.

Tyco is different: because of the scale of the business and because the remaining Tyco is smaller than the businesses we spun off, how shareholders might react is somewhat of an unknown. We recognized that there would be some churn in the stock during the first three to six months as the businesses found their natural investor bases. Clearly, health care investors are different from those that are going to look at the remaining Tyco, which is a slower growth, cash-generating kind of a business versus the more technology-driven health care business or the more cyclical electronics business. But as we have said since the first conference call when we announced the spin-off, we weren't doing this for a short-term boost in the stock price.

McKinsey on Finance: *What was the most challenging part of getting the companies ready to be independent?*

Chris Coughlin: The most challenging part was to get the management teams in place and transferring the technical knowledge from some of the corporate functions that resided at the Tyco headquarters to the two new businesses. So we set up a formal mechanism to

manage the whole transition process and held reviews every month with each function.

One of the nice things about this separation is that it provided some enormous opportunities for our people. We had built some real strengths in some of the functions, so as we separated and needed, say, treasurers for all three companies, we were able to fill those positions internally. The CFO for electronics, for instance, came from inside that organization, and we appointed a new CEO from another Tyco business. In health care, we had an experienced team in place that pretty much remained in tact. There were other opportunities for people to move up many other functions including tax, treasury, and legal.

McKinsey on Finance: *How about recruiting new board members?*

Chris Coughlin: It was easier than we expected. Typically, recruiting 1 board member can be a challenge, but how do you find 20? We went through a very rigorous process to identify skill sets that we needed on each of the boards; we also decided to have nonexecutive chairmen at the two new companies because neither CEO had led a public company before. Given the scale of these companies and the market-leading positions they have, we were surprised that the process actually attracted very many qualified people. But not having to go on to an existing board where people might have been working together for years and not having to worry about fitting in, that ended up being a real plus.

Interestingly, one of the decisions of the existing Tyco board was not to split itself up—which is different from what's happened in a number of other major spin-offs. I think what drove that decision was that our board came in together shortly after the previous board had stepped down. They saw the advantage of a new full team building a strong working relationship. So although you might ask if it wouldn't be better to have some of the board that was experienced in overseeing some of the businesses, I think they felt that the best approach was to attract completely new members.

McKinsey on Finance: *You obviously played a very important role in the whole process. What would you say to CFOs who are trying to play a more strategic role, rather than just dealing with the technical issues. How do they go about doing that?*

Chris Coughlin: The way the world is today, I can't imagine the CFO *not* playing a strategic role, particularly in a business as large and diverse as this one. A critical part of the strategy is allocating capital across the businesses—where are we going to invest, what are we going to do with the cash flow between acquisitions and with our dividend policies, and so on. With the capital markets being what they are and with investor expectations of CEOs as well as CFOs, these two positions have to be very closely linked. The more complex the business model, the more CFOs just have to play a strategic role. To do that, you have to have extremely strong technical finance functions behind you. At Tyco we never would have been able to execute this kind of a transaction, nor could I have spent the time that I needed on both the strategy and managing the overall separation process if we hadn't had world-class experts in the controller, treasurer, and tax roles. It's unbelievable what they did.

McKinsey on Finance: *Now that the spin-offs are complete, have they done things that they wouldn't have done if they were still part of a bigger company? Has the experience been positive?*

Chris Coughlin: It's still early, having just completed the separation six weeks ago, but I think that there are some clear indications of good things. For example, I think the health care business has made very significant strides in attracting new talent that more than likely would not have been attracted to the old Tyco. They now see Covidien as a health care company with a very defined strategy, where people can advance while remaining in health care and playing a very significant role.

'It's very difficult to manage a broad base of businesses in ***a single portfolio,*** *and to argue that that's the right way to do it becomes more and more difficult'*

Additionally, each of the three companies is moving aggressively toward changing their portfolios. We indicated at the time we separated that all three companies still had to make changes to their portfolios that include making strategic acquisitions as well as divesting certain businesses.

And I think they're each more nimble now, as separate companies with their own management teams, M&A groups, tax groups, accounting groups, and so on. And with all the complexity of going through such transactions, we can actually do more in a shorter period of time. For example, the health care business has already announced that they're getting out of their retail business; Tyco International is exiting its infrastructure services business, Earth Tech, and Tyco Electronics has announced that it's getting out of its power systems business.

I also think that allocation of capital has become much more defined and much more focused, so we're seeing more transactions in each of the three companies in bringing businesses and technologies in, as well as divestitures.

McKinsey on Finance: *So now the deals are done and you're the CFO of a much smaller company. Any regrets?*

Chris Coughlin: No. There aren't many multi-industry players that last for a very long time. They get to a certain size, and their business units get to a certain size, where the value of being part of a single company declines—depending on the type of businesses and the diversity of the portfolio. For example, we have a very large service component in our ADT and SimplexGrinnell businesses. These businesses require a very large and very different kind of workforce than in health care. Well, how much synergy are you going to have moving people from the health care business into a home or business security business?

If you're buying small companies and can add management expertise and processes and competencies that maybe smaller companies don't have, that's one thing. But when they become $10 billion–plus organizations with tens of thousands of employees around the world, I think you have to honestly look at what value is created by adding to a corporation. It's very difficult to manage a broad base of businesses—such as heavy manufacturing,

service businesses, and technology-driven companies—in a single portfolio, and to argue that that's the right way to do it for a long period of time becomes more and more difficult. The world obviously changes and it's incumbent on management to continue to take a very hard look at its portfolio of businesses, the value that's being added, and whether they are truly better off being a part of the same large company.

On the personal side, it is a pretty big deal to say, "Hey, look, I'm the CFO of a $40 billion company with 250,000 employees and there aren't many companies around like that." But the reality is that my job is to organize and help manage the company, to drive the financial and capital structure of the company, and to drive the benefit to our shareholders. Tyco International remains a very complicated business, and there's still much work to do in making our company more efficient. These businesses were never deeply integrated, so we believe there's significant value yet to be captured. So there's as much challenge now, although it's different than it was before—and we're still a $20 billion company with 100,000 employees. MoF

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How to choose between **growth and ROIC**

Investors reward high-performing companies that shift their strategic focus prudently, even if that means lower returns or slower growth.

Bin Jiang and Timothy Koller

Value-minded executives know that although growth is good, returns on invested capital (ROIC) can be an equally—or still more—important indicator of value creation.[1] Yet even executives at the best companies often wrestle with strategic decisions in order to reach the right balance between growth and returns. We repeatedly come across executives whose companies earn high returns on capital but who are unwilling to let those returns decline to encourage faster growth. Conversely, we see executives at companies with low returns working to promote growth instead of improving their ROIC.

Large companies in particular can find it difficult to grow without giving up some of their existing returns.[2] What's more, many executives are accustomed to seeing growth and returns improve (or decline) hand in hand as market conditions change. As a result, decision makers may hesitate to alter strategic directions, fearing a lag in market acceptance.

To understand better how value is created over time, we identified all non-financial US companies that had a market cap over $2 billion[3] in 1995 and had been listed for at least a decade as of that year. When we examined their growth and ROIC performance over the subsequent decade, we found clear patterns in the interaction between the two measures. These patterns can help guide value-creation strategies suited to a company's current performance.

For companies that already have high ROICs,[4] raising revenues faster than the market generates higher total returns to shareholders (TRS) than further improvements to ROIC do (Exhibit 1). This finding doesn't mean that companies

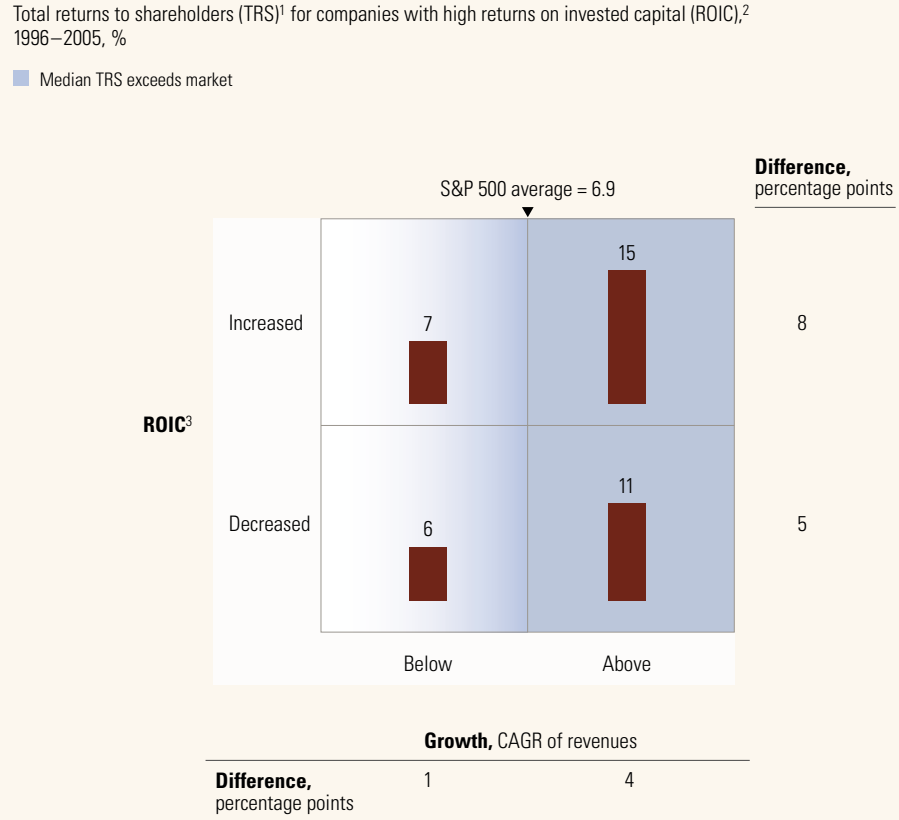
[1] Bing Cao, Bin Jiang, and Timothy Koller, "Balancing ROIC and growth to build value," *McKinsey on Finance*, Number 19, Spring 2006, pp. 12–6.
[2] For more on this topic, see Nicholas F. Lawler, Robert S. McNish, and Jean-Hugues J. Monier, "Why the biggest and best struggle to grow," *McKinsey on Finance*, Number 10, Winter 2004, pp. 17–20.
[3] Normalized to 2003 dollars.
[4] Those with a ten-year average ROIC greater than or equal to 20 percent in 1995.

Exhibit 1

High ROIC

For companies that already have high ROIC, growth generates higher TRS than further improvements to ROIC.

Total returns to shareholders (TRS)[1] for companies with high returns on invested capital (ROIC),[2] 1996–2005, %



[1]Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).
[2]78 companies with 10-year average ROIC ≥20% and market capitalization >$2 billion in 1995.
[3]Excluding goodwill.

with high ROICs can disregard the impact of growth on their profitability and capital returns. But executives do have the latitude to invest in growth even if ROIC and profitability erode as a result—as long as they can keep ROIC levels in or above the medium band.

Companies that fall in the middle of the ROIC scale[5] (Exhibit 2) have no latitude to let their performance on either measure decline. For these companies, improving ROIC without maintaining growth at the pace of the market or generating growth at the cost of a lower ROIC usually results in a below-market TRS. In most cases, the market rewarded these companies with above-market returns only when they maintained their growth and improved their ROIC.[6]

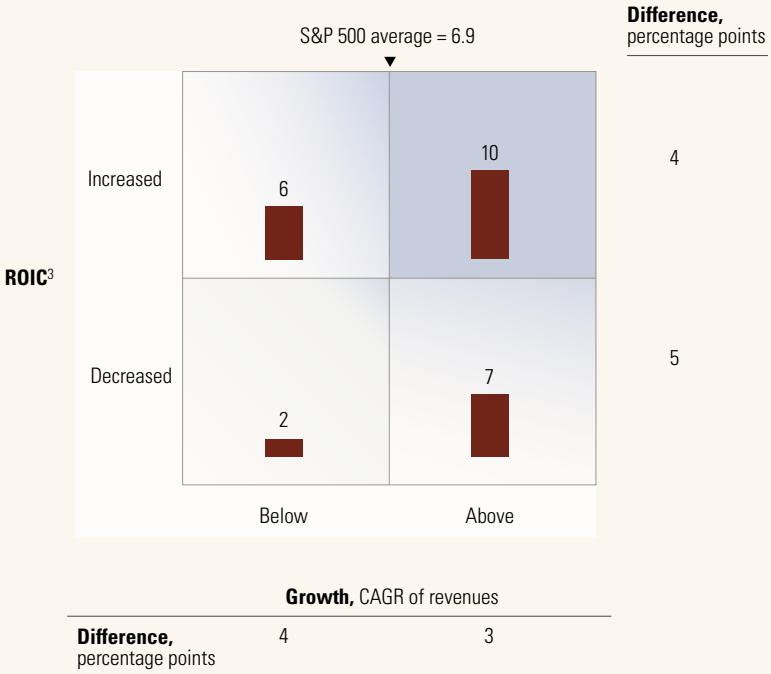
[5]Those with a ten-year average ROIC in 1995 greater than or equal to 9 percent but less than 20 percent.
[6]Because our data represent the median of a group, a company could achieve above-market TRS even though its growth was below market or its ROIC had declined.

Exhibit 2

Medium ROIC

Companies with medium ROIC must maintain their growth *and* improve their ROIC.

Total returns to shareholders (TRS)[1] for companies with high returns on invested capital (ROIC),[2] 1996–2005, %



[1]Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).
[2]129 companies with 10-year average ROIC ≥9% but <20% and market capitalization >$2 billion in 1995.
[3]Excluding goodwill.

The pattern continues for companies with a low ROIC[7] (Exhibit 3). Although both ROIC and growth are still important, an improvement in ROIC is clearly more important: companies that increased their ROIC generated, on average, a TRS 5 to 8 percent higher than those that didn't. Growth relative to the market made less difference (1 to 4 percent) for shareholders, particularly if the company improved its ROIC. This result isn't surprising. Because such companies were generating returns at or below their weighted-average cost of capital, they would have had difficulty accessing capital to finance further growth unless they improved their operations and earned the right to grow. Indeed, nearly one-third of the companies in this category from 1995 were acquired or went bankrupt within the following decade.

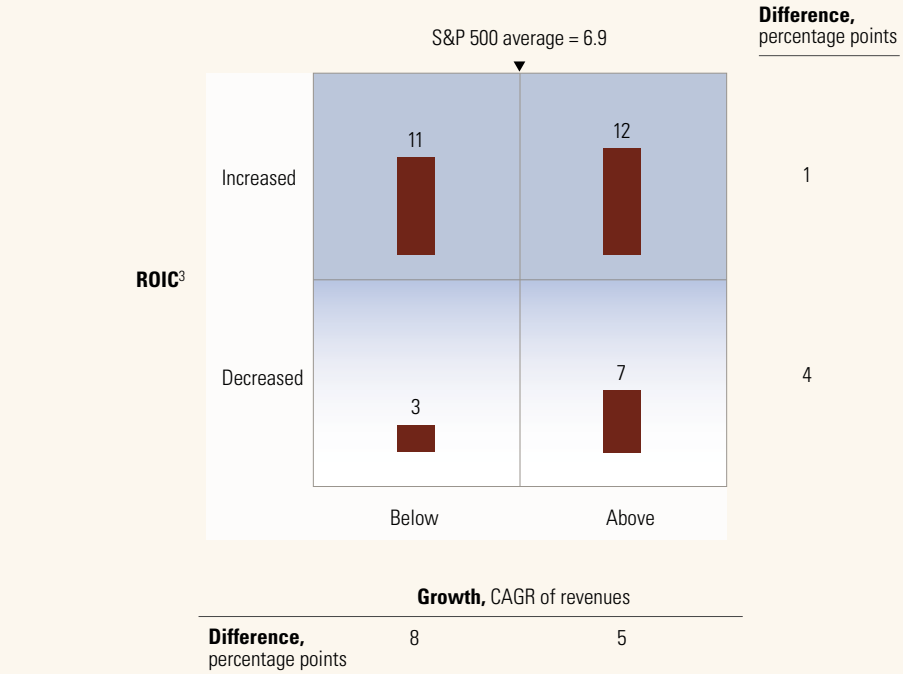
[7]Those with a ten-year average ROIC in 1995 greater than or equal to 6 percent but less than 9 percent.

Exhibit 3

Low ROIC

For companies with a low ROIC, improvement in ROIC is clearly more important than growth.

Total returns to shareholders (TRS)[1] for companies with high returns on invested capital (ROIC),[2] 1996–2005, %



[1]Median of compound average annual TRS from 1996 to 2005 for each group of companies, adjusted for compound 1996–2005 average TRS of S&P 500 index companies (6.9%).
[2]64 companies with 10-year average ROIC ≥6% but <9% and market capitalization >$2 billion in 1995.
[3]Excluding goodwill.

Of course, when an industry reaches maturity and consolidates, companies may find it impossible to avoid slow growth and, at the same time, compressed margins. And when a company cannot find growth opportunities or improve its returns on investment, executives might better serve shareholders by selling the company to owners who can drive higher growth or by returning capital to shareholders through stock buybacks. MoF

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