Are your strategy discussions stuck in an echo chamber?

Building a “market-momentum case”—based on external as well as internal data—can help executives allocate resources more effectively and identify new sources of value.

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Sometimes, companies can inadvertently lose sight of the big picture when setting business strategies and targets. Line managers and senior executives hold overly optimistic views about projects and performance, and they use mostly internal data to develop plans around major product lines or individual customer segments or regions.[1]

As a result, they often end up with the familiar "hockey stick" plan—a projection that performance will sail upward after a brief early dip to account for up-front investment. This forecast does not reflect market realities, so the company consistently underperforms against the plan given market pressures, under-investment, or both.[2]

A multinational industrial company learned this the hard way. Analysts and investors questioned the company's ability to grow profitably in a market that was under significant price pressure from new entrants. Yet senior executives at the company continued to insist it was possible. They based their optimism on, among other things, market intelligence from line managers about customer preferences, and on a business plan that assumed efficiencies would compensate for decreased prices—and that margins would, therefore, not deteriorate.

Armed with this optimistic view, the company did not make big moves to capitalize on the advantages it held over new entrants. After several quarters in which the company missed its growth and margin targets, the share price dropped sharply. Senior management realized it had to revise both the company's strategy and its communication to investors about its strategic targets.

Clearly, there is no benefit to conducting strategy discussions in an echo chamber. Companies need to factor external perspectives into their resource-allocation conversations. And executives must be willing to challenge their own assumptions about whether the baselines and metrics they are using are the correct ones.

A full "market-momentum case" can help them do that. It provides a dispassionate forecast of where a company's economics are going rather than where they have been. It demonstrates how any changes in end markets, competitors, prices, and other external variables will affect a company's profits, cash flow, and valuation if no action is taken. The market-momentum case can serve as a solid starting point for strategy discussions; it can also serve as a useful benchmark against which to measure all business plans.

In our experience, when executives consider the market-momentum case alongside existing strategic plans, they typically end up in engaged conversations about how investments, targets for growth, and cost-reduction initiatives may complement one another and be successful—a far cry from the relative silence in the echo chamber.

Why the market-momentum case?

Consider the standard strategy-setting process: managers develop a "base case" that outlines financials and other targets over the next three to five years. To meet senior leaders' and the board's expectations, managers tell a hopeful story in the base case—demonstrating continual improvement in margins and financial impact, and minimizing inevitable obstacles to growth. After all, who ever got promoted by pushing a strategic plan that predicted declining margins and stagnation?

That is when the hockey sticks emerge. No one is explicitly discussing core questions, such as: Why do we believe the company can grow faster than the market in two years? Exactly which investments are supporting this optimistic outlook, and are these investments accurately reflected in the operating plan for the next 12 months? How might this base case be offset by pricing pressure? What's more, managers' biases toward overconfidence and overoptimism can affect not just strategic-planning discussions but also other complex business conversations about, for instance, acquisitions, cost transformations, and divestitures.[3] More forecasts, more hockey sticks.

A market-momentum case gives the company a holistic view of how profit and loss, the balance sheet, and corporate value will be affected if the company follows market growth, cost development, and pricing dynamics without taking any countervailing actions.

Executives often hesitate to present such an integrated economic case, fearing that it might result in a corporate valuation below the current market value of the company. This, however, is the point: if companies don't make explicit strategic investments to increase value or take direct actions to improve operations, they may drift with the market and deteriorate quickly. A discussion that starts with the market-momentum case can help to ensure that alternatives are being debated, actions are being supported by investment, and everyone is aware of the risks and challenges.

Building the market-momentum case

There is no one right way to build a market-momentum case; individual companies will have varying types of external data at their disposal and will be at different starting points in their strategy and resource-allocation discussions. It is critical, however, that the market-momentum case be built without advocacy from the parties involved. In this regard, the CFO or chief strategy officer (CSO) may be in the best position to lead the effort. Even in scenarios in which the business-unit leaders have deep market perspectives and insights, the CFO or CSO can provide a useful reality check, as these leaders are typically seen as relatively dispassionate arbitrators.

To successfully build a market-momentum case, companies and planning teams should take the following four steps:

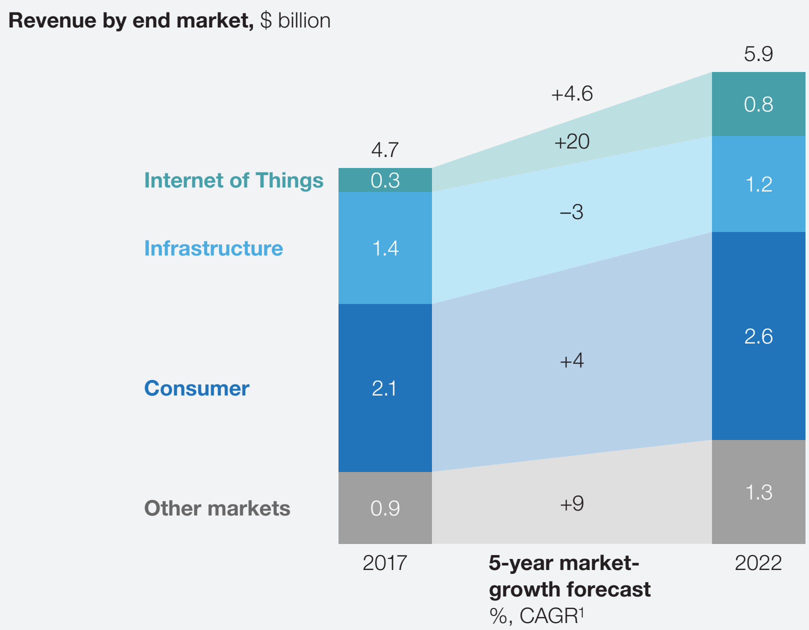
1. Take inventory

The first step is to consider the company's performance over the past five years. This step requires a thorough review of a range of corporate metrics—for example, organic growth, return on invested capital, capital injection for growth, and mergers and acquisitions. But these measures alone will not present the whole picture. Company performance must be evaluated against end-market performance over the same period; the latter can be assessed using variables such as market growth, market share, and average industry margins. The goal of this exercise is to give planning teams and executives an accurate understanding of the business context and the choices still available to them: What new product-development initiatives or acquisitions has the company pursued previously, how successful were they really, and what opportunities are still left in the pipeline?

If companies don't make explicit strategic investments to increase value or take direct actions to improve operations, they may drift with the market and deteriorate quickly.

Exhibit 1

Taking the outside view helped a technology company better understand its opportunities for growth.



[1] Compound annual growth rate.

Source: Company filings; IDC; S&P Capital IQ; McKinsey analysis

2. Identify the end-market momentum

The next step is to map all of the company's products to their customer end markets. This process might be simple if the company is organized according to end markets; in today's global businesses, however, this is often not the case. To understand the issue, let's consider a company in the high-tech industry that designs and manufactures thousands of SKUs across many lines of businesses—for instance, power converters, digital and analog microchips, discrete semiconductor chips, and similar parts. The company's growth plans were informed by an aggregated look at all the segments, resulting in projections that seemed aggressive. Upon their review of products and end markets, however, executives realized that more than 80 percent of the high-tech company's products were going primarily to three major markets: a consumer-driven end market, an infrastructure market, and an Internet of Things (IoT) market.

This perspective on "where we play" was not at all reflected in the company's business structure, which was oriented according to product lines, not end markets. The findings prompted the CSO to analyze internal and external market research and to interview experts on growth in these end markets and the development of average sale prices. The CSO then used the data to develop a completely revised perspective on what the top line of the market-momentum case would be: slow growth in the consumer market, shrinkage in the infrastructure market, and high growth in the IoT market (Exhibit 1).

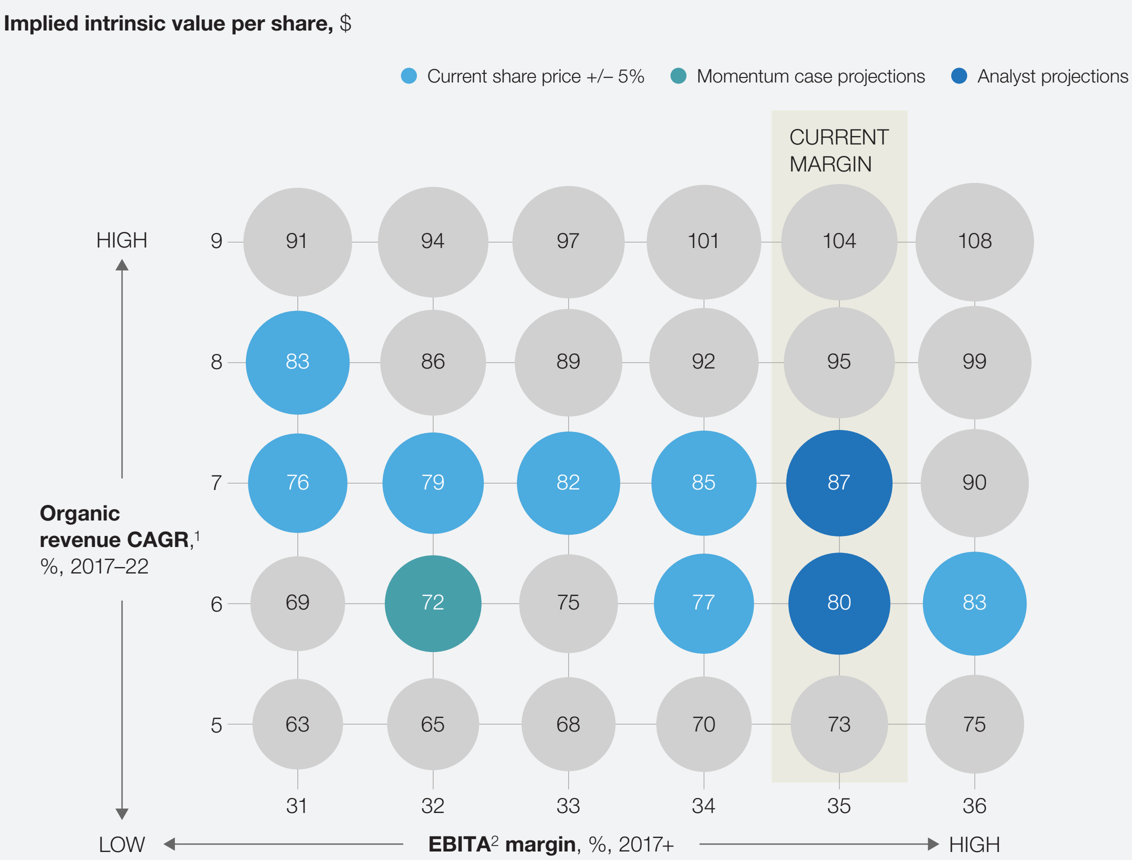
3. Analyze the margin momentum

In many companies, margins for the entire product portfolio will change as the product mix does. A market-momentum case will pressure-test whether the trajectory of margins for the portfolio is stable in the wake of these shifts. An explicit forecast of product- or segment-level margins is particularly warranted in the presence of certain, inevitable industry trends—drugs coming off patent, for example, or inflation in the cost of product inputs.

The central strategy team in one healthcare-equipment company was reviewing the company's investment in a technology-driven-product market. Through external interviews and market research, the team learned that, within three to five years, Asian competitors were planning to

Exhibit 2

Valuation based on market momentum will be lower than value implied by investors and analysts.



[1] Compound annual growth rate.
[2] Earnings before interest, taxes, and amortization.

Source: Company filings; IDC; S&P Capital IQ; McKinsey analysis bring to that market a technology with functionality similar to the healthcare company's own. Margins in that product segment would be under significant pressure—a fact that was not reflected in the team's base-case projections. Under pressure to show an optimistic base case, the leader of that product segment simply assumed that the company could reduce costs to make up for any drop in price. There was no explicit discussion about whether such a move was possible or whether there were appropriate investments against this plan. The P&L in the market-momentum case, however, showed a different picture: product margins for the whole company would significantly deteriorate under this scenario. The strategy team used the market-momentum case to start a discussion about how much investment would be needed to counteract competitors' moves and whether strategic alternatives, like a sale, might be warranted.

4. Value the momentum case

A market-momentum case, once established, should be used to assess implied shareholder value. Many companies use a discounted-cash-flow model to determine the value of a business plan, which will often show a value per share that is 20 to 50 percent above the market. By contrast, a market-momentum case, when done right, may reveal a figure close to or even below current valuation or analysts' targets—a scenario that is not only acceptable but also likely in a company's life cycle. We also find that the market-momentum case often reflects the starting point of a typical investor's view of a company. Consequently, an explicit discussion of the value implied by the market-momentum case can help to educate board members; they begin to realize that investors do understand market trends and price the company relatively fairly (Exhibit 2). And the board and senior management can better explain to investors how they believe the company will overcome market momentum and outperform peers.

Implementing the market-momentum case

It often does not take much time to develop a market-momentum case; this was true even before the advent of digital tools and analytic methods. Teams generally spend most of their time trying to understand external market forecasts and competitive trends. Even so, modern digital tools (for instance, cloud-based analytics) can make the development and continuous refinement of a market-momentum case easier for planning teams to manage. Indeed, companies can integrate the tools and approaches that best fit within their existing strategic planning processes.

If the company has a top-down strategic planning process, the corporate center (CFO or CSO office) should centrally define the end markets to which the overall company is exposed and provide relevant data to the business units that deliver products to the markets—for instance, information about total-addressable-market (TAM) size and growth forecasts. This centralized approach will ensure a consistent application of market-momentum insights across a company in which multiple businesses may sell to the same end market. In practice, there would be some healthy back and forth among the business units and the corporate center, as the business units' proximity to customers may present opportunities to update the end-market perspective.

If the company has a bottom-up strategic planning process, the company could adopt a flexible, decentralized model in which the business units lead the development of a market-momentum case. The central corporate-planning team may find it challenging to reconcile the different data points and methodologies used by individual business units; some may weight TAM over growth forecasts, for example. But they can mitigate this problem by mandating that business units make important market assumptions transparent, which CFO and CSO teams can reconcile or override, if needed.

So how should the CFO consider the market-momentum case amid all the plans, targets, aspirations, and goals within the typical complex organization? The short answer is, it depends. Executives at the corporate center, for instance, can use a market-momentum case to set targets and metrics that hold the business units accountable for key performance indicators that demonstrate outperformance. Alternately, executives can use a market-momentum case to identify potential gaps in the product portfolio, as well as the big strategic moves that can address those gaps. In the case of the healthcare-equipment company cited earlier—the one facing pressure associated with a core technology—the planning team was prompted to realistically assess whether the company should develop a lower-cost, replacement technology, or an exit strategy.

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A strategic-planning process that systematically incorporates the "outside view" in near- and long-term planning can drive executives out of their echo chambers. Rather than being overoptimistic about company performance, they can use a market-momentum plan to increase internal transparency and boost the effectiveness of management planning. ■

[1] Daniel Kahneman and Dan Lovallo, "Delusions of success: How optimism undermines executives' decisions," *Harvard Business Review*, July 2003, hbr.org.

[2] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.

[3] Daniel Kahneman and Dan Lovallo, "Timid choices and bold forecasts: A cognitive perspective on risk taking," *Management Science*, Volume 39, Issue 1, January 1993, pp. 17–31.

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