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Beyond focus: Diversifying for value

Companies that manage scope effectively deliver superior returns.

Neil W. C. Harper and S. Patrick Viguerie

Of all the things a company can do to improve its total returns to shareholders (TRS), honing its business focus is acknowledged to be among the most important. Extensive research by both practitioners and academics has produced a general creed that more focused business activity typically generates higher TRS.

Yet many CEOs and management teams running successful businesses have a different view based on their day-to-day experiences. Their assertion: leveraging scarce resources across multiple, even diverse businesses, is appropriate and can lead to superior value creation. They argue that at least some critical capabilities are constraining factors, including for example, management talent, or availability of capital. Moreover, they contend, investors implicitly fund strategies and management teams rather than individual projects.

To reconcile these perspectives, we examined 267 companies in six industries[1] in a sample including a crosssection of US business and broadly tracking the TRS performance of the S&P 500. We classified[2] the companies in our sample as focused, moderately diversified, or diversified,[3] using publicly reported financial information, data from analyst reports, and interviews with industry experts.[4] We then assessed performance in terms of TRS and adjusted for potential differences in risk by looking primarily at excess TRS, or TRS more than the mean of the relevant industry group.

The results should surprise adherants to conventional wisdom. Over the 10-year period from 1990–2000, the focused group tallied an average annual excess TRS of 8 percent, compared with 4 percent for the diversified group (Exhibit 1). But the moderately diversified group notched up 13 percent annual excess TRS and higher median EPS (earnings per share) growth.[5] Over a 20-year period, focused and moderately diversified companies again significantly outperformed diversified ones. Our conclusion: some moderately diversified business models can generate shareholder returns that are at least as strong as those generated by more focused models. The "focus is better" argument is not always the right answer, we found. And when it is, it may need a more nuanced explanation.

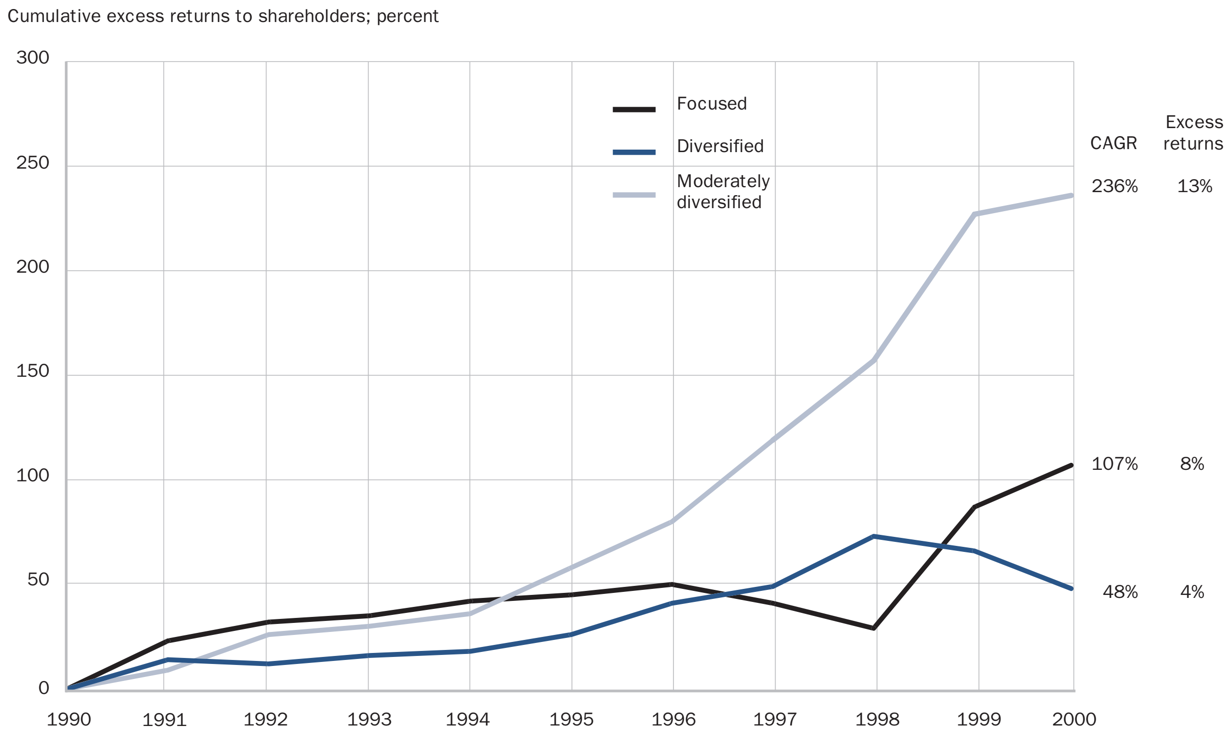
Diversifying for superior growth

To achieve and sustain the benefits of managing corporate scope, we looked in greater detail at the moderately diversified companies we identified. Several critical themes became clear.

Expanding options as an industry grows and matures

Moderately diversified strategies can, if carefully applied at the appropriate time in the corporate life cycle, allow corporations to surpass multiple industry or industry sub-segment growth cycles (Exhibit 2). For example, consider a company that has been a

Exhibit 1. Moderately diversified companies generated greater excess returns over 10 years



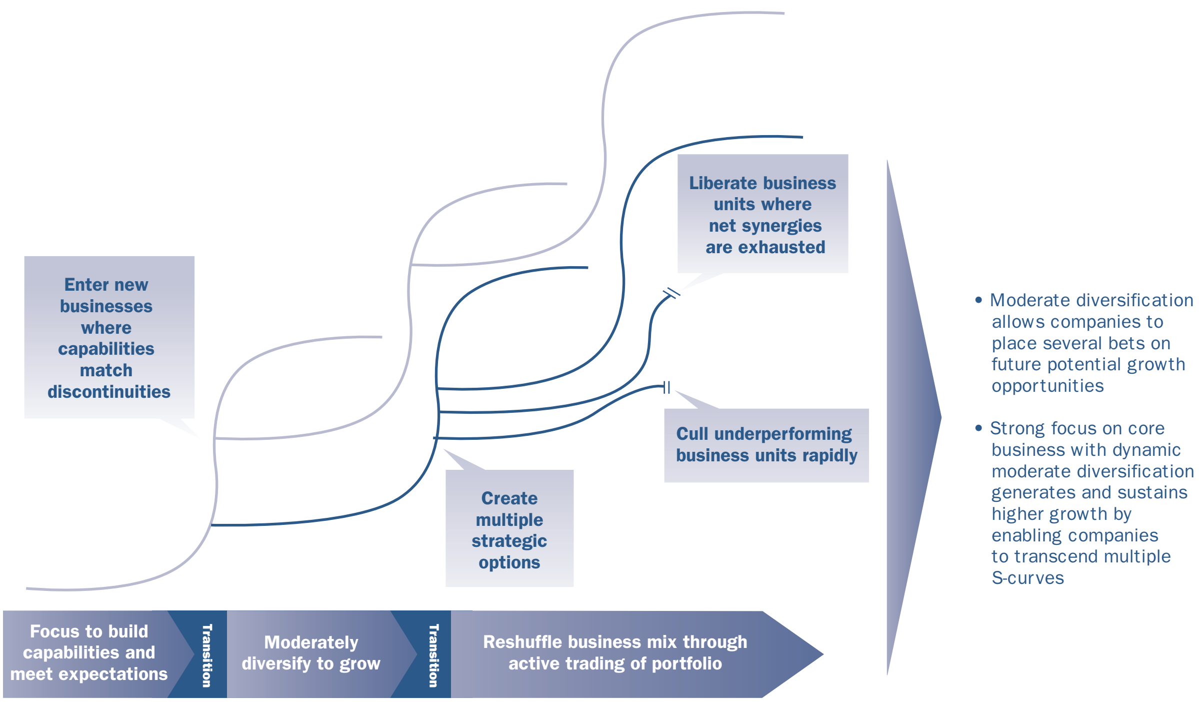
Source: McKinsey analysis

single business entity, but finds itself in a rapidly maturing space with growth rates tailing off. As it reaches this point of inflection on its industry S-curve, such a company faces a set of choices to maximize value from the "legacy" business as it matures, to reinvigorate growth expectations and to create a more sustainable entity in the longer term. This typically involves trade-offs among strategies to maximize short-term cash flow, to retain customers and ensure the value of a business well into its maturity, and to leverage customer relationships to build new businesses.

Corporations that have successfully carried out this strategy have moderately diversified and leveraged existing strengths. They use these strengths to take advantage of existing or emerging external discontinuities, such as developments in technology, changes in legislation, or changes in competitive landscape, to develop a strong position on emerging or early-stage business life cycles. Such successful diversification is typically into either somewhat related industries or into new business arenas where there are clear opportunities to leverage developed or emerging capabilities.

Consider Broadwing. Broadwing began life as the Cincinnati Bell local telephone company, but recognized in the 1980s that as a stand-alone and somewhat regulated entity its growth prospects were not highly attractive. Through an exploration of its existing

Exhibit 2. Moderate diversification allows companies to transcend multiple S-curves at certain points in their life cycles



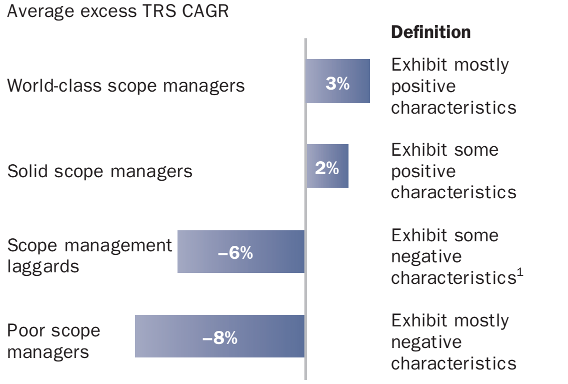
Source: McKinsey analysis

capabilities the company recognized its strengths in certain telephony-related systems and services including customer care, billing, and telemarketing. In addition, management realized that increasing market demand for third-party provision of such services represented an opportunity. Broadwing built a significant new business to provide call-center and back-office services to third parties that by the late 1990s was larger in terms of revenue than its traditional fixed-line local telephony business. In 1998 it spun off the operation as Convergys, a business with approximately $1 billion in revenue. Over that period the excess returns to the original shareholders, who by 1998 held both Broadwing and Convergys stock, were significant.

Naturally, companies can also add value by (re)imposing a greater degree of focus to transform overly diversified portfolios to a moderately diversified or focused position. Such corporations have refocused their portfolios around related businesses to create an attractive balance between growth and more mature businesses to more effectively leverage capabilities and telegraph their growth potential to the markets. Ivax, for example, was diversified across five businesses for most of the 1990s; its portfolio included generic pharmaceuticals, intravenous products, branded pharmaceuticals, cosmetics, and specialty chemicals. Recognizing that embedded long-term growth prospects were poor in many of these industries, Ivax undertook a bold move to focus its business

Exhibit 3. Strong corporate scope management is associated with higher excess returns

Excess returns versus industry, 1990–2000
Average excess TRS CAGR



[1] Includes companies with "neutral" net characteristics.
Source: Compustat, McKinsey's corporate performance database

portfolio. In the late 1990s it divested its specialty chemicals, cosmetics, and intravenous products businesses and made a series of international acquisitions to extend its more focused activities in branded and generic pharmaceuticals. The result: the company's stock price has more than tripled since 1998, with more than half of the increase attributable to enhanced long-term growth expectations.

Scoping out scope

To take advantage of the superior growth they can achieve by diversifying moderately at the appropriate time, companies must have a clear understanding of the degree of focus[6] in their existing portfolios and their relative expected long-term growth rate.[7] A thoughtful calibration of a company's starting point along each of these dimensions can help it evaluate opportunities to reshape its corporate portfolio and compare the impact of portfolio moves to other actions to create value.

The corporations most successful at transforming their strategies, whether increasing diversification or narrowing their focus, tend to follow some basic principles. They proactively assess their capabilities and scan possible external discontinuities in their industries to shape their focus objectives and then undertake a process of actively trading assets to achieve them. They rapidly sell underperforming businesses before market pressure demands it, but they also sell or otherwise separate successful businesses as soon as the majority of synergies have been captured, so as to achieve the benefits of separation earlier. Such benefits will include improved management focus, targeted management incentive programs, enhanced strategic freedom, and an improvement in the market for corporate control.

The impact of applying this approach can be significant—we found that the difference in average annual excess TRS over a 10-year period between "world class scope managers" (those that exhibited mostly positive behaviors based on these principles) and "poor scope managers" (those that exhibited mostly negative behaviors), was 11 percent. That can clearly translate into a significant amount of shareholder value (Exhibit 3).

For many executives, putting these principles into action entails a change of mindset. Many management teams are reluctant to part with their strong-performing businesses, even when synergies have long been captured. But their reluctance may mean leaving a significant amount of shareholder value unrealized. For example, on average the value creation for the parent shareholder from a divestiture is about 12 percent.

In proactively monitoring and matching existing and emerging internal capabilities with external discontinuities, successful scope managers zero in on, for example, changes in technology, regulation, or consumer behavior that may create adjacent opportunities. They do this both in related businesses and in new arenas where their capabilities may provide a source of initial competitive advantage.

One moderately diversified company, Kimberly-Clark, has dynamically reshuffled its portfolio based on its internal capabilities. The company started out in consumer products and newsprint. Over the course of the 1990s, Kimberly-Clark actively traded its business portfolio, continuously buying, selling, and looking for spin-off opportunities. Management closed a number of smaller, underperforming businesses where opportunities to improve were limited. The company also added to its business mix, to move into additional personal care products, leveraging its skills and capabilities and eventually diversifying into a small but growing health care business. Eventually it even leveraged the capabilities it developed while managing its own corporate jet fleet to build and manage a small airline business, which it ultimately spun off as Midwest Express.

The company's active approach to trading, continuously evaluating the growth potential of existing businesses, and mapping its skills against the needs of those businesses, allowed Kimberly-Clark to generate superior shareholder returns. As a result, the company has maintained long-term growth expectations on a rolling basis at anywhere from 10 percent to 30 percent of its share price.

The appropriate breadth of the corporate portfolio, or its scope, is a critical component of the CEO agenda. Yet a consistent view of how best to manage it is elusive. While managers are well-served to maintain a healthy bias towards focus as a starting point, pursuing a range of moderately diversified portfolio strategies, if applied at the appropriate stage in the corporate lifecycle, may help to generate and sustain significant additional growth and superior shareholder returns. MoF

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[1] Computer hardware, oil and gas, pharmaceuticals, pulp and paper, telecom services, and chemicals.

[2] Publicly reported revenues by business segment and reported Standard Industry Classification codes are inadequate as the basis for classification, largely because Financial Accounting Standards Board revenue segments are overly broad.

[3] We defined "focused" companies as those with at least 67 percent of revenues from one business segment, "moderately diversified" companies as those with at least 67 percent of revenues from two segments, and "diversified" companies as those with less than 67 percent of revenues from two business segments. We excluded conglomerates entirely because they have already been heavily researched and we did not expect new research to reveal new insight.

[4] The impact was to change some classifications: AT&T reported revenues from two segments—consumer and business—hence classifying it as "moderately diversified," and while the company does have significant consumer and business telephony operations, it also has a cable and broadband business, and, until recently, a wireless business, suggesting a "diversified" classification.

[5] These are the aggregate performance results of 37 moderately diversified companies and are consistent over both the 10 and 20 year periods.

[6] Based upon revenue share from different discrete business units.

[7] The portion of stock price accounted for by long-term (greater than five years) market expectations, relative to the mean of industry peers.

Viewpoint

Time for CFOs to step up

As investors home in on business fundamentals and credible accounting, the CFO's traditional role overseeing planning and performance takes on new urgency.

Timothy M. Koller and Jonathan Peacock

The chief financial officer's job has become more complex in recent years as mergers and acquisitions, financial structuring, and managing relations with investors and analysts have demanded increasing time and attention. At the same time, the potential value that the CFO adds in a more traditional role—as guardian and leader of good planning and performance management—has lapsed into neglect. Today, as business fundamentals and credible accounting become the new touchstones by which investors judge corporate quality, many companies would benefit from renewed attention by the CFO to helping the CEO understand the performance of the company's businesses and evaluating critical strategic decisions.

No question, mergers, financial dealings, and investor relations are important. Mergers can add significant value under the right circumstances, as can innovative financing. Good communications with investors and analysts can avoid unnecessary market volatility and ensure companies get credit for strategies they pursue. But for most companies, shareholder value comes from internally generated growth, through new products or services, new businesses or through cost/capital efficiences.

It is a characteristic of today's business climate that a seemingly endless stream of advice exists about shortcuts that promise to create value without much hard work. In just the past few years executives have been exposed to VBM (Value Based Management), EVA® (Economic Value Added, also known as economic profit), Balanced Scorecard, CFROI (Cash Flow Return on Investment), and a flurry of other performance measures. More recently, intangibles like brand and knowledge have captured attention. Most of these ideas are good and largely common sense, but none are perfect. And certainly none of them contain a magic bullet that would make improving performance easy.

Instead, the hard work of designing and implementing a successful planning and performance management approach is about developing a method that works for your company. Even the most sophisticated financial measures that aren't adapted to your situation will fail; a less sophisticated approach can create significant value if it is tailored to your industry and your needs.

With that in mind, here are four principles that CFOs can rely on to keep themselves—and their companies—on track.

1. Understand how your company creates value. It is surprising how many executives don't know exactly how their business units create value. In our research we found that half the retailers in the United States don't earn their cost of capital. Yet managers at many of these companies demonstrate an obsession with growth that will destroy value until they can figure out how to improve their returns on capital. In the pharmaceutical industry, for example, where the leading companies typically earn after-tax returns on capital in excess of 30 percent, growth has a much larger value impact than increasing returns. Yet many pharmaceutical companies don't effectively measure or manage the value of their research, development, and product launch activities. This process need not be overly complex, but it must give management transparency on cash flow, risk, and returns on capital invested.

In the absence of authoritative planning leadership, it is easy for executives to focus on the wrong value-creation measures. At one company, top managers agreed to vote on performance measures. Product innovation was popular with the management team. Analysis of how the company really created value, however, demonstrated that product innovation was not nearly as important as customer service and process management. Focusing on product innovation was distracting top management from real opportunities to create value. The bottom line: understanding how your company creates value isn't conceptually difficult, but it does require a disciplined approach.

2. Integrate financial and operational measures. Most planning and performance management systems are based entirely on short-term financial measures. Even a sophisticated financial measure like economic profit, which measures the return a company earns over its cost of capital, tells only where a company has been—not where it is going. Nor do most systems identify the value drivers behind financial performance. These value drivers need to be easily conveyed to line management, and also need to be periodically reviewed and updated. Shorter term metrics like economic profit should be used in conjunction with indicators of longer term performance, like market share, to avoid decisions that may improve value temporarily but destroy it in the long run.

The story of one leading consumer packaged goods company illustrates the flaw of focusing purely on financial measures. One of this company's most successful business units reported substantial operating profit growth year after year, consistently meeting or beating targets. As long as the unit appeared to be doing well, senior management did not question the unit's performance. Only later was it revealed that the way the unit achieved its profit growth was by raising prices. In itself, this would not be a bad move, but over several years the effect of the price increases was to create an umbrella for competitors to take market share. Declines in market share eventually reached the point where operating profit growth could not be sustained. The crisis that resulted led financial markets to lose confidence, forcing a major reorganization.

For the CFO, creating the best performance measurement systems entails seamlessly integrating financial and nonfinancial measures. With such a system in place, management can understand what drives financial results and provides access to leading indicators that help managers understand where the business is going.

3. Keep the measurement system transparent and uniform. Performance measurement systems can take on a life of their own. One company created a corporate staff of dozens to accurately calculate sophisticated financial measures. Predictably, the business units didn't believe, understand, or use them to run their businesses—largely because they were not involved in developing or adapting the measures. At another company, the calculations were so complex that business unit managers didn't understand how their decisions would affect their results.

Another common problem stems from implementing parallel or even competing measures. Typically, only one measure is taken seriously, while others get lost in the system. One company prominently introduced economic profit as a new performance measure, but only as a supplement to traditional income statement and balance sheet metrics. As such, it had no official standing in planning and reporting sessions and never made its way into the compensation system. Despite all the effort, the new measure was ignored.

Measuring financial performance is an imprecise discipline, but any system should focus on the true drivers of growth and return on investment. Companies should start with a simple, directionally correct measurement driven off standard financial statements as those are typically more useful than complex, theoretically correct systems. Furthermore, companies should use one system and language for budgeting, performance measurement, capital budgeting, and incentive compensation to avoid sending conflicting signals to managers.

4. Focus on the dialogue. The real purpose of planning and performance management is to help a company make better strategic and operational decisions. The best decisions are based on superior understanding of the business, which comes from an effective dialogue within the management team or between business unit managers and corporate managers.

The best numbers will not replace judgment, nor should they. But they will help managers understand the overall business, and help senior managers better understand the business units they oversee. They will help managers negotiate aspirational but realistic targets. And they will help them understand why business units meet or do not meet performance targets and what should be done.

The CFO is the guardian and the leader of good planning and performance management; he or she must not lose sight of the control dimension that the CFO role has traditionally held. By going back to basics, CFOs can bring to bear the capability, people, processes and systems to deliver on the principles outlined above and they can more effectively answer the critical questions investors are asking today about fundamental performance. The process may be less exciting than M&A and some other higher profile elements of the CFO job, but it is the bedrock through which value creation is managed. MoF

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Moving up in a downturn

Smart incumbents and challengers alike build advantage during slack times.

Richard F. C. Dobbs, Robert D. Jesudason, and Francis H. Malige

Recessions are unnerving. Price pressures increase while sales decline. Competition intensifies. Suppliers go out of business. But some companies seem to emerge from a recession with renewed strength. Some industry leaders fight off challengers to reinforce their market leadership. Smart challenger companies move ahead of their peers and into positions of leadership.

The stock market appears to be able to identify likely postrecession leaders and reward them with significantly higher valuations relative to their peers. During the 1990 to 1991 US recession, the gap between successful and unsuccessful incumbent leaders[1] in terms of market-to-book ratio increased from 12 percent in 1990 to 24 percent in 1991 and 38 percent in 1992. Among challengers, the gap between successful and unsuccessful companies widened from 5 percent in 1989 to 14 percent in 1990 to 18 percent in 1991 and 25 percent in 1992. The resulting increase in leaders' overall share of market capitalization gave them additional power to act as shapers in their industries, building a virtuous cycle of increasing valuations and better performance.

Successful strategies in a downturn

To identify how successful companies emerge from a downturn as leaders in their industries, we segmented 1,200 US companies by the change in their relative performance over a 20-year period, including the 1990 to 1991 recession.[2] We then compared and contrasted the management strategies of winning and losing industry leaders and challengers during the recession to the strategies of winners and losers in expansion periods before and after. We emerged with a list of nearly 150 companies that either remained or became industry leaders during the recession.

What did successful companies do that can lend insights in the current economic cycle? Challengers who emerged from the recession in the top quartile of their industries acted on many of the same levers as successful leaders who maintained their position, though challengers did take advantage of the downturn in ways that top quartile incumbents could not. Also, as might be expected, the strategies of the winners in both groups were different during the recession than during times of expansion (Exhibits 1 and 2). Our research uncovered strategic patterns of pursuing M&A, driving capital and expenditure efficiency with a vision of the future, and conservative debt financing.

Opportunistic M&A

The 1990 to 1991 recession appears to have been a good time to hunt for well-priced acquisitions, despite a significant reduction of overall M&A activity in and immediately after the downturn. Leading companies that retained their leadership status conducted 33 percent more M&A activity[3] during the

Exhibit 1. Strategies of successful leaders relative to their unsuccessful peers

Strategic lever	During the recession (1990–1991)	During the expansion ('80s and '90s)
M&A activity	• Higher M&A activity • Focus on smaller deals	• Significantly lower M&A activity • Focus on larger deals
Asset efficiency	• Significantly reduced and focused capex • Higher fixed assets and working capital productivity	• Somewhat lower capex • Similar fixed assets and working capital productivity
Cost efficiency	• SG&A expenditure refocused rather than cut back • Higher employee productivity • Higher R&D expenditure • Higher advertising	• Lean SG&A expenditure management • Higher employee productivity • Similar level of R&D expenditure • Somewhat lower advertising
Financing capacity	• Significantly higher debt financing capacity • Cautious use of excess cash	• Similar debt financing capacity

Source: McKinsey analysis

recession and 75 percent less activity outside the recession than did their unsuccessful peers.

The suggestion: successful top-quartile incumbents benefit from opportunistically picking up failing competitors at knock-down prices or by making surgical acquisitions of specific desired assets. Deals completed during the recession averaged only $85 million, an almost 90 percent decrease from their prerecession average of $645 million. This pattern should not come as a surprise, given the disproportionate management attention and integration effort that large M&A deals require. Leaders in a recession focus on protecting and improving their existing businesses; they are less likely to risk shifting management focus from the recession to executing and integrating a major acquisition.

Great Lakes Chemical, for example, a leader in the specialty chemicals industry, used the recession to reinforce its position through a series of M&A transactions, projecting itself to a top ranking in the industry.[4] The company made ten acquisitions in the 1990 to 1992 period alone, which contributed to its compound annual sales growth rate of 18 percent. At the same time, Great Lakes Chemical averaged a return on invested capital of 28 percent. To achieve this M&A-driven growth, the company exploited its under-leveraged balance sheet and already high level of operational performance. As a result, in terms of total return to shareholders (TRS) Great Lakes Chemical outperformed the S&P chemicals index by almost 270 percent between 1988 and 1993.

Exhibit 2. Strategies of successful challengers relative to their unsuccessful peers

Strategic lever	During the recession (1990–1991)	During the expansion ('80s and '90s)
M&A activity	• Similar M&A activity • Focus on significantly larger deals	• Significantly lower M&A activity • Focus on somewhat larger deals
Asset efficiency	• Significantly lower capex	• Significantly lower capex
Cost efficiency	• Significant cut-back on SG&A expenditure • SIgnificant cut-back on R&D • Significant cut-back on advertising	• Similar level of SG&A expenditure • Significantly higher R&D • Somewhat higher advertising
Financing capacity	• Significantly higher debt financing capacity • Aggressive use of excess cash	• Significantly higher debt financing capacity

Source: McKinsey analysis

The acquisition activity of successful challengers does not appear on the surface to distinguish them from their less successful peers; our measure of acquisition activity shows no statistically significant differences between successful and unsuccessful companies in the challenger group. However, this belies a very significant increase over non-recession periods when successful challengers perform 63 percent less M&A activity than their less successful peers.

In fact, successful challengers executed significantly larger deals during the recession than all other groups, with an average deal size in the 1990 to 1992 period of $174 million—more than double that of the successful leaders group. At the same time, the average number of deals per company in a year decreased by more than 30 percent. This seems to suggest that during the recession, successful challengers pursued M&A transactions that provided them with greater strength to shape their individual industries and relied on superior skills in deal identification, structuring, and integration to manage the added complexity. This underlines the frequent assertion that superior M&A skills are a key success factor for successful challengers.

Southwest Airlines offers one example of a substantial targeted M&A program. Based on our ranking methodology, Southwest Airlines rose from its second-quartile status before the 1990 to 1991 recession to the top position in its industry afterwards. It achieved this by aggressively leveraging the buyer's market for Boeing 737 regional jets to boost its capacity at excellent rates. The airline then complemented the acquisition of aircraft by acquiring only the landing slots, not the entire business, of their failed competitor Midway Airlines in 1991. In terms of TRS, Southwest Airlines outperformed the S&P airlines index by almost 630 percent between 1988 and 1993.

Successful leaders spent 22 percent more on R&D during the recession than their unsuccessful peers.

Asset efficiency

During the last recession, leaders that remained leaders stood out as efficient users of assets. Over the period their capital expenditure (capex) and depreciation[5] were 29 percent and 25 percent lower than those of their unsuccessful peers. This compares with non-recession periods, when the successful leaders spent just 10 percent less on capex than their peers, and show similar depreciation/sales ratios to them. Of course, such an attitude to assets did not preclude aggressive expansion.

Duke Power, for example, successfully defended its leadership status during the last recession, accelerating the development of a series of alliances to expand its capabilities in nonregulated areas ranging from engineering to nuclear waste to trading. The use of alliances during the recession provided an excellent way to obtain a foothold in new markets with limited capex and prepared the way for a subsequent program of acquisitions. Between 1988 and 1993 Duke Power outperformed the S&P utilities index by almost 60 percent in terms of TRS. Moreover, the recent acquisition of Westcoast Energy is a further example of Duke Power's sustained capacity to successfully execute M&A even in the current time of uncertainty.

Challengers that succeeded had a similar approach to asset productivity in and out of recession: those that moved up to become industry leaders had capital expenditures nearly 10 percent below the average of their industries during both the recession and the period of economic growth. There is some evidence, however, that many of the challengers that were successful during the recession had excess capacity at the start—collectively, successful challengers had a median depreciation/sales ratio 6 percent above the industry median—and were able to transform their capacity advantage into market share advantage.

Dell Computer is one example of a good execution of this aggressive approach. Dell started investing significantly before the recession and continued expanding its capital base despite the downturn. Dell's invested capital grew by 20 percent in 1989 and by more than 60 percent per year from 1990 to 1991. The results are well known: Dell's market share quadrupled from less than 1 percent in 1989 to almost 4 percent in 1992. Between 1988 and 1993 Dell Computer outperformed the S&P IT hardware index by more than 520 percent in terms of TRS.

Efficiency, but with an eye to the future

Leaders that remained leaders typically enjoyed sound employee efficiency, but during the last recession this particularly distinguished them from their unsuccessful peers: the employee/sales ratio versus the average of their industry was 27 percent lower for leaders that maintained their top-quartile status than it was for leaders that did not.

This is not to say that the leaders that succeeded during the recession were those that religiously cut costs across the board. Indeed, successful leaders actually spent 14 percent *more* on SG&A[6] than unsuccessful ones during the recession. This stands in sharp contrast to nonrecession periods, during which successful leaders spent 14 percent *less* on SG&A than their peers. In other words, leaders that succeeded during the recession cut back less than others on the nonpersonnel part of SG&A spend. Successful leaders spent 9 percent more (as a percentage of sales) on advertising, for example, than unsuccessful leaders in the recession compared to 3 percent less in nonrecession periods. Furthermore, successful leaders also spent 22 percent more on R&D[7] during the recession than their unsuccessful peers, contrasted with 9 percent more outside of the recession. The message seems to be that the industry leaders that remain successful concentrate on refocusing their SG&A expenditure during recessions, and do not merely cut it across the board.

Intel, for example, boosted its R&D expenditure during the 1990 to 1991 recession, reaching $780 million in 1992—an increase of 114 percent over 1989—with an increase in sales of 87 percent. Investment was also extended to Intel Penang in Southeast Asia, along with new operations in Ireland and New Mexico. The increase in R&D expense was considered necessary by Intel to "build the product . . . customers are demanding." Intel's commitment to R&D underpinned its strong performance during and after the recession, which helped strengthen its leadership position—between 1988 and 1993, Intel delivered TRS of almost 430 percent, outperforming the S&P semiconductors index by almost 40 percent.

Again, the story is quite different for challengers. During the 1990 to 1991 recession the successful challengers showed 13 percent lower SG&A-to-sales ratios than less successful challengers, and had slightly better efficiency as measured by their employees-to-sales ratio. Unlike the situation with leaders, however, cutting back SG&A appears to have been successful for challengers. POGO Producing, an oil and gas exploration company, moved from the fourth to the first quartile of industry performers precisely by employing this strategy. During a period in which the company's sales increased by 15 percent, POGO reduced costs by 3 percent by focusing on profitable oil production and lower-risk oil exploration. This strategy paid off as POGO outperformed the S&P oil & gas index by over 150 percent in terms of TRS between 1988 and 1993.

Challengers' excess cash/total assets dropped from a level 6 percent less than their industries prerecession to 41 percent below in 1990.

Wise use of financing capacity

Finance theory suggests that debt-financing capacity should not have an impact on success, as companies always have an ability to raise equity. However, in our research lower leverage emerges as an important enabler of success both in and out of recession.

During the 1990 to 1991 recession, leaders that remained successful had 16 percent lower interest expense/EBITDA[8] compared with leaders who lost their top-quartile position. This compares to a difference of only 5 percent out of recession. These figures illustrate how important low leverage can be during a recession. Similarly, successful challengers had 28 percent lower interest during the recession compared with 22 percent in nonrecession periods, underlining the importance of lower leverage both in recessions and expansions. Those leaders and challengers that entered the recession with significantly lower leverage than their peers were typically more successful, possibly because their lower leverage gave them much higher flexibility for opportunistic M&A, or to build for the future. The implication for highly leveraged companies is that they may need to focus their business portfolios through disposals. Unfortunately, a recession is generally a singularly bad time for this activity.

A source of significant difference among successful leaders and challengers was their ability and willingness to use excess cash to finance acquisitions and expansions. While the leaders that remained successful protected the excess cash on their balance sheet and their ratio of excess cash to total assets fluctuated around the average of their industry, successful challengers used their excess cash in their aggressive expansion. These challengers' excess cash/total assets dropped from a level 6 percent less than their industries prerecession to 41 percent below in 1990, and 30 percent below in 1991. At the same time, unsuccessful challengers entered the recession with significant excess cash balances and they continued to accumulate excess cash throughout the recession. The same measure for them stood at 19 percent above the industry in 1989 and reached 39 percent above the industry in 1991.

The 1990 to 1991 recession provided a significant opportunity for ambitious challengers to reposition themselves. Leaders, too, had to rethink and refine strategies to successfully defend their positions. While no two recessions are identical, corporate leaders in today's environment would do well to heed the lessons of the past. **MoF**

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[1] In our research project, we defined industry leaders as those in the top quartile of their industries. Challengers are those companies in the other quartiles as well as new entrants to the sample.

[2] Preceded by a long period of growth and characterized by low inflation, the 1990 to 1991 US recession is arguably the most appropriate comparison for the current global slowdown.

[3] Measured by an index of acquired asset value to total assets versus the average of their industries.

[4] According to our ranking method based on MVA (market value added) and ROIC (return on invested capital).

[5] We have used depreciation as a surrogate for asset intensity as it is not impacted by the age of the asset unlike net asset value; capex and depreciation were compared as a ratio of sales and versus the average of their industry.

[6] Sales, general, and administrative, measured by an index of SG&A-to-sales versus the average of their industries.

[7] Measured by an index of R&D to sales versus the average of their industries.

[8] Earnings before interest, taxes, depreciation, and amortization measured versus the average of their industries.

Corporate governance develops in emerging markets

Shareholders in emerging markets show they're willing to pay a premium for good governance standards.

Carlos E. Campos, Roberto E. Newell, and Gregory Wilson

Companies in emerging markets often assert that Western standards of corporate governance—particularly the US and UK models of governance that put maximizing shareholder value at the core of a company's mission—don't apply to them. "Things are different here," executives often say, citing extensive family ownership and different corporate cultures as conditions that make developed country standards of corporate governance less a priority.

We think otherwise. Our research indicates that both foreign and domestic investors in emerging markets do reward companies that adopt rigorous corporate governance standards. At one level, the findings suggest that emerging markets are naturally responding to the global trend in recent years of large activist shareholders pushing corporations to improve their governance structures and practices. And in light of the financial crises that have plagued emerging markets over the past five years, our research also provides evidence that a consensus is forming in the developing world that publicly stated strategies mean little to investors if a company lacks disclosure, transparency, management accountability, and ultimately a strong commitment to shareholder value.

In McKinsey's Emerging Markets Investors Opinion Survey 2001,[1] 76 percent of investors in Asian companies say that they worry about board practices as much as or more than financial issues. In every country surveyed, investors state that they would pay a premium for a well-governed company, as high as 30 percent in some emerging markets.[2]

Good governance is rewarded

Is there any hard evidence that improving corporate governance actually pays off? If investors are indeed putting their money where their mouth is, then there should be a clear link between a company's market valuation and its corporate governance practices. We evaluated 188 companies from six emerging markets[3] to see if such a link exists. Each company was rated along 15 elements of good corporate governance (Exhibit 1). To ensure consistency in the ratings, we developed explicit criteria for how ratings should be assigned. To control for researcher bias, we directed local teams to evaluate the companies from each market.[4]

The result: there is clear evidence that good governance is rewarded with a higher market valuation. Companies that have a higher score on our corporate governance index also enjoy higher price-to-book ratios.[5] This is true even after we controlled for a company's financial performance and other firm characteristics,

Exhibit 1. 15 elements of good corporate governance

1. **Dispersed ownership:** Although the presence of a large or majority blockholder is not necessarily a negative governance issue, a more dispersed ownership normally tends to be more attractive to investors. Most important, a company should have no single shareholder or group of shareholders who have privileged access to the business or excessive influence over the decision-making process.

2. **Transparent ownership:** A company's actual ownership structure should be transparent, providing adequate public information on breakdown of shareholdings, identification of substantial/majority holders, disclosure on director shareholdings, cross and pyramid holdings, and management shareholdings.

3. **One share/one vote:** A company should offer one share/one vote to all of its shareholders, and have only one class of shares. All shareholders should receive equal financial treatment, including the receipt of equitable share of profits.

4. **Antitakeover defenses:** The company should not have any share-, capital-, or board-related anti-takeover defenses.

5. **Meeting notification:** Shareholders should be notified at least 28 days prior to each general shareholder meeting to allow overseas investors to participate, and online participation should be available for shareholders.

6. **Board size:** The board should be neither too big nor too small. Empirical analyses suggest that the optimal board size is from five to nine members.

7. **Outside directors:** No more than half of the directors should be executives of the company.

8. **Independent directors:** At least half of the non-executive directors should be independent outsiders.

9. **Written board guidelines:** A company should have its own written corporate governance rules that clearly describe its vision, value system, and board responsibilities. Based on the rules, directors and executives should be fairly remunerated and motivated to ensure the success of the company.

10. **Board committees:** The board of a company should also appoint independent committees to carry out critical functions such as auditing, internal controls, and top management compensation and development.

11. **Disclosure:** Frequent and credible disclosure and transparency. At a minimum, a company should provide disclosure on financial and operating performance; business operations and competitive position; corporate charter, bylaws, and corporate mission; and board member backgrounds and basis of remuneration.

12. **Accounting standards:** A company should use an internationally recognized accounting standard (US GAAP, UK GAAP, or IAS) for both annual and quarterly reporting.

13. **Independent audit:** A company should perform an annual audit using an independent and reputable auditor.

14. **Broad disclosure:** A company should offer multiple channels of access to its information, including both on-line and off-line access. Information should be in both local language and English.

15. **Timely disclosure:** Information should be disclosed in a timely manner based on standards at the listing stock exchange.

Source: Derived from *OECO Principles of Corporate Governance,* Organization for Economic Co-operation and Development, 1999.

such as size. Investors are more confident in—and actually pay a premium for—a company that is committed to protecting shareholder rights, has frequent and transparent financial reports, and has an independent board providing management oversight. These fundamentals apply even though the corporate governance approaches that individual companies emphasize can vary.[6]

The premium investors will pay can be quite large. In all countries and industries, a firm could expect a 10 to 12 percent increase in its market valuation by moving from worst to best on any one of the 15 elements of corporate governance (Exhibit 2). Consider Alsea SA, a company in the Mexican food industry. Its book value and market value were 720 million pesos and 1,440 million pesos, respectively, in 1999. The company's onerous antitakeover provisions earned it the lowest possible score on that component of the evaluation. Even if Alsea didn't completely eliminate its array of takeover protections, it would be reasonable to assume that its market value would increase by more than 10 percent based on our research of companies in similar situations.

We also found important differences between countries in how companies rate on corporate governance. In general, Korean and Malaysian companies had the highest average scores, while Mexican and Turkish companies had the lowest. This is due to the concerted efforts in Korea and Malaysia after the 1997 Asian crisis to improve corporate governance, efforts that were not made in Mexico or Turkey after their respective crises in 1994. The fact that Korean and Malaysian companies have larger, more established capital markets is also a factor, since this means that there are more outside investors who are likely to scrutinize companies and demand change.

Exhibit 2. Effect of moving from worst to best in one component of corporate governance

Country	Industry	Effect
India	Chemicals	10.6
	Textiles	12.4
Korea	Auto Parts and Equipment	10.0
	Textiles	9.8
Malaysia	Building Materials	10.4
	Engineering and Construction	10.0
Mexico	Food	11.8
	Retail	11.8
Taiwan	Electronics	10.7
	Food	10.7
Turkey	Building Materials	12.0
	Food	12.2
	Textiles	11.8

Source: McKinsey analysis

Korea in particular stands out as a pioneer in advancing the cause of board responsibilities and shareholder rights.[7] Korea in many ways led the governance reform efforts after the Asian crisis. The government mandated, among other things, that the major banks and chaebol[8] appoint a majority of outside directors and establish committees and transparent board responsibilities. It removed ceilings on foreign ownership, thus sparking competition, and lowered the threshold for a group of shareholders to sue the board if they failed to protect their interests. So far, the shareholder rights group People's Solidarity for Participatory Democracy has challenged major companies such as SK Telecom and Samsung Electronics to test these new reforms.

Ties to nearby developed countries clearly help shape the approaches that some emerging countries take to higher standards of governance. Mexican companies, for example, generally score poorly on corporate governance measures largely because of their reluctance to give up family control. But they score very highly on transparency. This is because among the six countries surveyed, Mexican companies were most likely to be cross-listed on US exchanges, and even family-controlled boards must comply with tough SEC standards on financial reporting.

Leapfrogging the competition

Adopting sound corporate governance practices can also help companies leapfrog competitors. To follow up our statistical analysis, we took an in-depth look at 11 companies in seven countries that have all substantially improved their corporate governance practices. As expected, their performance also improved: each beat its respective local market indices by at least 20 percent in the 12-month period from May 2000 to May 2001.

Market valuation is driven by many factors, of course. Further research will be needed to draw firm conclusions about the impact of governance on valuation. Still, a closer look at our case studies illustrates why good governance should translate into improved performance. Disclosure and transparency around financial results, for example, allow a company to set clear targets and hold employees accountable for results, all the way from top management to the newest employees. An audit committee is an essential check on the CFO and can bring a much-needed market perspective to risk management strategies and techniques. Similarly, a management compensation committee is critical for creating the right incentives. And independent, outside directors bring a fresh and objective perspective to the company, which is critical for decisions that are counter to the interests of company insiders. **MoF**

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1 We surveyed attendees at the International Finance Corporation's Global Private Equity Conference (May 10–11, 2001). The 46 respondents, all of whom are private equity investors, manage approximately $5 billion in assets, 90 percent of which is invested in emerging markets.

2 McKinsey & Company's Emerging Markets Investor Opinion Survey 2000. We surveyed institutional investors on their views of corporate governance and, in particular, their willingness to pay for well-governed companies. In aggregate, respondents managed approximately $3.25 trillion in assets.

3 India, Korea, Malaysia, Mexico, Taiwan, and Turkey.

4 We tested the relationship between market valuation and corporate governance using a least-squares regression. The independent variable was each company's aggregate corporate governance score, stated as the percent difference from the average score in the given industry and country. The dependent variable was the company's price-to-book ratio at the end of 1999, again stated as percent difference from the country-industry average. A price-to-book ratio above average indicated that investors were willing to pay a premium for the company.

5 This result was statistically significant at the 95 percent confidence level.

6 For example, executives in Korean companies stress shareholder rights and corporate board reform, while those in Mexico focus on account transparency.

7 For more on the Korean effort, *see* "Building Asian Boards," Dominic Barton, Robert F. Felton, and Ryan Song. *The McKinsey Quarterly*, 2000 No. 4 Asia.

8 Korean term for a conglomerate of many companies clustered around one parent company. Chaebol usually hold shares in each other and are often run by one family.

Viewpoint

A new way to measure IPO success

The double-digit first-day jump, celebrated as the measure of success for an IPO, must be replaced by metrics that include longer-term vision.

Roman Binder, Patrick Steiner, and Jonathan Woetzel

The IPO market is beginning to show signs of recovery. While uncertainty hangs over equity markets as a whole, many analysts are taking encouragement from post-IPO pricing well above the initial list. Some anticipate a surge in IPOs as companies proceed with offerings postponed from 2001.

As the market recovers, one common indicator of success that many IPO watchers continue to apply is the increase in share price on the first day of trading. During the 1990s IPO boom, some considered a two-digit increase to be *the* measure of IPO success. Others drew a benchmark from so-called daily doublers, or IPOs that doubled their share price on day one. True, an argument can be made that some measure of underpricing is appropriate compensation for first-round investors who face levels of risk that they would not face for secondary offerings.[1] But even then, from the perspective of issuing shareholders, an excessive first-day jump should be viewed as a measure of the mis-pricing and failure of an IPO, rather than as a measure of its success.

No question, extremes such as Theglobe.com's November 1998 IPO, with first day returns over 300 percent, helped to firmly establish an industry norm of significant IPO under-pricing—offering shares at prices far below the expected first-day closing price. On average, IPOs were underpriced by only 11 percent between 1990 and 1998, but that gap soared to almost 70 percent during 1999 and 2000. Indeed, the enormous jumps of the 1990s have even sparked regulators to scrutinize numerous deals. Whether driven by capital market inefficiencies or inappropriate pricing, the fact is that issuing shareholders probably got short shrift. In 1999 and 2000 alone corporate America left more than $60 billion on the table[2]—money that could have been invested in the development of the newly listed companies.

How should IPO success be measured? To answer that question we examined 230 IPOs around the world between 1991 and 2000, ranging from $50 million to $18 billion. We included a broad selection of IPO situations: new dot-com companies, established private companies and family-owned businesses, and spin-offs of larger corporations or state-owned companies. Within this range we sought common measures of IPO success across business sectors, economic cycles, and sources of offered assets in strong and weak markets. We analyzed financial data and detailed offer prospectus information, and conducted interviews to clarify and interpret the results.

While there are obviously large differences in the number and types of activities involved for the myriad of IPO situations, we developed a new, practical way to measure an IPO's success that eschews the goal of a huge first-day leap in share price. We view it as a more valuable metric because it takes into account a company's longer-term competitiveness and the degree to which both new and existing shareholders are fairly compensated.

Our metric comprises two parts:

1. Market Competitiveness: relative company value equal to or higher than industry peers. Within 30 days of the IPO, the company's market capitalization should be at or above the level of its industry peers. For companies in banking and financial services, for example, relative company value may be measured as market-to-book value of equity. For industrial companies, multiples such as market value of equity over earnings, entity value over EBITDA[3] or cash flow may be more appropriate. This relative value expresses a company's competitiveness in the capital markets. Investors can thus use it as a guide to better understand a company's continuing ability to attract funding.

Using this measure, 50 percent of the IPOs from the 1990s considered highly successful by the first-day jump measure (i.e., greater than 20 percent jump) would actually have been judged to have been failures. By contrast, 74 percent of the companies that proved strong relative to competitors after 30 days had less than a 20 percent first-day jump.

2. Market Pricing: Less than 20 percent change between offering price and 30-day post-IPO market capitalization. Only an offering price that reflects the market value of the assets sold ensures that both new and issuing shareholders are fairly compensated. Market value should be measured 30 days after an IPO to allow the market time to fairly evaluate the assets on offer. Once again, using this measurement many IPOs considered successful during the 1990s generally appear to have been unfairly priced. Large first-day jumps translate into significant price changes over the first 30 days of trading and are thus a significant and inappropriate transfer of value to subscribers. Only a quarter of IPOs with first-day jumps exceeding 20 percent eventually settled within 100 percent to 120 percent of their IPO price 30 days later. Conversely, only 14 percent of IPOs that did settle within 100 percent to 120 percent of their IPO price after 30 days had seen a first-day jump exceeding 20 percent.

In fact, only 8 percent of all the IPOs we measured were both competitive in terms of relative value with industry peers and offered at a fair market price. That's obviously not the kind of statistic that fits easily with the IPO hype that characterized the last bull market. But when the IPO game does return, it would be worth keeping in mind for those executives looking to take assets public in order to genuinely boost shareholder value. MoF

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[1] Information assymetry between existing and new investors can lead to underpricing, as agreed in a broader context by Nobel laureates George A. Akerlof, A. Michael Spence, and Joseph E. Stiglitz.

[2] Jay Ritter, quoted in "A penny in whose pocket?" *The Economist*, May 26, 2001, U.S. Edition. *See also,* http://bear.cba.ufl.edu/ritter/.

[3] Earnings before interest, taxes, depreciation, and amortization.

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ATHENS
ATLANTA
AUCKLAND
AUSTIN
BANGKOK
BARCELONA
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BUDAPEST
BUENOS AIRES
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