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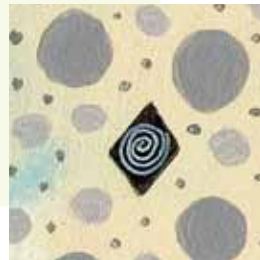
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# Paying back your shareholders

**Successful companies inevitably face that prospect. The only real question is how.**

**Bin Jiang  
and Tim Koller**

Most successful companies eventually find themselves generating more cash than they can reasonably reinvest in their businesses at attractive returns on capital. Even in the wake of the recent recession, investors are pressuring companies to distribute a mountain of cash they've accumulated in the past few years. In fact, European and US companies currently hold a total of around \$2 trillion in excess cash.<sup>1</sup>

For many companies, that pressure raises several questions. How much cash should they return to shareholders and how much should they retain for investment and for managing volatility? When they do return cash to shareholders, how should they do so—through cash dividends or share repurchases?

## **Return cash—or invest it?**

Some executives and board members argue that returning cash to shareholders reflects a failure of management to find enough value-creating investments. Share repurchases and dividends, these people argue, send a negative signal to the markets that a company can find nothing better to do with its cash. But in most cases, simple math leaves such companies with little choice: if they have moderate growth and high returns on capital, it's functionally impossible for them to reinvest every dollar they earn.

Consider this example: a company earning \$1 billion a year in after-tax profits, with a 25 percent return on invested capital (ROIC) and projected



revenue growth of 5 percent a year, needs to invest about \$200 million annually<sup>2</sup> to continue growing at the same rate. That leaves \$800 million of additional cash flow available for still more investment or returning to shareholders.<sup>3</sup> Yet finding \$800 million of new value-creating investment opportunities every year is no simple task—in any sector of the economy. Furthermore, at a 25 percent ROIC, the company would need to increase its revenues by 25 percent a year to absorb all of its cash flow. It has no choice but to return a substantial amount of cash to shareholders (Exhibit 1).

Moreover, concerns about negative signals to the market are misplaced. We've never seen a situation in which the stock market was surprised that a company couldn't reinvest its cash flow. As many companies are currently finding, investors typically anticipate distributions to shareholders long before managers decide to undertake them, since it's obvious that there aren't many alternatives. (What investors don't know is *when* a company will

return the cash, so the share price often rises when companies begin share repurchase programs.) It therefore comes as little surprise that, in aggregate, US companies have returned to shareholders around 60 percent of earnings in dividends and share repurchases each year over the past 50 years (Exhibit 2)—even if some individual companies hold on to more cash than they need for operational purposes.

A number of leading companies have adopted the sensible approach of regularly returning to shareholders all unneeded cash and using share repurchases to make up the difference between the total payout and dividends. While these companies don't have formal published policies, you can deduce them from actual practice. Over the five years ending in 2010, for instance, IBM generated \$48 billion of cash flow from operations after capital expenditures and acquisitions and returned \$56 billion to shareholders<sup>4</sup> in dividends and share repurchases. It's hard to imagine that even a

Exhibit 1

### Returning cash is inevitable.

Excess cash flow for \$1 billion net income, \$ million

Projected return on invested capital (ROIC), %	50	600	700	800	900	<p>A company with a 25% ROIC and a projected revenue growth of 5% a year has \$800 million of additional cash flow.</p>
	25	200	400	600	800	
	15	(333)	0	333	667	
		20	15	10	5	
		Projected growth rate, %				

company like IBM could have successfully reinvested that much cash in its own businesses over that time, especially since it was already spending \$6 billion a year on R&D and more than \$1 billion on advertising and promotion.

### How to pay it out

While distributions to shareholders, relative to income, have been stable for a long time, the split between dividends and share repurchases has changed significantly. Until the early 1980s, less than 10 percent of distributions involved share repurchases. Now, about 50 to 60 percent do.

Why the shift? It's primarily about flexibility. Companies, especially in the United States, have conditioned investors to expect that dividends will

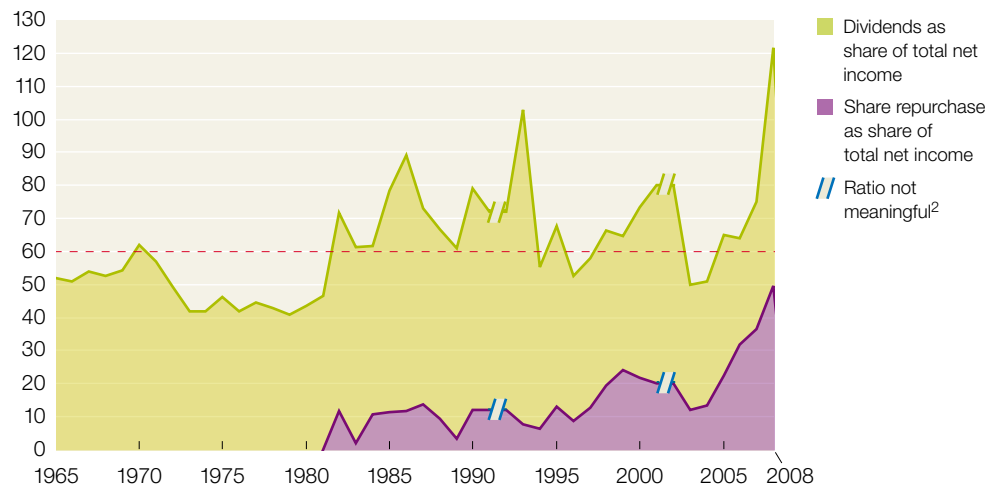
be cut only in the most dire circumstances. From 2004 to 2008, just 5 percent of US-listed companies with revenues greater than \$500 million cut their dividend, and in almost every case the company faced a severe financial crisis. So companies are reluctant to establish a dividend level that they aren't confident of sustaining. They opt, instead, to buy back shares.

Some investors, too, prefer repurchases because they can then choose whether or not to participate. Institutional investors, for example, can maintain their investment in a company without the transaction costs of reinvesting dividends. Individual investors, by not participating in a share repurchase, can defer taxes on the dividends and turn them into capital gains even years in the future.

## Exhibit 2

### On average, US companies have returned about 60 percent of their net income to shareholders.

US net income payout ratio,<sup>1</sup> %



<sup>1</sup>Sample includes nonfinancial US companies with real revenue >\$100 million in any year between 1989 and 2009.

<sup>2</sup>Data for 1991–92, 2001–02 are excluded because of abnormally low net incomes.



Does it matter whether distributions take the form of dividends or share repurchases? Empirically, the answer is no. Whichever method is used, earnings multiples are essentially the same for companies when compared with others that have similar total payouts (Exhibit 3).<sup>5</sup> Total returns to shareholders (TRS) are also the same regardless of the mix of dividends and share repurchases (Exhibit 4).<sup>6</sup> These results should not be surprising. What drives value is the cash flow generated by operations. That cash flow is in turn driven by the combination of growth and returns on capital—not the mix of how excess cash is paid out.

#### **Setting the right mix**

So how should a company decide between repurchases and dividends? That depends on how

confident management is of future cash flows—and how much flexibility it needs.<sup>7</sup>

Share repurchases offer companies more flexibility to hold onto cash for unexpected investment opportunities or shifts in a volatile economic environment. In contrast, companies that pay dividends enjoy less flexibility because investors have been conditioned to expect cuts in them only in the most dire circumstances. Thus, managers should employ dividends only when they are certain they can continue to do so. Even increasing a dividend sends signals to investors that managers are confident that they will be able to continue paying the new, higher dividend level. Share repurchases also signal confidence but offer more flexibility because they don't create a tacit commitment to addi-

## Exhibit 3

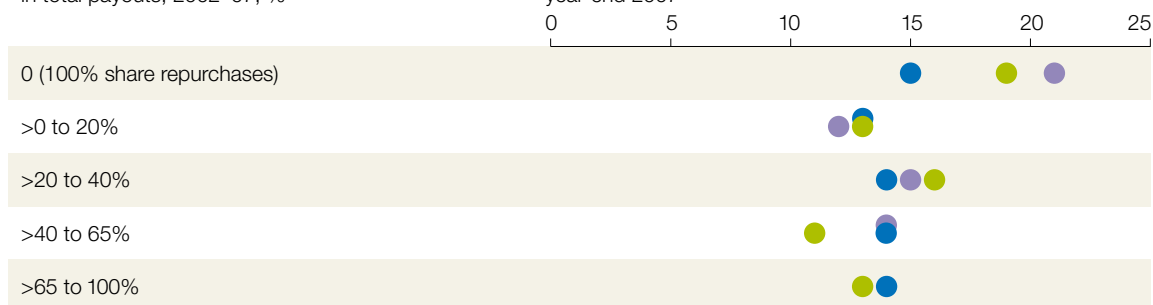
**Earnings multiples are not affected by the payout mix.**

**Level of total payouts:** average annual payouts (dividends + share repurchases) as % of total net income,<sup>1</sup> 2002–07

● 0–65% ● 66–95% ● 96–130%

**Payout mix:** average share of dividends in total payouts, 2002–07, %

**Ratio of median enterprise value to EBITA multiple,** year-end 2007<sup>2</sup>



<sup>1</sup>Insufficient data for payout levels of 96–130% at payout mix of >65 to 100% dividends and for payout levels of >130% for all payout mixes.

<sup>2</sup>For 279 nonfinancial companies that were in the S&P 500 at the end of 2009, were continuously in operation since 1999, and paid dividends or repurchased shares. EBITA = earnings before interest, taxes, and amortization.

## Exhibit 4

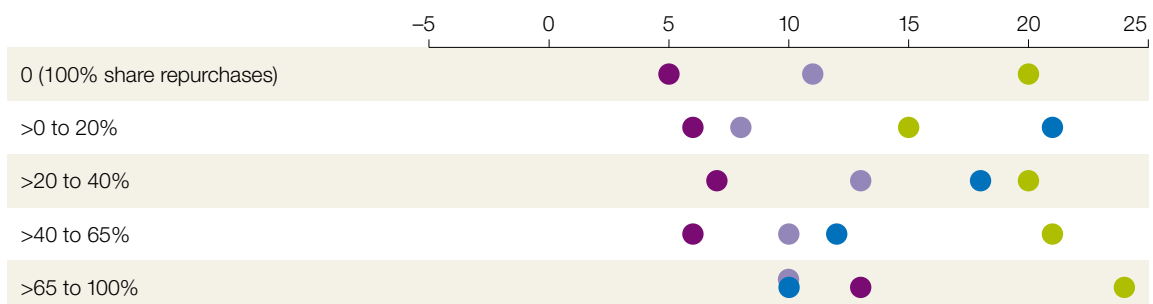
**Returns to shareholders are unrelated to the payout mix.**

**Level of total payouts:** average annual payouts (dividends + share repurchases) as % of total net income,<sup>1</sup> 2002–07

● 0–65% ● 66–95% ● 96–130% ● >130%

**Payout mix:** average share of dividends in total payouts, 2002–07, %

**Median total returns to shareholders (TRS),** CAGR, 2002–07,<sup>2</sup> %



<sup>1</sup>Insufficient data for payout level of 66–95% at payout mix of zero dividends (100% share repurchase).

<sup>2</sup>For 293 nonfinancial companies that were in the S&P 500 at the end of 2009, were continuously in operation since 1999, and paid dividends or repurchased shares. CAGR = compound annual growth rate.

tional purchases in future years.<sup>8</sup> (As an aside, signaling effects, whether for dividends or share repurchases, do not reflect value creation. They may lift the market’s expectations of a company’s future cash flows but do not affect the cash flows themselves—and therefore do not create any value.) As you would expect, changing the proportion of dividends to share buybacks has no impact on a company’s valuation multiples or TRS, regardless of payout level.

One argument for share repurchases that doesn’t hold up to scrutiny: share repurchases increase value because they increase earnings per share. Such an increase is a simple mathematical effect offset by a decline in the price-to-earnings ratio, since a company is more risky as a result of higher leverage. The net effect on share value is zero. Another argument for share repurchases is that companies can repurchase undervalued shares for the benefit of those shareholders who hold on to them. In theory this is correct; however, we’ve rarely seen companies with a good track record of repurchasing shares when they were undervalued; more often than not, we see companies repurchasing shares when prices are high.



Successful companies inevitably get around to returning cash to shareholders in some form, if only because they simply can’t reinvest their cash as fast as it accumulates. And while there’s no fundamental difference in the value of dividends when compared with share repurchases, companies need to balance their approach against the flexibility that management needs. ○

<sup>1</sup>“Excess cash” is defined as the amount of cash outstanding over and above operating cash, which is defined at 2 percent of revenue.

<sup>2</sup> Over and above replacement capital expenditures that, we’ve assumed, equal depreciation. If the company has some debt financing, it could return even more of its profits.

<sup>3</sup> The same basic principle applies to different companies, depending on their levels of growth and returns on capital.

<sup>4</sup> IBM returned \$73 billion to investors and received \$17 billion from issuing new shares (primarily the exercise of employee stock options), for net distributions of \$56 billion. IBM could pay out more cash than it generated from operations because it also generated cash flows from divestitures, borrowing, and changes in cash balances.

<sup>5</sup> We also examined the value of companies by using statistical techniques and found no impact on the dividend or share repurchase mix once we adjusted for differences in total payouts, growth, and returns on invested capital.

<sup>6</sup> After adjusting for differences in total payout.

<sup>7</sup> See Marc H. Goedhart, Timothy Koller, and Werner Rehm, “Making capital structure support strategy,” mckinseyquarterly.com, February 2006.

<sup>8</sup> The academic research is not conclusive on whether dividend increases or share repurchases send a stronger signal to investors.



# Can Chinese companies live up to investor expectations?

**In a reversal of long-term trends, Chinese companies now enjoy a valuation premium over their peers in developed markets. What's changed?**

**David Cogman  
and Emma Wang**

Are Chinese and other companies in emerging markets finally getting the respect they deserve?

Historically, they've traded at a discount on all metrics of valuation—typically, in the range of 20 to 30 percent.<sup>1</sup> Even as the underlying Chinese economy developed and the shares of these companies became a commonly accepted investment option, neither institutional nor retail investors quite shook the perception that such securities were generally risky. Yet if the Asian financial crisis of the late 1990s reinforced that belief, the credit crisis of 2007 may have reversed it. Indeed, companies in several major emerging markets now trade at a premium to their peers in developed markets.

It's true that in the wake of the crisis and the ensuing recession, investors have taken note of the great rebalancing of economic power, shifting from West to East, and have rethought long-held beliefs about the relative security of asset classes in both developed and developing economies. But an important question arises: have companies in emerging markets changed or just investors' perceptions of them? The question is apt in a number of emerging markets, including Brazil, India, and Russia, but it's particularly so in China, where the reversal in premiums is most noticeable. If these valuations reflect investors' expectations for future growth and returns, are there valid reasons to



believe that those of Chinese companies have improved through the recession? Or are investors already assuming an improvement in economic realities? Economic data suggest the latter.

### A shift in valuation

In emerging markets, the historical discount of companies was generally in line with their performance. As we observed a few years ago,<sup>2</sup> emerging markets may typically have exhibited higher growth but also had much lower returns on capital than their Western peers. This difference almost completely explains the difference in valuation multiples. From 2006 to 2010, our analysis found the average return on equity (ROE) of Chinese companies to be six percentage points below that of US companies—a gap that remained even when the profitability of US companies fell.<sup>3</sup> This gap alone would imply a price-earnings ratio (P/E) multiple 20 percent lower. Even if companies in these markets had been growing three to five percentage points faster, their lower returns on capital still warranted a P/E discount of 10 to 15 percent relative to their developed-market counterparts. This discount has reversed in some markets in the wake of the economic crisis. Companies in China, along with those in India and Latin America, now trade at a premium to companies in developed markets (Exhibit 1).

In 2008–09, it was quite easy to write this development off as a temporary, liquidity-fueled anomaly. Investors wanted to be anywhere but developed markets. While companies in developing ones still had less transparent financial reporting and weaker governance, they generally had less risky banking systems as a result of stronger government controls. Also, governments didn't have to prop up industrial companies, as the United States did in

the automotive sector. Some major emerging markets, with their promise of high growth and lower cost bases, were perceived as safer than developed markets—though not all emerging markets were equally favored. Only China and India achieved the valuation premium for a protracted period; companies in Brazil and Russia traded at a discount to those in developed markets throughout the recession.

In China, the shift in valuations has not proved to be an anomaly. They remain at a 20 to 30 percent premium above those in the United States and the European Union—and the gap is not explained by a different industrial structure. On an industry-by-industry basis, the gap is even larger. In 2008, P/E ratios for Chinese companies in the industrial, consumer goods, and financial sectors were 9 percent lower, 22 percent higher, and 33 percent lower, respectively, than those of their US counterparts in the same sectors. In 2010, these companies had valuations 38 percent, 58 percent, and 6 percent higher than those of their respective US counterparts.<sup>4</sup>

### A down payment on growth

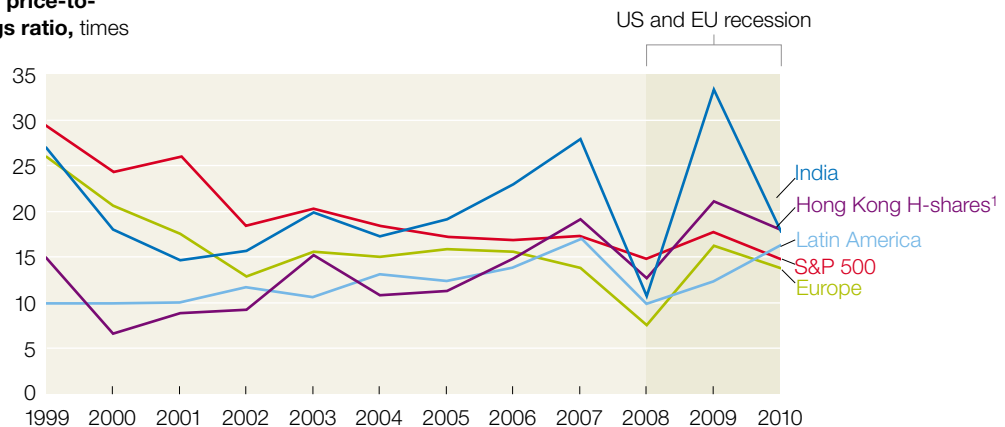
If current valuation levels are based in economic reality, we should see evidence to support them—either some indication that operating performance will improve significantly in the near future or data supporting an expectation that growth levels will continue to outpace those of companies in developed economies. The data are not convincing on either point.

In fact, given the relationship between growth and P/E multiples, Chinese companies would need significant operating improvements to justify the current valuation level (Exhibit 2). Their returns on capital haven't materially changed in the past

## Exhibit 1

## Companies in some emerging markets no longer trade at a discount to those in Western markets.

Trailing price-to-earnings ratio, times



<sup>1</sup>Shares of companies incorporated in mainland China and listed on Hong Kong Stock Exchange.

Source: Bloomberg; McKinsey analysis

decade (Exhibit 3), and very few sectors or company types have experienced a major improvement in returns on capital.<sup>5</sup> When goodwill is included, the returns of Chinese companies continue to lag behind those of their US and EU counterparts by around 2 to 3 percent on average—about as much as they have for the past decade. When goodwill is excluded, the gap rises considerably: from 1999 to 2004, the returns on capital of US companies were, on average, six percentage points higher. Since then, our analysis finds that the gap has risen to between 13 and 14 percent.<sup>6</sup>

If valuation levels are not based on improved operating performance, they are, in effect, a down payment on expected growth. And it's true that in this respect, Chinese companies have outperformed their counterparts in the United States and Europe for the past few decades. Yet since the crisis,

there has been a general moderation in expectations for growth in corporate earnings and GDP in both the United States and China.

In fact, the gap between expected growth in the United States and Europe and in China is almost the same today as it was before the recession. This fact should come as no surprise. Chinese companies will have significant opportunities to export to developed markets for years to come; the crisis did not change their potential for growth in domestic markets; and many of them are now past the initial stage of rapid expansion. Over the short term, during the next few years, expected corporate earnings growth is actually about the same in China as in the United States and Europe. In the longer term, the gap between forecast US and Chinese growth is not much different from pre-crisis levels.

### Living up to expectations

It's possible that Chinese companies will make good on these higher expectations. Certainly, it will help if they can deliver the levels of growth that some analysts forecast. But growth alone won't be enough; companies will need to improve their returns on capital as well.

Chinese managers interested in improving their returns will, in general, have to be more disciplined in thinking about how effectively their different businesses and growth opportunities use capital. That won't be easy. A few companies are becoming more thoughtful about the way they prioritize investments and are bringing greater discipline to decision making. But when capital is freely available and the size of a company determines the personal importance of its managers—as is the case in China—the motivation for discipline in the use of capital is often weak.

Investors and stakeholders also have a critical role to play. The government is already exerting considerable administrative pressure on state-owned enterprises to improve their capital efficiency: on average, these enterprises lag significantly behind private-sector ones in returns on capital. The government can exert this pressure through the banking system, which remains the principal supplier of capital to the Chinese economy, and also through the State Council's State-owned Assets Supervision and Administration Commission (SASAC), the agency that represents the government as shareholder in the state-owned companies. SASAC has for several years been working actively with its portfolio companies to improve their discipline in using capital. Public-market shareholders can also play a helpful role. If the importance of an issue like investment discipline is regularly reinforced through dialogue with companies, it will gradually move up the management agenda.

## Exhibit 2

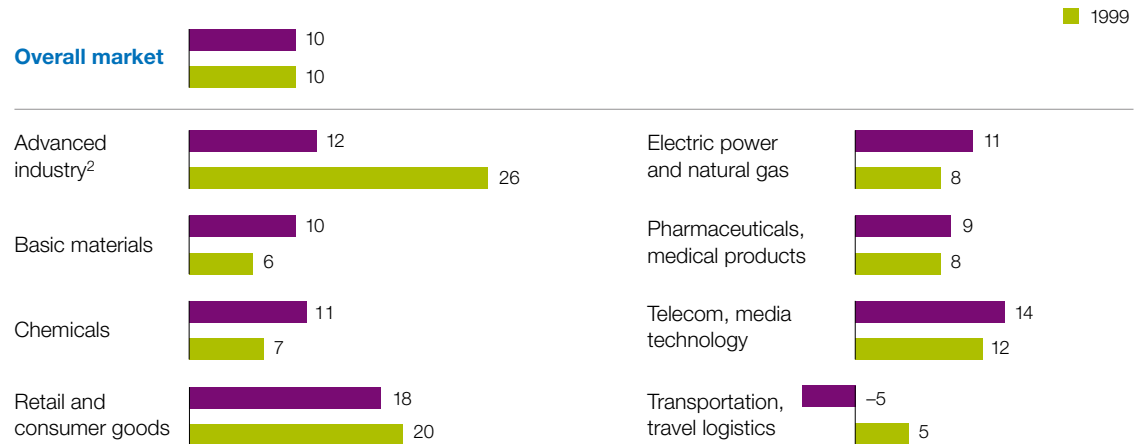
### Chinese companies would need significant operating improvements to justify current valuation levels.



<sup>1</sup>Based on forecast long-term growth rate at year-end 2010.

Source: Bloomberg; Economist Intelligence Unit; McKinsey analysis

## Exhibit 3

**Few of China's sectors have significantly improved returns.****Return on invested capital (ROIC) by industry,<sup>1</sup> %**

<sup>1</sup>Based on sample of 60 companies listed in mainland China and Hong Kong.

<sup>2</sup>Data are for 2003 and 2009; advanced industry includes automobile and assembly, renewable-energy equipment, and semiconductors.

Source: Bloomberg; McKinsey analysis

Companies hoping that stricter management of the corporate portfolio will improve returns might also employ a tool underutilized by even Western companies: divestitures and the restructuring of portfolios. Yet domestic M&A activity in China is extremely low by any metric, and divestitures by conglomerates are extremely rare. There is a potentially significant value creation opportunity here: divestitures create more value for the selling company's shareholders than for the buyer's,<sup>7</sup> and sellers are more likely to get top dollar if they divest while a business is still strong.<sup>8</sup> Our perspective is that selling noncore businesses isn't a mark of failure or poor management—it's a sign that managers are actively making a practical trade-off between increasing a company's size

and managing it more efficiently, which is what the markets are suggesting.

The Chinese government is mindful of these issues, which underlie much of the SASAC's work to improve the performance of state-owned companies as well as the plans to create active bond and equity markets, reducing the banking system's role in capital intermediation. The former creates pressure through administrative measures to use capital more effectively, and the latter uses market forces to encourage a more efficient allocation of capital and, by extension, to impose greater discipline on companies. This has been an objective of the State Council since the 11th five-year plan, in 2006, but events from 2007 onward

slowed its progress. It's likely to be back on the agenda in the 12th five-year plan, and the current focus on controlling inflation and domestic liquidity is also raising awareness that too much freely available capital can have unpleasant side effects.



It's a critical moment for Chinese companies, whose valuations are high even as many reach the point where growth inevitably slows. Investors apparently remain confident that companies will be able to raise their operating performance, at least for now. ○

<sup>1</sup> Trailing P/E multiples of all Hong Kong-listed mainland Chinese companies versus US and EU broad market indexes, 2002–06 average.

<sup>2</sup> Marc H. Goedhart, Timothy Koller, and Nicolas C. Leung, "The scrutible East," mckinseyquarterly.com, November 2004.

<sup>3</sup> Both regions experienced a similar fall in profits during the recession, as a drop in demand in the United States led to a fall in exports in China.

<sup>4</sup> Datastream and McKinsey analysis.

<sup>5</sup> The notable exceptions are resource companies, but that arguably results from the rise in commodity prices.

<sup>6</sup> US companies achieved higher returns on invested capital—that is, better operating performance for assets—but gave up most of that improvement in the prices they paid to acquire assets inorganically.

<sup>7</sup> David Cogman and Carsten Buch Sivertsen, "A return to deal making in 2010," mckinseyquarterly.com, January 2011.

<sup>8</sup> Lee Dranikoff, Timothy Koller, and Antoon Schneider, "Divesting proactively," mckinseyquarterly.com, June 2002.

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# When big acquisitions pay off

**Some are quietly creating value that doesn't make the headlines. Here's how.**

**Ankur Agrawal,  
Cristina Ferrer, and  
Andy West**

Big mergers and acquisitions make for splashy headlines, but do they make financial and strategic sense? Executives, board members, and investors are wise to be skeptical. Such deals—worth 30 percent or more of the acquirer's market capitalization—are extremely complex. And as high-profile failures have demonstrated, big deals can destroy significant value for shareholders.

Big deals can create significant value for the acquirer, however, even if success takes time to unfold. Indeed, in our analysis of such deals over the past decade, half had created excess returns to shareholders when measured two years after the deal's completion.<sup>1</sup> In one-third, returns were significantly higher relative to the industry average.

The difference between success and failure often comes down to strategy. Only a few situations give companies a clear, compelling reason to take on a big deal's risks and integration complexity. Companies with few options for organic growth, for example, can use a large deal to enter a new sector or market quickly. Those in consolidated industries, such as oil and gas or mining, can find success in big deals when other options are limited and major economies of scale exist. And on the rare occasion when a large target company is a very clear strategic fit with the prospective buyer, a big deal can improve an acquirer's growth and performance rapidly.



But a successful deal also results from strong execution. In case studies of nine of the best-performing deals and six of the worst in our dataset, we found that successful acquirers employ several approaches to execution and integration that are different from those used by unsuccessful ones—and different from those typically used by acquirers in smaller deals. Successful acquirers set performance targets higher than due-diligence estimates of a merger’s value. They reject the common idea that an acquisition represents an opportunity to adopt the best of two companies’ cultures. Finally, their CEOs focus their involvement on a few most critical areas.

#### **Aiming higher than due diligence**

In the hectic pace of integration after a deal closes, many integration managers adopt the synergy estimates calculated by the pre-deal due-diligence team as performance targets. Yet how much a company pays for a deal isn’t necessarily the same as it’s worth. Even the best due-diligence efforts can be only so good. They’re often constrained by time and access to data. They typically focus on whether expected cost synergies alone can justify a deal, placing more emphasis on how much could be saved by eliminating redundant functions, facilities, people, or products and much less on how much can be gained through growth. To compound the error, as individual managers weigh the uncertainty of due-diligence estimates against their own performance risk, they often translate synergy estimates into even more conservative—and easily achievable—cost and revenue targets.

Yet, as our case studies suggest, companies that reassess their synergy targets after a deal closes seem to achieve higher synergies than those that don’t. These more ambitious companies use pre-deal estimates of synergies not as performance targets but as a performance baseline—the

minimum they expect. In fact, in a survey on corporate transformations that included mergers and acquisitions, executives managing deals in which baseline aspirations were reset by a number of robust facts after a deal was reached were four times more likely to characterize those deals as very or extremely successful than executives whose baseline aspirations were not reset.<sup>2</sup>

The successful acquirers in our case studies reset their aspirations by identifying opportunities to transform the business and then building a fact base to support those opportunities. Sometimes they came from fundamental changes to operations or from providing customers with new products or services that hadn’t come up in due diligence—or weren’t investigated, as a result of limited time or information access.

After a merger between two global mining companies, for example, the acquirer had more access to details on the overlap between its own and the target’s customer base and suppliers. Previously confidential information on the terms and conditions of sales agreements—and the needs and expectations of customers—led to unexpectedly high levels of cross-selling and bundling between the target’s and acquirer’s products, as well as unexpectedly lower input costs, thanks to improved supply chain management. While these considerations were not a large part of the original investment thesis, they were a major part of the deal’s success, improving the combined company’s earnings before interest, taxes, depreciation, and amortization (EBITDA) by more than 20 percent.

Similarly, when a North American packaged-goods company reviewed its synergy targets after a deal’s close, managers learned that the target company’s marketing strategy was better than its own. Importing those and other best practices helped

the company realize synergies 75 percent above due-diligence estimates.

Setting such aggressive target estimates requires individual leaders to leave their comfort zones and share aspirations. Workshops encouraging the joint exploration of opportunities can help. Senior managers of one large deal in the pharma industry, for example, summoned teams from different backgrounds to a three-day off-site event. It started with an idea generation session where each team compiled a list of growth-related opportunities. The group then assessed each of the opportunities, ranking them by size and priority, and eventually developed a high-level implementation plan. In three days, the group did not discuss the due-diligence model or its synergy estimates. In the end, the acquirer uncovered more than 40 percent more synergies and rebalanced its synergy expectations significantly across teams. In addition, the teams were motivated by their targets and believed they were achievable—a much better outcome than being allocated a target based on a brief due-diligence period.

Higher performance targets have their challenges, of course, and to meet those targets companies must have the right kind of managers. In a broad-based survey on organizational health,<sup>3</sup> managers at the most successful acquirers reported having a higher-than-average sense of accountability, as well as inspirational and authoritative leadership. Developing those traits requires companies to create an environment that encourages managers to take calculated risks and gives them confidence to aim beyond the original size and scope of the synergy targets. Such an environment includes clearly defined managerial roles, strong links between individual performance and consequences (positive and negative), and attractive incentives for high performers.

In one case study, for example, a global bank in a large acquisition actively encouraged managers to develop ambitious business plans and provided the resources to pursue them. Managers were generously rewarded for meeting their goals but also faced consequences if they failed: those



## In our case studies, the leaders of successful big deals typically focused in a meaningful way on only one or two areas where their involvement mattered most.

who missed agreed-upon targets for a third time were let go. All of these attributes can—and, if possible, *should*—be developed long before a large deal is under way. In fact, in our transformations survey, respondents in companies that focused on building capabilities before an acquisition were twice as likely to describe it as successful.

### **Asserting cultural control**

It's not uncommon for an acquiring company to assert control over the culture of the acquired one—if it is small. But many executives have been reluctant to do so with really large deals, taking instead a merger-of-equals posture or one purporting to adopt the best of each company's culture. That approach, we find, typically leads to confusion and reduces accountability, hindering integration and lengthening the time needed to get past integration and on with running the business. In fact, in our case studies' examination of culture, the biggest difference between successful and unsuccessful large deals was the recognition in the former that one culture inevitably tends to dominate. Unsuccessful acquirers typically discovered that the emerging dominant culture wasn't always the best fit for the deal's strategic intent.

In successful deals, companies acted more purposefully. They started by building a fact base

to identify cultural differences, focusing on extremely targeted improvements to the acquiring company's culture, if needed. Then they spent the majority of their time explaining the differences and helping acquired employees understand what they needed to do to migrate to the culture of the new organization. Finally, they aggressively managed that migration. This sounds intuitive but is quite different than what happened in many of our unsuccessful case studies, where promises of “best of both cultures” resulted in high aspirations supported with little transitional support and, ultimately, an unfair playing field for acquired employees.

Managers of a large international media deal, for instance, started with a survey of cultural performance, management practices, and outcomes. The survey identified nine dimensions of culture, and the data it generated gave managers a benchmark of each company's position on performance. These managers then used that data to inform discussions with the integration leaders, so that everyone understood the differences between the cultures, and then to identify very targeted improvements and shape the language and messaging to the merged company. Finally, they created an “on-boarding” program that helped acquired employees understand what to expect and how to succeed. The topics included how the

acquiring company conducted performance reviews and financial planning, set and communicated goals, and enforced accountability. At some levels, the program even included getting people comfortable with little things that would “feel” very different, such as the reimbursement of expenses, laptop policies, and time and expense reports.

There are exceptions when an acquirer wants to leave cultural gaps in specific areas or to protect a specific capability by creating a distinct culture in parts of the business. An acquirer that relies on top-down innovation, for example, may want to retain the entrepreneurial culture of a target’s R&D department. But this approach should be restricted to cases when the uniqueness of the target’s culture creates value—and the acquirer makes the needed investment to keep a culture separate by forming clear organizational and operational boundaries.

When one North American high-tech company acquired a target with a potentially disruptive new technology, for instance, it found that the investment required to protect the target’s culture was at least equal to the cost of integrating it. The effort, which lasted five years, required a senior executive to manage all interactions full time, changes to the parent company’s HR policies and systems to meet the target’s needs, flexible financial reporting and budgeting that fit the target’s operating model, and forgoing almost all cost synergies from redundant operations. Yet the investment proved to be very worthwhile; the asset flourished under new ownership and significantly exceeded expectations.

#### **Balancing CEO involvement**

Demands on the CEO’s time can be overwhelming after a large deal because of the magnitude, complexity, and risk of integrating a large company,

typically of comparable size. The CEO’s involvement is critical for the deal team to maintain focus and energy; transformation survey respondents were six times more likely to describe deals as successful when the CEO was significantly involved. Yet not every decision or risk demands the CEO’s attention, and in a large deal the CEO cannot spend adequate time on every issue that might merit his or her attention in a smaller deal.

The degree of focus may be surprising: in our case studies, the leaders of successful big deals typically focused in a meaningful way on only one or two areas where their involvement mattered most. Everything else, they delegated to an empowered group of senior leaders. The CEOs could therefore focus on protecting the base business even as they pushed the organization to realize the deal’s full potential. In one global oil-and-gas merger, for instance, the CEO met with his acquired top team—the target company’s CFO and the CEO—for several hours every few weeks, with explicit instructions that they bring only the most challenging issues to the table. All other integration updates and process-related issues fell to the integration leader, who escalated them only if necessary.

Delegating this much authority and responsibility requires CEOs to encourage others to think and act imaginatively without explicit CEO input. This approach is critical to uncovering transformational synergies. CEOs should thus create risk-free environments for generating and evaluating ideas and bring in outside experts (including academics, private-equity partners, and consultants) who can foster creativity. In the organizational-health survey, successful acquirers scored 1.5 times higher than average ones in the frequency with which they used external ideas or outsourced expertise.

The CEO's intervention is critical to overcome biases in performance evaluation systems, often structured toward short-term, organic goals. To help organizations pursue higher aspirations, CEOs should review their top-management incentive systems to make sure they reward people who aim to realize long-term transformational synergies that frequently require otherwise-avoidable short-term investments. ○

<sup>1</sup> We looked at all 197 deals, from 2000 to 2009, completed by the largest 1,000 companies as of 2009 by market cap where the value of the deal exceeded 50 percent of the acquirer's value. We then excluded deals for which financial data were incomplete and deals done in the financial, energy, or mining industries, where valuations were excessively volatile. In selecting case studies, we expanded the analysis to include five deals worth 30 to 50 percent of the acquirer's value.

<sup>2</sup> The online survey was in the field from January 19, 2010, to January 29, 2010. It elicited responses from 2,512 executives representing the full range of regions, industries, functional specialties, and seniority. The survey's initial results were published in "What successful transformations share: McKinsey Global Survey results," *mckinseyquarterly.com*, March 2010. Our analysis looked only at the responses from executives working for companies whose transformations involved a merger.

<sup>3</sup> This survey was completed by more than 600,000 employees of 500 organizations globally between 2003 and 2010; our analysis focused on the nearly 4,000 respondents in companies that had completed a large acquisition. Complete results will appear in Scott Keller and Colin Price, *Beyond Performance: How Organizational Health Delivers Ultimate Competitive Advantage*, Hoboken, NJ: Wiley & Sons, June 2011.

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# Growing through deals:

## A reality check

**The size and frequency of deals matter less than how companies execute them.**

**Andres Cottin,  
Werner Rehm, and  
Robert Uhlener**

The bigger a company gets, the harder it is to keep up with investors' expectations for growth. Mergers and acquisitions are essential, but how big do deals need to be—and how frequent? Because a single deal that might double the market capitalization of a small company will scarcely register for a large one, many big companies pursue ever-larger deals—or a whole lot of smaller ones. Does either of those strategies more often lead to success?

Apparently not. Patterns of deal size and frequency have made little difference in performance as measured by excess total returns to shareholders (TRS) among the world's top 1,000 companies<sup>1</sup>

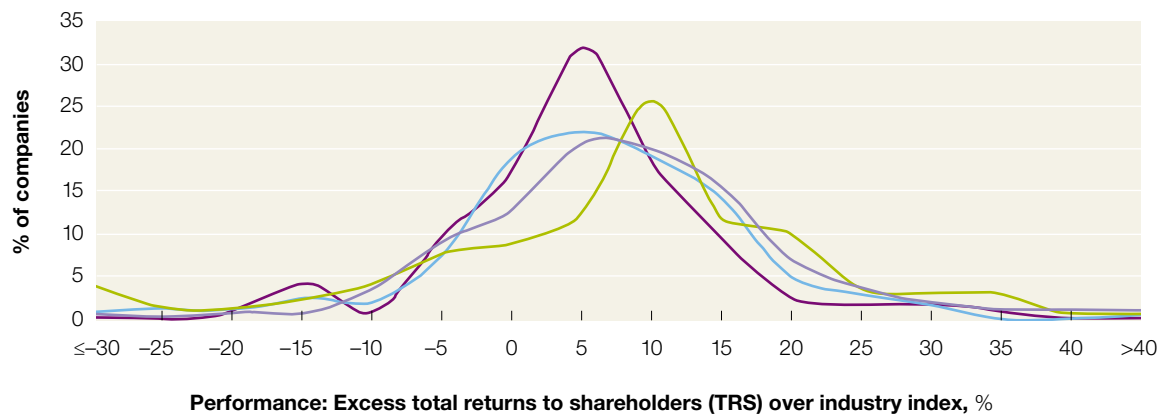
by market capitalization. It seems not to matter much whether companies completed one large deal, many small deals, or few deals. In statistical parlance, the distribution of samples reflecting different combinations of deal sizes and market caps was both widely distributed and overlapping. From a value-creation perspective, this finding means that the size and number of deals matter less than the discipline with which they are identified, priced, integrated, and managed. ◦





<sup>1</sup> The sample included the top 1,000 companies by market capitalization in 1999 and 2009. After we excluded banks, companies in Africa and South America, and companies with insufficient data, 917 companies (which collectively completed more than 30,000 deals) remained in the sample.

Exhibit

**The distribution of samples reflecting different combinations of deal sizes and market caps was both widely distributed and overlapping.**

Top 1,000 companies globally by market capitalization, 1999–2009



Acquired <b>more than</b> 18% of market capitalization with . . .		Acquired <b>less than</b> 18% of market capitalization with . . .	
			
. . . <b>fewer than</b> 15 deals	. . . <b>more than</b> 15 deals	. . . <b>fewer than</b> 15 deals	. . . <b>more than</b> 15 deals
<b>For all companies</b> 18% = median acquired market capitalization and 15 = median number of deals.			

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# Sustaining top-line growth:

## The real picture

**A historical view shows that beating markets is tougher than most leaders believe.**

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

Many leaders set unrealistic growth targets. Often, they don't properly consider how fast their underlying markets are growing and thus how much market share must be grabbed to meet ambitious goals. Or they ignore the likelihood that their competitors are doing many of the same things to grow. They also underestimate the ongoing need to find new products to replace revenue declines from current offerings as they mature.

A historical look at corporate performance puts the growth challenge into perspective. The first exhibit shows the real revenue growth distribution for large nonfinancial companies from 1997 to 2007. (We ended the analysis in 2007 to avoid dis-

tortion resulting from the severity of the recession that began that year.) The median revenue growth rate was 5.9 percent. About one-third of these companies increased their revenues at rates faster than 10 percent. But that one-third figure probably overestimates organic growth, since it includes the effects of acquisitions.

Over a longer time horizon, other difficulties come into view. The second exhibit presents real 1965–2008 revenue growth for the 500 largest nonfinancial companies in the United States. The median was 5.4 percent a year. Although the rate fluctuated from 1 percent to 9 percent according to the economy's health, there was no upward or downward



trend and thus no rising tide to lift growth over the longer haul.

During this same period (1965–2008), median GDP growth in the United States was 3.2 percent, meaningfully lower than the corporate revenue growth rate. How did companies grow, in the aggregate, faster than the economy did? The biggest factor is that US companies have been globalizing, so their revenues from countries outside the United States—48 percent of the total in 2008—have been growing much faster than their US revenues. Many companies are counting on global

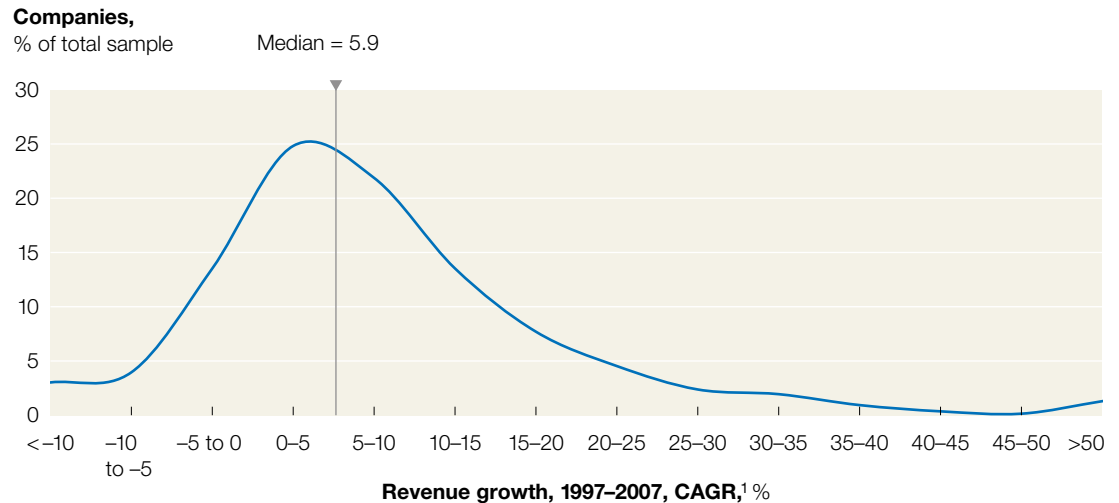
growth, particularly in emerging markets, to go on driving them forward. But a rising number of companies around the world are competing for a share of that momentum.

Finally, it's worth bearing in mind just how many casualties the growth game has. Beginning in the mid-1970s, a quarter of all the large companies we studied actually shrank in real terms in a given year. That's sobering, since most companies today are publicly projecting healthy growth over the next five years. In fact, many of these mature companies will get smaller in real terms. In related

Exhibit 1

**During a ten-year span, about one-third of large nonfinancial companies enjoyed revenue growth greater than 10 percent.**

Distribution of real revenue growth rate for US-based nonfinancial companies with revenues >\$500 million, 1997–2007

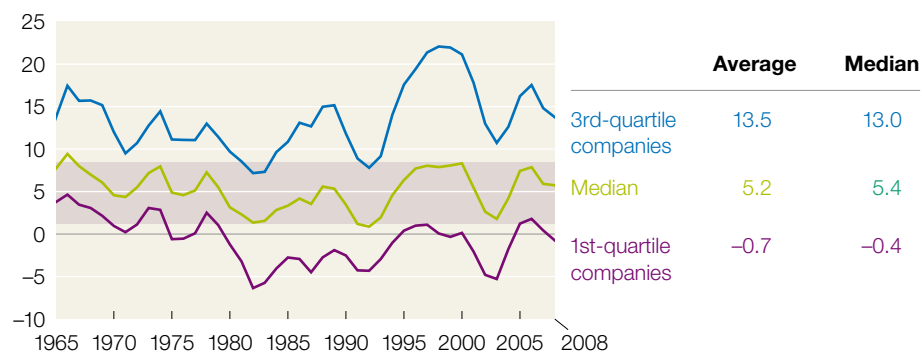


<sup>1</sup>Compound annual growth rate.  
Source: Standard & Poor's Compustat; McKinsey analysis

## Exhibit 2

## Over a longer period, the revenue growth rate fluctuated with the health of the economy, exhibiting no upward or downward trend.

Real revenue growth rate for top 500 nonfinancial companies in United States, 3-year CAGR,<sup>1</sup> %



<sup>1</sup>Compound annual growth rate.

Source: Standard & Poor's Compustat; McKinsey analysis

research, we find that a startling 44 percent of all companies that grew at rates faster than 15 percent from 1994 to 1997 were growing at rates lower than 5 percent ten years later.

Although the importance of growth is undeniable, large companies should have a realistic view of the challenges they face and the implications of aggressive targets. Pursuing above-average growth rates—8 percent, say, rather than the 5 percent gains of a company's underlying markets—means

that a \$10 billion company must add \$11.6 billion (rather than \$6.3 billion) in revenue per year by the tenth year to meet its goal. While that is undoubtedly realistic for *some* companies in *some* industries at *some* times, the headlong pursuit of fast growth can also yield bad decisions. Over the long haul, it can overshadow the benefits of patience and discipline: patience to nurture new growth platforms over many years and discipline to uncover the types of growth that will create the most value. ○

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## Leasing: Changing accounting rules shouldn't mean changing strategy

**Recent proposals will mean more transparency for investors—but won't change how companies operate and create value.**

**Werner Rehm**

When the US and international accounting-standards boards published a draft of their new lease-accounting rules last summer, they defined the move as a significant post-financial-crisis change that would increase transparency for investors.<sup>1</sup> In theory, they're right. Gone would be the distinction between operating and capital leases. Instead, companies would need to account on their balance sheets for every material asset they have the right to use and to include depreciation for those assets on their income statements.

Like other regulatory changes in the wake of the recent financial crisis, these have spurred lively debate among accountants and analysts. Indeed, in March 2011 there were some indications that the

US Financial Accounting Standards Board (FASB) may have had a change of heart and decided to adopt something closer to the old rules.<sup>2</sup> Amid all these discussions, executives should remember that the implications for the value of individual companies are minimal. Companies might need to provide investors with more details on assumptions for specific leases and may have to amend some debt covenants and compensation contracts to account for mechanical changes in earnings before interest, taxes, depreciation, and amortization (EBITDA) and interest payments. But none of the changes that stem from the originally proposed new accounting rules for leases will make any difference to a company's cash flows or to how it operates and creates value.

For executives—particularly in industries with extensive leasing portfolios, such as retailing and transportation—the message is clear: these changes in accounting rules, by themselves, warrant no shift of real-estate or financing strategies. As we’ve outlined in earlier research, accounting-rule changes that do not require companies to disclose more information don’t bring forth new insights that might lead investors to change their assessments of a company’s value.<sup>3</sup> In this case, investors are well aware of, and closely track, leasing liabilities, which have long been outlined in balance sheet footnotes.

#### **The rules may change . . .**

At a high level, the originally proposed change in rules would mean two things for a company’s accounting practices. First, accountants would need to recognize, on their balance sheets, a liability for future lease payments over the initial lease period, as well as any likely lease extension.<sup>4</sup> That liability would be amortized over time and, much like a mortgage, would not decline in equal parts over the life of the lease.

Second, companies would need to put on their balance sheets the value of the right to use an asset. Initially, this value would equal the liability. The asset, however, would have to be reported using straight-line amortization, declining in equal parts over the life of the lease. Consequently, the liability would always be larger than the asset.

The effect of these two rules would be an increase in EBITDA, the reported depreciation, and the reported interest expense, as well as a longer balance sheet. Because of the mismatch between liability and asset, shareholder equity would also change.

These proposed rules would affect any company that leases property or equipment. But they will most

affect companies in sectors that rely heavily on leases, such as retailing, which traditionally leases large amounts of real estate. A company’s net reported property, plant, and equipment (PP&E) numbers, which would include leased assets, could increase from 30 to 60 percent, depending on the subsector. Reported long-term debt would similarly increase by the amount of the lease liability, and reported EBITDA would go up by 30 to 40 percent<sup>5</sup> because the lease payment would become an interest and amortization expense.

#### **. . . but the economics will stay the same**

As with any proposed rule change, the comment period prior to this one has raised many questions. Executives at some companies are wondering whether equity valuations or debt capacity will change under the proposed rules as reported leverage goes up and EBITDA interest coverage goes down. If so, some are asking whether they need to rethink their target leverage or debt levels—or even revise their asset ownership strategies, given the significant impact of the proposed rules on the balance sheet.

Yet no strategic changes should be necessary; only accounting practices should change. Even among companies whose balance sheets and income statements would be most affected by the proposed rules, cash flows will change only if executives alter their strategic decisions simply because of new accounting rules. Otherwise, little is likely to change. Let’s consider the impact in three areas: valuation levels, underlying debt capacity, and ownership strategy.

#### **Valuation levels**

Investors probably won’t revalue companies, because under the proposed rules no material new information would be released. In the two sectors that account for most of the outstanding present










































value of lease liabilities—retailing and transportation (exhibit)—investors and financial analysts already have decades of experience making adjustments for the impact of off-balance-sheet oper-

ating leases. They've grown quite adept at using metrics such as earnings before interest, taxes, depreciation, amortization, and rent (EBITDAR) to assess corporate profitability, so even though

## Exhibit

### The impact of debt from leases is fairly concentrated.

Estimates for US companies with >\$100 million in market capitalization

	 Top 3 by change after adjustment	<b>Distribution of lease debt, %</b> (100% = \$1.1 trillion)	<b>Average ratio of debt to total value,<sup>1</sup> %</b>		
			Unadjusted for lease debt	Adjusted for lease debt	Change after adjustment, percentage points
Nonfood retailing	 18	20	40	 20	
Transportation	 10	39	50	 11	
Energy	 9	25	29	 4	
Food and staples retailing	 8	22	34	 12	
Capital goods	 7	46	48	 2	
Software and services	 7	12	17	 5	
Telecommunication services	 7	50	55	 5	
Consumer services	 5	33	40	 7	
Health care equipment and services	 5	25	31	 5	
Media	 5	44	48	 4	
Technology hardware and equipment	 4	10	14	 4	
Consumer durables and apparel	 3	28	36	 8	
Food, beverage, and tobacco	 3	22	24	 2	
Materials	 3	33	36	 3	
Commercial and professional services	 2	43	48	 5	
Pharmaceuticals, biotechnology, and life sciences	 2	19	21	 2	
Automobiles and components	 1	72	73	 1	
Household and personal products	 1	20	22	 2	
Semiconductors and semiconductor equipment	 1	10	12	 2	
Utilities	 <1	-59	-59	 <1	

<sup>1</sup>Includes financial debt, minority interest, preferred stock, and net pension and other post-employment-benefits liabilities at book value.

adjusting market-based leverage ratios for leases raises the average debt-to-value ratio by 10 to 20 percent, they're unlikely to change their views about the value of these companies. In other sectors, while reported debt might increase—even significantly—the impact is negligible compared with total market capitalization. Even investors who do not understand this transparent change in reported numbers are unlikely to revalue these companies.

#### Underlying debt capacity

Cash flows and asset values will remain exactly as before, so debt capacity will not change—even if the reported leverage and interest coverage ratios do. These changes could potentially violate some simple debt covenants, but since many covenants already include adjustments for lease payments, it's unlikely that even companies with these arrangements would encounter difficulties. If a debt covenant has been defined solely on generally accepted accounting principles, without any adjustment clause, the change is so obvious that lenders and borrowers could easily bridge the numbers and append the original agreement.

It would be troubling if lenders used the change to pressure companies into completely new loan agreements. Given today's relatively low borrowing

costs, however, an exit from existing debt clauses will probably be more beneficial than harmful.

#### Ownership strategy

The only factors that should influence a company's decision to lease or own equipment or property should be those that change the company's underlying fundamentals. These include the net-present-value impact of cash flows, the value of the flexibility that comes with shorter-term leases, alternate uses for the assets (decreasing the cost of a lease), and their strategic importance. The proposed accounting-rule changes would alter none of these, so a well-planned asset ownership strategy does not need to change. ○

<sup>1</sup> The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board proposed new rules to FASB 13, which governs lease accounting. They are expected to be finalized in 2011 and to go into effect in 2013.

<sup>2</sup> As of the time of writing, in March 2011, the FASB has directed its staff to consider rules that would still keep two types of leases that look close to the old distinction between operating and capital leases.

<sup>3</sup> See Timothy Koller and Werner Rehm, "Why accounting rules shouldn't drive strategy," *mckinseyquarterly.com*, February 2007; and Timothy Koller, "Numbers investors can trust," *mckinseyquarterly.com*, August 2003.

<sup>4</sup> Executory costs (such as real-estate taxes, utilities, and landscaping) would be excluded from this liability and measured as a periodic expense even if they are included in the original lease terms.

<sup>5</sup> Source for estimates: *Issues and solutions for the retail and consumer goods industries*, PricewaterhouseCoopers, 2010.

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