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The real business of business

Shareholder-oriented capitalism is still the best path to broad economic prosperity, as long as companies focus on the long term.

**Marc Goedhart,
Tim Koller, and
David Wessels**

The guiding principle of business value creation is a refreshingly simple construct: companies that grow and earn a return on capital that exceeds their cost of capital create value. The financial crisis of 2007–08 and the Great Recession that followed are only the most recent reminders that when managers, boards of directors, and investors forget this guiding principle, the consequences are disastrous—so much so, in fact, that some economists now call into question the very foundations of shareholder-oriented capitalism. Confidence in business has tumbled.¹ Politicians and commentators are pushing for more regulation and fundamental changes in corporate governance. Academics and even some business leaders have called for companies

to change their focus from increasing shareholder value to a broader focus on all stakeholders, including customers, employees, suppliers, and local communities.

No question, the complexity of managing the interests of myriad owners and stakeholders in a modern corporation demands that any reform discussion begin with a large dose of humility and tolerance for ambiguity in defining the purpose of business. But we believe the current debate has muddied a fundamental truth: creating shareholder value is not the same as maximizing short-term profits—and companies that confuse the two often put both shareholder value and stakeholder interests at risk. Indeed, a system

focused on creating shareholder value from business isn't the problem; short-termism is. Great managers don't skimp on safety, don't make value-destroying investments just because their peers are doing it, and don't use accounting or financial gimmicks to boost short-term profits, because ultimately such moves undermine intrinsic value.

What's needed at this time of reflection on the virtues and vices of capitalism is a clearer definition of shareholder value creation that can guide managers and board directors, rather than blurring their focus with a vague stakeholder agenda. We do believe that companies are better able to deliver long-term value to shareholders when they consider stakeholder concerns; the key is for managers to examine those concerns systematically for opportunities to do both.

What does it mean to create shareholder value?

If investors knew as much about a company as its managers, maximizing its current share price might be equivalent to maximizing value over time. In the real world, investors have only a company's published financial results and their own assessment of the quality and integrity of its management team. For large companies, it's difficult even for insiders to know how the financial results are generated. Investors in most companies don't know what's really going on inside a company or what decisions managers are making. They can't know, for example, whether the company is improving its margins by finding more efficient ways to work or by simply skimping on product development, maintenance, or marketing.

Since investors don't have complete information, it's not difficult for companies to pump up their share price in the short term. For example,

from 1997 to 2003, a global consumer-products company consistently generated annual growth in earnings per share (EPS) between 11 and 16 percent. Managers attributed the company's success to improved efficiency. Impressed, investors pushed the company's share price above that of its peers—unaware that the company was shortchanging its investment in product development and brand building to inflate short-term profits, even as revenue growth declined. In 2003, managers were compelled to admit what they'd done. Not surprisingly, the company went through a painful period of rebuilding, and its stock price took years to recover.

In contrast, the evidence makes it clear that companies with a long strategic horizon create more value. The banks that had the insight and courage to forgo short-term profits during the real-estate bubble earned much better returns for shareholders over the longer term.² Oil and gas companies known for investing in safety outperform those that haven't. We've found, empirically, that long-term revenue growth—particularly organic revenue growth—is the most important driver of shareholder returns for companies with high returns on capital (though not for companies with low returns on capital).³ We've also found a strong positive correlation between long-term shareholder returns and investments in R&D—evidence of a commitment to creating value in the longer term.⁴

The weight of such evidence and our experience supports a clear definition of what it means to create shareholder value, which is to create value for the collective of all shareholders, *present and future*. This means managers should not take actions to increase today's share price if they will reduce it down the road. It's the task of

management and the board to have the courage to make long-term value-creating decisions despite the short-term consequences.

Can stakeholder interests be reconciled?

Much recent criticism of shareholder-oriented capitalism has called on companies to focus on a broader set of stakeholders, not just shareholders. It's a view that has long been influential in continental Europe, where it is frequently embedded in the governance structures of the corporate form of organization. And we agree that for most companies anywhere in the world, pursuing the creation of long-term shareholder value requires satisfying other stakeholders as well.

We would go even further. We believe that companies dedicated to value creation are healthier and more robust—and that investing for sustainable growth also builds stronger economies, higher living standards, and more opportunities for individuals. Our research shows, for example, that many corporate-social-responsibility initiatives also create shareholder value, and managers should seek out such opportunities.⁵ For example, IBM's free web-based resources on business management not only help to build small and midsize enterprises but also improve IBM's reputation and relationships in new markets and develop relationships with potential customers. In another case, Novo Nordisk's "Triple Bottom Line" philosophy of social responsibility, environmental soundness, and economic viability has led to programs to improve diabetes care in China. According to the company, its programs have burnished its brand, added to its market share, and increased sales—at the same time as improving physician education and patient outcomes. Similarly, Best Buy's efforts to reduce attrition among women employees

not only lowered turnover among women by more than 5 percent, it also helped them create their own support networks and build leadership skills.

But what should be done when the interests of stakeholders don't naturally complement those of a company, for instance, when it comes to questions of employee compensation and benefits, supplier management, and local community relationships? Most advocates of managing for stakeholders appear to argue that companies can maximize value for all stakeholders and shareholders simultaneously—without making trade-offs among them. This includes, for example, Cornell Law School professor Lynn Stout's book, *The Shareholder Value Myth*,⁶ in which Stout argues persuasively that nothing in US corporate law requires companies to focus on shareholder value creation. But her argument that putting shareholders first harms nearly everyone is really an argument against short-termism, not a prescription for how to make trade-offs. Similarly, R. Edward Freeman, a professor at the University of Virginia's Darden School of Business, has written at length proposing a stakeholder value orientation. In his recent book, *Managing for Stakeholders*, he and his coauthors assert that "there is really no inherent conflict between the interests of financiers and other stakeholders."⁷ John Mackey, founder and co-CEO of Whole Foods, recently wrote *Conscious Capitalism*,⁸ in which he, too, asserts that there are no trade-offs to be made.

Such criticism is naive. Strategic decisions often require myriad trade-offs among the interests of different groups that are often at odds with one another. And in the absence of other principled guidelines for such decisions, when there are trade-offs to be made, prioritizing long-term value

The evidence makes it clear that companies with a long strategic horizon create more value.

creation is best for the allocation of resources and the health of the economy.

Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment relative to competitors, underpaying employees, or skimping on benefits will have trouble attracting and retaining high-quality employees. Lower-quality employees can mean lower-quality products, reducing demand and hurting reputation. More injury and illness can invite regulatory scrutiny and more union pressure. More turnover will inevitably increase training costs. With today's more mobile and more educated workforce, such a company would struggle in the long term against competitors offering more attractive environments. If the company earns more than its cost of capital, it might afford to pay above-market wages and still prosper—and treating employees well can be good business. But how well is well enough? A stakeholder focus doesn't provide an answer. A shareholder focus does. Pay wages that are just enough to attract quality employees and keep them happy and productive, pairing those with a range of nonmonetary benefits and rewards.

Or consider how high a price a company should charge for its products. A shareholder focus would weigh price, volume, and customer satisfaction to determine a price that creates the most shareholder value. However, that price would also have to entice consumers to buy the products—and not just once but multiple times, for different generations of products. A company might still thrive if it

charged lower prices, but there's no way to determine whether the value of a lower price is greater for consumers than the value of a higher price to its shareholders. Finally, consider whether companies in mature, competitive industries should keep open high-cost plants that lose money just to keep employees working and prevent suppliers from going bankrupt. To do so in a globalizing industry would distort the allocation of resources in the economy.

These can be agonizing decisions for managers and are difficult all around. But consumers benefit when goods are produced at the lowest possible cost, and the economy benefits when unproductive plants are closed and employees move to new jobs with more competitive companies. And while it's true that employees often can't just pick up and relocate, it's also true that value-creating companies create more jobs. When examining employment, we found that the European and US companies that created the most shareholder value in the past 15 years have shown stronger employment growth.⁹

Short-termism runs deep

What's most relevant about Stout's argument, and that of others, is its implicit criticism of short-termism—and that is a fair critique of today's capitalism. Despite overwhelming evidence linking intrinsic investor preferences to long-term value creation,¹⁰ too many managers continue to plan and execute strategy, and then report their performance against shorter-term measures, EPS in particular.

As a result of their focus on short-term EPS, major companies often pass up value-creating opportunities. In a survey of 400 CFOs, two Duke University professors found that fully 80 percent of the CFOs said they would reduce discretionary spending on potentially value-creating activities such as marketing and R&D in order to meet their short-term earnings targets.¹¹ In addition, 39 percent said they would give discounts to customers to make purchases this quarter, rather than next, in order to hit quarterly EPS targets. Such biases shortchange all stakeholders.

As an illustration of how executives get caught up in a short-term EPS focus, consider our experience with companies analyzing a prospective acquisition. The most frequent question managers ask is whether the transaction will dilute EPS over the first year or two. Given the popularity of EPS as a yardstick for company decisions, you might think that a predicted improvement in EPS would be an important indication of an acquisition's potential to create value. However, there is no empirical evidence linking increased EPS with the value created by a transaction.¹² Deals that strengthen EPS and deals that dilute EPS are equally likely to create or destroy value.

If such fallacies have no impact on value, why do they prevail? The impetus for short-termism varies. Some executives argue that investors won't let them focus on the long term; others fault the rise of shareholder activists in particular. Yet our research shows that even if short-term investors cause day-to-day fluctuations in a company's share price and dominate quarterly earnings calls, longer-term investors are the ones who align market prices with intrinsic value.¹³ Moreover, the evidence shows that, on average, activist investors strengthen the long-term health of the companies they pursue, often challenging existing

compensation structures, for example, that encourage short-termism.¹⁴ Instead, we often find that executives themselves or their boards are usually the source of short-termism. A 2013 survey of more than 1,000 executives and board members found, for example, that most cited their own executive teams and boards (rather than investors, analysts, and others outside the company) as the greatest sources of pressure for short-term performance.¹⁵

The results can defy logic. We recently participated in a discussion with a company pursuing a major acquisition about whether the deal's likely earnings dilution was important. One of the company's bankers opined that he knew any impact on EPS would be irrelevant to value, but he used it as a simple way to communicate with boards of directors. Elsewhere, we've heard company executives acknowledge that they, too, doubt that the impact on EPS is so important—but they use it anyway, they say, for the benefit of Wall Street analysts. Investors also tell us that a deal's short-term impact on EPS is not that important. Apparently everyone knows that a transaction's short-term impact on EPS doesn't matter, yet they all pay attention to it.



Shareholder capitalism won't solve all social issues

There are some trade-offs that company managers can't make—and neither a shareholder nor a stakeholder approach to governance can help. This is especially true when it comes to issues that affect people who aren't immediately involved with the company as investors, customers, or suppliers. These so-called externalities—parties affected by a company who did not choose to be so—are often beyond the ken of corporate decision making because there is no objective basis for making trade-offs among parties.

If, for example, climate change is one of the largest social issues facing the world, then one natural place to look for a solution is coal-fired power plants, among the largest man-made sources of carbon emissions. But how are the managers of a coal-mining company to make all the trade-offs needed to begin solving our environmental problems? If a long-term shareholder focus led them to anticipate potential regulatory changes, they should modify their investment strategies accordingly; they may not want to open new mines, for example. But if the company abruptly stopped operating existing ones, not only would its shareholders be

wiped out but so would its bondholders (since bonds are often held by pension funds). All of its employees would be out of work, with magnifying effects on the entire local community. Second-order effects would be unpredictable. Without concerted action among all coal producers, another supplier could step up to meet demand. Even with concerted action, power plants might be unable to produce electricity, idling their workers and causing electricity shortages that undermine the economy. What objective criteria would any individual company use to weigh the economic and environmental trade-offs of such decisions—whether they're privileging shareholders or stakeholders?

In some cases, individual companies won't be able to satisfy all stakeholders. For any individual company, the complexity of addressing universal social issues such as climate change leaves us with an unresolved question: If not them, then who? Some might argue that it would be better for the government to develop incentives, regulations, and taxes, for example, to encourage a migration away from polluting sources of energy. Others may espouse a free-market approach, allowing creative destruction



to replace aging technologies and systems with cleaner, more efficient sources of power.



Shareholder capitalism has taken its lumps in recent years, no question. And given the complexity of the issues, it's unlikely that either the shareholder or stakeholder model of governance can be analytically proved superior. Yet we see in our work that the shareholder model, thoughtfully embraced as a collective approach to present and future value creation, is the best at bridging the broad and varied interests of shareholders and stakeholders alike. ○

¹ An annual Gallup poll in the United States showed that the percent of respondents with little or no confidence in big business increased from 27 percent in the 1983–86 period to 38 percent in the 2011–14 period. For more, see “Confidence in institutions,” gallup.com.

² Bin Jiang and Tim Koller, “How to choose between growth and ROIC,” *McKinsey on Finance*, September 2007, mckinsey.com.

³ Jiang and Koller, “How to choose between growth and ROIC.”

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⁵ Sheila Bonini, Tim Koller, and Philip H. Mirvis, “Valuing social responsibility programs,” *McKinsey Quarterly*, July 2009, mckinsey.com.

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⁷ R. Edward Freeman, Jeffrey S. Harrison, and Andrew C. Wicks, *Managing for Stakeholders: Survival, Reputation, and Success*, first edition, New Haven, CT: Yale University Press, 2007.

⁸ John Mackey and Rajendra Sisodia, *Conscious Capitalism: Liberating the Heroic Spirit of Business*, first edition, Boston, MA: Harvard Business School Publishing, 2013.

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¹⁰ Robert N. Palter, Werner Rehm, and Jonathan Shih, “Communicating with the right investors,” *McKinsey Quarterly*, April 2008, mckinsey.com.

¹¹ John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, “Value destruction and financial reporting decisions,” *Financial Analysts Journal*, 2006, Volume 62, Number 6, pp. 27–39.

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¹³ Palter, Rehm, and Shih, “Communicating with the right investors.”

¹⁴ Joseph Cyriac, Ruth De Backer, and Justin Sanders, “Preparing for bigger, bolder shareholder activists,” *McKinsey on Finance*, March 2014, mckinsey.com.

¹⁵ Commissioned by the Canada Pension Plan Investment Board and McKinsey & Company, the online survey, “Looking toward the long term,” ran from April 30 to May 10, 2013, and garnered responses from 1,038 executives representing the full range of industries and company sizes globally. Of these respondents, 722 identified themselves as C-level executives and answered questions in the context of that role, and 316 identified themselves as board directors and answered accordingly. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP. For more, see fclt.org.

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Maintaining a long-term view during turnarounds

Changing course demands an intense focus on short-term performance, but success needn't come at the expense of long-term value.

**Kevin Carmody,
Ryan Davies, and
Doug Yakola**

Peter switched on his desk lamp. It was getting dark, and the past 11 hours had been full of meetings and decisions. His trucking company had been struggling with the high diesel prices and soft economy of the early 2000s, but he had been fighting back by cutting costs across the board. He wasn't failing yet, but he wasn't sure how long he could fend it off.

He opened an approval request on his desk for the second time that week and read it again. It was a multimillion-dollar purchase order for retrofitting his entire fleet to natural gas. Several months earlier, the decision had seemed to be a no-brainer: his trucks could run on natural gas for a fraction of the cost of diesel. In

a weak economy, the reduction in operating costs would be welcome—and he'd be positioned well to compete when the economy picked up. But as he stared at the numbers, he now wondered if it would still be the right move. The switch to natural gas would require a host of difficult organizational and operational changes—even if some of them would free up much-needed cash. He put down his pen and closed the file. What he really needed, he realized, was a way to more fundamentally turn things around.

Any leader who's been through a turnaround knows that driving one requires an intense focus on delivering near-term results. Some moves make obvious sense. Building value-creation

metrics into a long-term vision and implementing aggressive cash-management practices, for example, can help fund restructuring while avoiding existential crises down the road.¹

Other moves are riskier. The short-term pressure is so intense that many managers succumb to myopic decision making that can hurt a company's long-term health or even sow the seeds of irreversible failure. Examples abound of companies that survived a financial crisis by shutting off all discretionary spending, only to fail later when their operations became unreliable or required considerable new investment. The damage in these cases can exceed the impact of the initial financial hit. Depriving an organization of continuous investment in sustaining capital—whether in maintenance, growth and innovation, or people—can result in dozens of other incidents, each individually small and correctable but together adding up to create an unreliable operation that hurts the customer, the business, and its reputation.

The most successful turnarounds are those in which managers balance the short and long term in business decisions, both financially and organizationally. Financially, many investments that do not pay back their costs quickly (in less than two years) still create value and are important for the viability and health of the company. There are rarely clear answers to such investment decisions, but in our experience, a few techniques can help ensure that you make the best decisions with the information you have.

Avoid sweeping decrees

When faced with financial troubles, many companies respond by ordering a freeze on all spending, from capital spending to hiring, travel, and other discretionary expenses. Such moves can certainly be necessary in times

of distress. In most cases, however, it's better to take a more nuanced approach.

Managers should always discuss a company's largest investments individually, giving time and attention to both the short-term and long-term implications of delaying investment. Letting such decisions fall under a broad spending directive can have a devastating impact. One global manufacturing company whose operations relied on substantial electrical power decided to delay a scheduled transformer rebuild by a year to save cash. Five months into the year, the transformer failed catastrophically, taking 20 percent of production off line while the company built and installed a replacement. Elsewhere, a transportation company that delayed the scheduled replacement of key logistical equipment suffered a setback when the equipment failed, resulting in collateral damage to the physical plant and equipment.

For smaller investments, it's better to organize spending into categories in which the implications for long-term health can better be discussed and understood. There is an important distinction, for example, between repainting the hallways and refurbishing an electrical transformer that a broad proscription of spending on maintenance would not recognize. Similarly, a hiring freeze on executive assistants results in different risks from a freeze on vehicle operators or sales managers.

During one turnaround, executives at a consumer-products company found that plant managers historically had little discipline in spending—they invested in projects without considering hurdle rates or returns on the investment—and more than 350 projects would be affected by a spending freeze. During the turnaround process, executives

worked alongside plant managers to weigh the trade-offs between what was necessary to serve customers and deliver products and what could be delayed to reduce costs. Together, they determined that nearly half of the planned projects could be postponed. They then implemented an aggressive program for working-capital management to simplify inventory management, approving spending that would help the business grow in the short and medium term while instituting strict internal controls on areas that were less critical, such as overtime, excessive travel, and some maintenance.²

Prioritize investments

Managers under pressure in turnaround situations have little time to evaluate thoughtfully which activities and investments to support and which to cut. Often, decisions rest on which department head has the most organizational clout, has the strongest personality, or argues the loudest to protect his own programs and people—an understandable but not particularly effective way of making cuts.

A better approach we've seen companies take is to make a list of all actions that would create near-term cash, force ranked by the amount of damage each would do to the long-term health of the

company—typically prioritizing actions with the highest net present value (NPV) at one end and those with the most negative NPV at the other. Such a list should be created and discussed very early in a turnaround, and it must assess the effect of divesting or discontinuing every activity and selling every asset, with no exceptions. It will only be complete when the last thing left to do after taking every action on the list would be to shut the doors. It's a tough exercise to go through, but it gets all the ideas on the table for discussion.

Highest on this list will be a number of immediate actions that create little risk. Lower down will be actions that begin to affect long-term growth prospects or operational reliability. The trick is to separate sources of real long-term damage potential from threats of damage that are merely perceived. This can be accomplished by taking the time and effort to understand each investment in depth and by making sure someone is assigned to ask the tough questions.

It's also a good idea to assign quantifiable metrics to trigger the next cut on the list when a company comes within a certain number of months of no longer having sufficient cash to pay its bills. This creates a clear contingency plan in case things turn worse. Just as important, it creates a clear

To prioritize investments, companies can make a list of all actions that would create near-term cash, force ranked by the amount of damage each would do to the long-term health of the company.



understanding of the future health risk required to stabilize the business in the short term.

If Peter, the manager discussed at the beginning of this article, were to conduct this exercise, he might find many actions he could take that are higher on the list, with less long-term damage than eliminating the natural-gas conversion project. That could help him feel better about approving it. The exercise would also give him an opportunity to tighten the spending-approval interval so that he would only approve the minimal spending possible each time. This would ensure that he could retain control of future financial investments in case things were to change and he needed to take this more drastic action.

Discourage short-term actions with negative long-term consequences

In any turnaround, increased accountability and pressure on business-unit managers to hit their numbers can exacerbate short-termism—which often leads to decisions that create less value for the company. They can be tempted, for example, by any number of little ways to cheat. Some tactics may incur purely financial risk, such as conceding sales discounts to meet near-term volume and margin goals or structuring back-loaded or risky contracts. Others can be more dangerous, such as allowing lower-quality products to go to market, delaying a maintenance outage until the next accounting period, or continuing production despite safety or reliability

concerns. A manager at a global commodities company, for example, hoped to catch up on production by delaying the routine maintenance of a piece of heavy equipment despite concerns identified by engineers. The equipment failed not long after, leading to a lengthy production outage. The tension between execution and innovation is worth special note. Innovation requires experimentation and failure, which can be hard to defend in an environment where every dollar counts.

The challenge is to create urgency and accountability for near-term performance targets without encouraging shortcuts that destroy value and may have insurmountable negative consequences. Some companies deal with this by protecting people and budgets for strategically important innovation, even while aggressively reducing costs in other areas of the company. Others set targets for near-term results and then outline everything managers can do to meet those targets. The most important approach is to explicitly identify and understand the impact of every step that's part of the company's ability to create value.

Invest in people

In our experience, the single largest attribute of a successful turnaround and a healthy company is the people who manage and run it. Yet, in many cases, investment in people is one of the first areas to go when companies struggle. Whether that means pay freezes or cuts or the elimi-

nation of benefits, training, or team-building activities, such steps are often the easiest and fastest way to save cash fast. More than one company we know of dramatically reduced hiring of entry-level leadership talent during the 2009 recession and now struggles with a gap in future leaders at the middle levels of the organization.

Our view is that almost all of these moves will affect a company's long-term health. When a business is struggling, companies count on their employees even more than they do when it's healthy, whether to increase productivity, come up with creative ideas, improve teamwork, or simply provide moral support. Avoiding cuts in this area for as long as possible sends a message that people are valuable and will energize staff to take part in the turnaround. To be clear, it is important to continue to make case-by-case decisions on talent, but avoiding across-the-board cuts for people and benefits should be a strong consideration.

It is also crucial to support and encourage leaders to make hard decisions for the long term, even at some risk to near-term results. This starts with an aggressive education-and-awareness campaign that provides the entire organization with the

tools to understand what value creation means and how it is measured. This can include training on how to interpret financial statements and how to calculate NPV, return on invested capital, and economic profit. Incentives are obviously important—ideally, performance evaluation is tied to short-term results, with compensation linked in some ways to equity in order to reflect long-term value (particularly for senior leaders). Consistently communicating the narrative is also critical, as is role modeling by senior leaders.



Rapid performance transformation is hard to pull off. And even if a company succeeds in delivering near-term results, creating value in the longer term is an even higher bar. Turnaround leaders should create a vision and a road map with markers that keep both in mind—and lead their teams in managing against these. ○

¹ Ryan Davies and David Merin, “Uncovering cash and insights from working capital,” *McKinsey on Finance*, July 2014, mckinsey.com.

² For more on such programs, see Davies and Merin, “Uncovering cash and insights from working capital.”



Can we talk? Five tips for communicating in turnarounds

In tough times, investors scrutinize every detail. Here's how to manage the discussion.

**Ryan Davies,
Laurent Kinet, and
Brian Lo**

Few challenges are as daunting for investor relations as communicating with investors in the middle of a restructuring. Managers of public companies need to reckon with heightened scrutiny of reporting and regulatory disclosures. Those in private equity–owned companies face rigorous performance dialogues about management. And while doing so, managers in a turnaround must simultaneously convey a sense of humility about what went wrong and confidence that they know how to correct it.

Whether the turnaround takes the form of a formal restructuring or a strategic redirection, investors will cast a gimlet eye on the slightest nuances of every statement, report,

public appearance, and performance metric for signs of strength or weakness. Competitors will cast any hesitation and ambiguity in the most ominous terms, the better to win over customers, suppliers, and key employees. And, of course, all these challenges come at once, just when managing the core business is most difficult.

As with most complex situations, there is no one-size-fits-all approach to communicating during turnarounds. But our work suggests that some general rules of thumb for investor communications can be refined for these particularly difficult discussions. By adopting an investor's point of view, monitoring shifts in

the shareholder base, targeting specific future milestones, working to rebuild credibility, and branding the turnaround, management can better maintain focus and shore up critical investor support.

1. Communicate from an investor's point of view

A successful turnaround requires input and collaboration with a wide range of stakeholders, such as owners (investors), the board of directors, employees (including unions and work councils where relevant), customers, suppliers, government bodies, and communities. Communicating early and often is crucial to create a consistent narrative and convince stakeholders that the turnaround is a winning proposition for all involved.

But investors hold the purse strings. If they recognize a company's progress and reward it with a higher share price, employees may well be encouraged to double down on their efforts. Conversely, if the investors' view of a company remains glum for too long, it can dampen morale, lead to defections, and ultimately undermine the viability of the entire turnaround. Weak performance can also lead to a decline in share price that can open the door to an attack by activists or a takeover bid at far less than the intrinsic value of a business. In that environment, no news is usually considered bad news. Lack of communication can accelerate this process and its risks.

Moreover, communications with investors should set the tone for discussion with all audiences. It can be tempting to tailor messaging heavily for different stakeholders. But in our experience, this only adds complexity, conflicting narratives, and risks. We've seen some cases end quite

badly when the company mixed up what it told to whom, when messages for internal management leaked to investors or other stakeholders (such as unions), or when messages intended for external audiences confused employees about company priorities.

2. Watch for shifts among core shareholders

Even in the best of times, prudent managers devote energy to understanding how their most important shareholders view and value a company. These "intrinsic" investors base their decisions on a deep understanding of a company's strategy, its performance, and its potential to create long-term value. Because they are focused on a company's long-term intrinsic value, they are more likely than shorter-term investors to support management through a turnaround¹—and most likely to move the company's stock price as it evolves.² In our experience, shifts in this base of investors nonetheless can occur more dramatically in turnaround situations than when companies are struggling, which can be a harbinger of the likely difficulty of the turnaround ahead.

Thorough analysis of such investors can help managers assess the likely impact of various improvements. Interviews by external agents, such as communications or public-relations firms, can be particularly helpful to tease out pain points. It is then management's task to address those points head on and not try to hide the real issues behind platitudes and pleasing statements. One natural-resources company's shareholders, for example, acknowledged and complimented management's efforts to address specific hot-button issues that had come up during interactions among managers, the board of directors, and top shareholders.

Managers should make a point of being as candid as possible from the start. It's a well-established principle of politics, but it's just as applicable to companies in a turnaround.

3. Express a specific vision for the future

A company undergoing a turnaround must paint a detailed and compelling strategic vision of its plans to address the root cause of underperformance or distress. For one electricity and gas utility, this meant recognizing shortcomings in its capital discipline and committing not only to improve return on investment but also to deliver short-term results. For a payments company, it meant reducing fragmentation in the core business by properly integrating ten prior acquisitions that had tripled the size of the company, rationalizing facilities and SKUs, and building a new and more efficient central support structure.

The vision should also include high-level financial goals, with an outline of how they will be met. Companies should be candid about the trade-offs they're making, for example, between capturing savings to improve the bottom line in the short term and reinvesting in the business to sustain performance after the turnaround effort is complete. In our experience, investors understand that reinvestment is an important part of long-term value creation—and they are supportive, as long as they understand the investments managers are making and when they expect returns.

While getting too specific on timing can backfire, investors typically value, and in some cases demand, some sort of concrete guidepost. For example, one high-tech company set a mid-

term goal of growth in earnings margin of between 17 and 19 percent, and it regularly referred to progress toward that goal in reports and during earnings calls. One company in a cyclical industrial business, which had been earning returns below its cost of capital for five years, set a bold goal of return on invested capital at or above the cost of capital, even at the low point of the cycle—and it gave rough magnitudes of the cost and margin improvements it expected from its largest divisions to get there.

4. Rebuild credibility

Until managers of underperforming companies earn back credibility with investors, their valuations are unlikely to reflect more than a heavily discounted version of the improvements management is claiming. Regaining trust—both to demonstrate open and honest transparency and, frankly, to inspire confidence that managers know what they're doing—requires a change in tack from usual communications on a number of fronts.

Break all the bad news at once. As a general rule, managers should make a point of being as candid as possible from the very start. It's a well-established principle of politics, but it's just as applicable to companies in a turnaround. A new management team has a great opportunity to acknowledge all past mistakes and start with a fresh slate. For example, one industrial com-

pany's stock actually rose the day it announced a write-off of more than \$1 billion, since investors viewed this as a signal that the new management team would make a decisive break from the mistakes of the past and would make hard decisions to exit dead-end investments that were still absorbing capital and management time.

For an existing management team, the task is even more daunting. It takes strong leadership to criticize one's own actions, sometimes at the risk of being replaced. Investors may be more patient at the outset of a turnaround while they await evidence that the turnaround is working. But the patience of even the most committed intrinsic investor will wear thin if bad news just keeps dribbling out.

Build a track record of delivery. Communicate only the goals you know you can achieve—using metrics and milestones you revisit regularly—and then prove you can achieve them. Credibility is at a premium in a turnaround—and nothing erodes it like making a promise and falling short. Metrics do not need to be purely financial. For example, one mining company that had consistently missed its financial and output targets focused its turnaround goals on progress against operational metrics, such as overall equipment

effectiveness, to demonstrate tangible performance improvement. While such operational metrics were not directly linked to top-line performance, they offered investors a way to track managers' performance and hold them accountable for improvements.

Tie incentives to targets. Talk is cheap, and sophisticated investors gravitate to management teams that put their money where their mouth is. Structuring compensation packages to directly tie them to turnaround targets, as well as having executives and board members buy meaningful amounts of stock in a company, signals a commitment and confidence to follow through and deliver on a management team's promises. One company unveiled a new turnaround incentive plan that aligned incentives for management and frontline employees using similar performance metrics. Investors reacted positively, citing this as an example of the company's focus and commitment to turning a new page and a reason for holding on to their current position.

Increase transparency. Just as breaking bad news all at once can improve credibility in a turnaround, candor can help not only at the level of overall financial guidelines but also of specific projects.



We've seen two different basic-materials companies make a practice of detailing, during earnings calls and investor gatherings, 10 to 20 projects for improving operational efficiency and their impact on cash generation and workforce behavior. Investors noted that they appreciated the more vivid picture of the type of transformation the companies were undergoing and added that the observed margin improvements had come from more promising and sustainable sources than shortsighted cost reduction.

Be confident—and humble. Managers must exude confidence at their ability to withstand challenging times from markets and competitors, as well as project the success of the company's planned turnaround. But they also need to show humility in the face of distress, whether it's due to past underperformance or external factors. Shareholders will examine word choice and tone for signs of the kind of arrogance and overconfidence that come from denying past missteps.

5. Brand the turnaround

To many executives, branding a turnaround may seem to be mere marketing, but it can be an effective way to crystallize a focal point and amplify the narrative for the outside world—making the rebuilding effort more credible. One mining company, for example, gave a pithy name to its transformation effort and mentioned

it in every external communication. Soon after, investors and media alike were citing the project by name as shorthand for the company's promising turnaround, rendering internal and external communication more coherent and giving employees' internal efforts some external recognition.

A brand can also convey a sense of new beginning. Attaching a campaign name to write-offs, exits from failed ventures, and even mundane PowerPoint templates for earnings-call slides can reinforce a consistent and compelling change story and build critical momentum.



Ultimately, communication is not a substitute for performance. Nothing drives a stock price like beating expectations and punishing short sellers quarter after quarter. But a thoughtful approach to communicating to investors and other stakeholders can help managers build the momentum they need to bring a struggling company into a new era of value creation. ◯

¹ Robert N. Palter, Werner Rehm, and Jonathan Shih, "Communicating with the right investors," *McKinsey Quarterly*, April 2008, mckinsey.com.

² Sell-side analysts should not be disregarded, but more often than not we see CFOs overinvest time and energy with analysts relative to intrinsic investors.



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M&A 2014: Return of the big deal

Investors are optimistic about the value of big deals behind a growing wave of M&A. What key trends do they need to understand?

**André Annema,
Roerich Bansal, and
Andy West**

After years of stagnant activity, mergers and acquisitions surged in 2014, with the announcement of more than 7,500 deals¹ with a combined value exceeding \$3.5 trillion. That's an increase of more than 7 percent by number and more than 25 percent by value compared with 2013. While that volume hasn't yet reached the high of nearly 10,000 deals set in 2007, a new wave of activity is clearly under way.

More than a third of the total value of deals announced in 2014 came from large deals²—with more than 90 percent of that coming from large deals by corporate acquirers, especially in the healthcare and technology, media, and telecommunications sectors.³ That's something of

a surprise, both because previous research found that large-deal M&A strategies are riskier to execute and create less value than programmatic M&A⁴ and because, for the first time in our reckoning, investors seemed to approve. In fact, since 1998, the average announcement effects have never shown investors to be as optimistic about large deals as they have been in the past few years (Exhibit 1).

The average deal value added (DVA)⁵ for large deals increased from 6 percent in 2012 to about 12 percent in 2014.⁶ Acquiring-company shareholders in particular have benefited, as announcement effects for acquiring companies turned positive for the first time since 1998,

resulting in an average DVA of 0.9 percent for large deals in both 2013 and 2014. The share of large deals with a positive announcement effect for acquirers has also grown since 2012, from 36 percent to nearly 50 percent in 2014. Not surprisingly, investor confidence in large deals varies from sector to sector—but it seems not to be connected to the industry’s track record of creating value through large deals (Exhibit 2).

Why all the interest in big deals? We do not yet see conclusive evidence that companies, on average, have gotten better at them. Some may have new or improved rationales for such deals, but they’ll have to do a better job integrating than companies have in the past to capture the value they expect. And tax inversions are not playing more than

a modest role in big deals. Of the nine large tax-inversion deals announced, three were either withdrawn or rejected. The remaining six—of which four are still pending—amounted to 12 percent of total deal value in large deals, and those were predominantly in the healthcare sector.

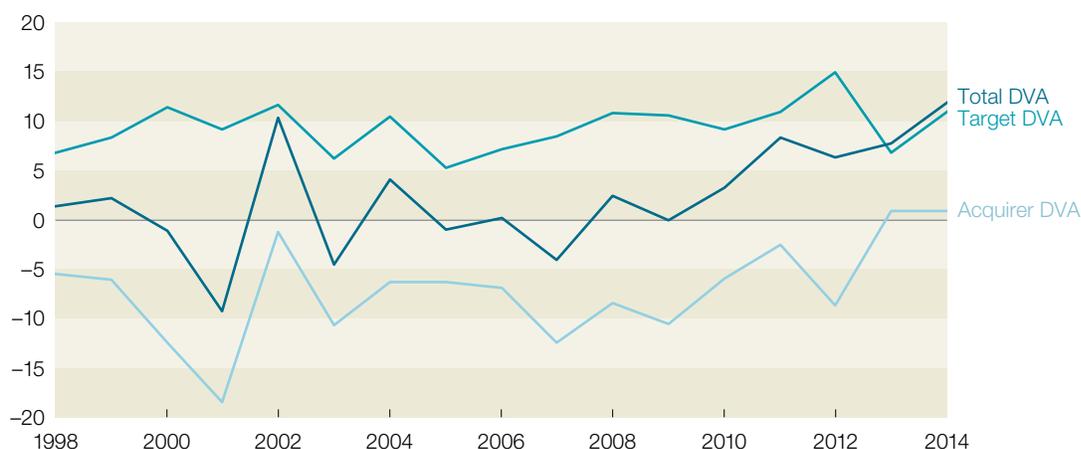
Other factors, instead, may be attracting investor support for big deals:

- In some sectors, it could be that performance differences among companies hold the promise of significant economies of scale through M&A (Exhibit 3). As differences in earnings grow, deals will look more affordable—though the specific logic of any given deal must be considered on a case-by-case basis.

Exhibit 1

Investors are optimistic about the value of large deals for acquirers.

Average deal value added (DVA)¹ index,
%, deal value >\$5 billion²



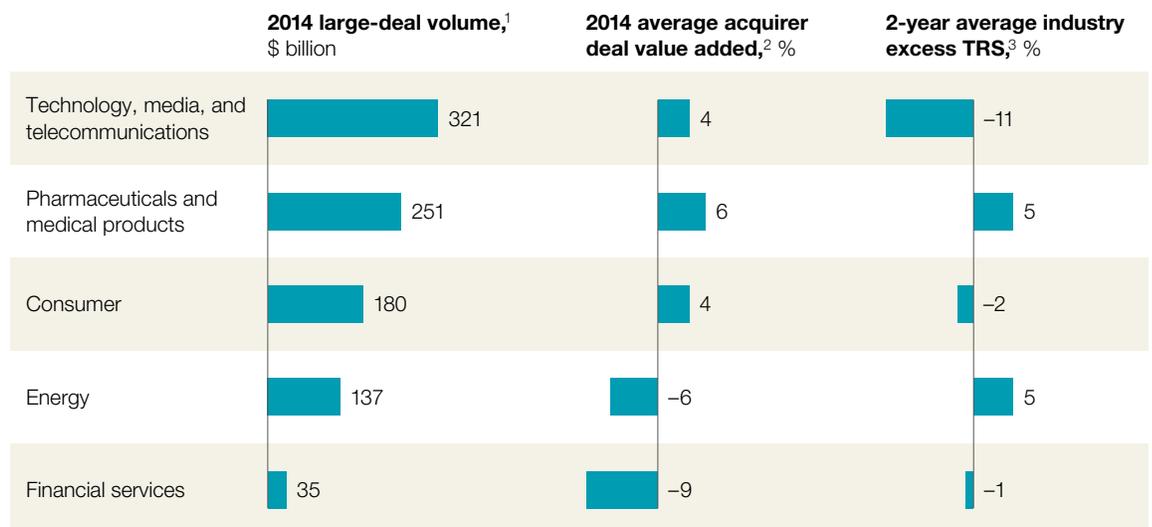
¹When both companies are publicly listed; defined as combined change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value.

²For announced M&A deals (not withdrawn) with greater than or equal to \$5 billion in deal value.

Source: Dealogic; Thomson Reuters Datastream; McKinsey analysis

- For many companies, it could mean that investors are, on average, just relieved to see them doing something with their sizable reserves. Excess cash among the top 1,000 US companies approached \$1.5 trillion by the end of 2013, creating real pressure to put money to work. Among the top 1,000 listed companies in the United States, about half of that cash appears to reside in the healthcare and technology, media, and telecommunications sectors—the sectors announcing most of the large deals in 2014. (Increased activity in healthcare occurred almost exclusively in pharmaceuticals and healthcare products.) For now, investors seem satisfied with the value-creation thesis of deals relative to returning cash to investors via dividends or share buybacks.
- Activist shareholders may be creating a sense of urgency around managing the corporate portfolio—especially as they increasingly target companies with market capitalizations above \$10 billion.⁷ Or it could be that companies are pursuing better-quality deals, on average, validating and testing the rationale for their deals prior to announcement.
- The increase in activity overall and portfolio reallocation may be creating value in their own right. McKinsey research has shown that companies with a high rate of capital reallocation over a longer period of time tend to outperform in shareholder returns.⁸ Even with the currently high volume of very large deals, the share of divestments in total deal volume remains above

Exhibit 2

Investor confidence is unconnected to historical deal performance.

¹ Defined as announced M&A deals (not withdrawn) with greater than or equal to \$5 billion in deal value.

² When both companies are publicly listed; defined as combined change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value.

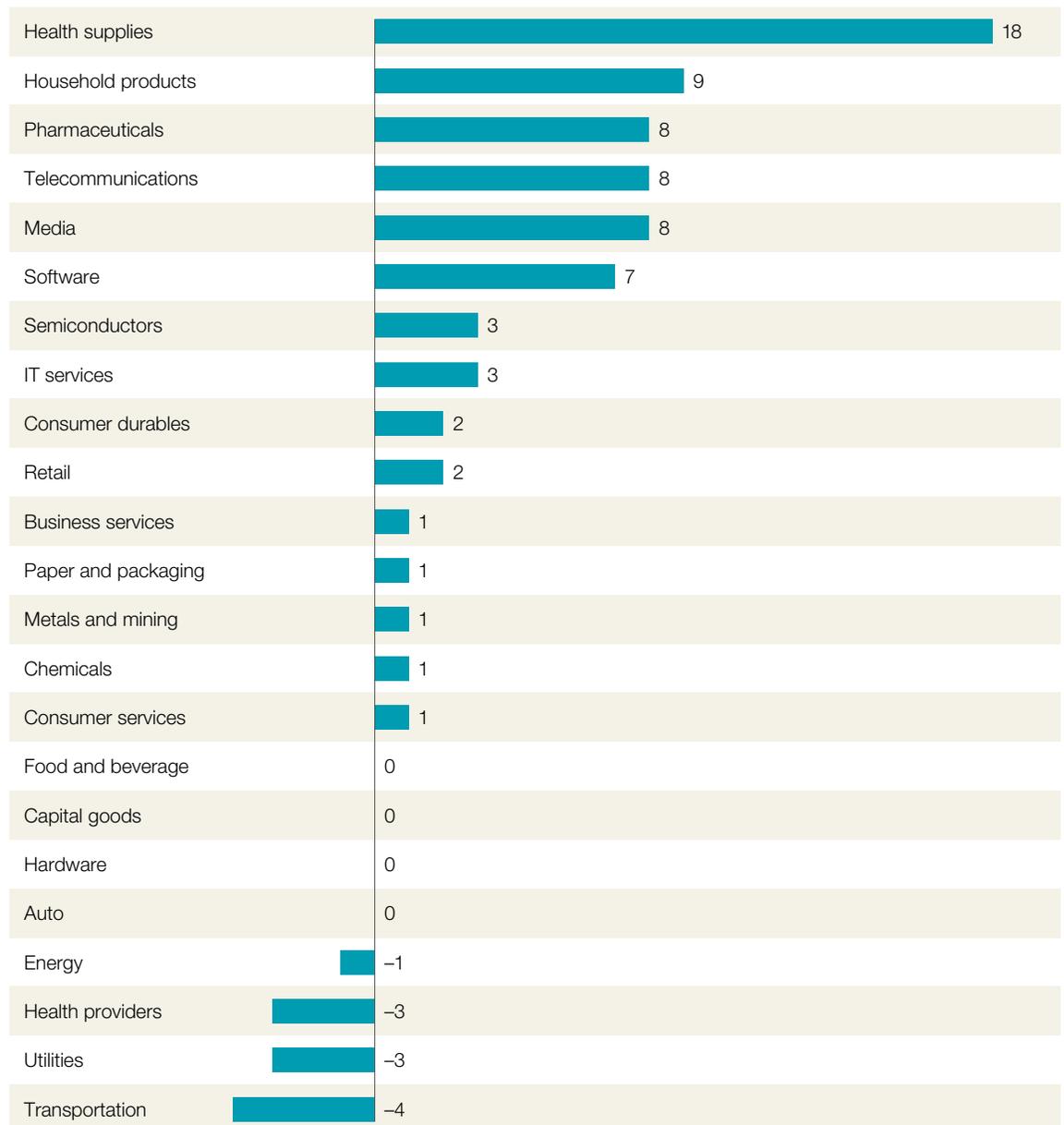
³ Deals in which the acquired company's market capitalization exceeded 30% of the acquirer's, 2000–12.

Source: Dealogic; McKinsey Corporate Performance Analysis Tool; McKinsey's global 1,000 M&A database

Exhibit 3

Performance differences in some sectors suggest economies of scale through M&A.

EBITA margin outperformance of large vs small companies,¹
percentage points



¹ Median earnings before interest, taxes, and amortization (EBITA) of large companies (top-quartile revenue in industry) minus the median EBITA of small companies (third-quartile revenue in industry) in 2013.

Source: S&P Capital IQ; McKinsey Corporate Performance Analysis Tool

average, implying that large portfolio moves are happening as well. We certainly see the potential for value creation from such deal strategies, but only if companies have real capabilities to successfully manage large and complex integration or divestiture programs.



Like previous M&A waves, it is the reemergence of large deals that drives the increase in deal activity. Announcement effects across the board have improved, and negative reactions to deals have become less severe—though investors in some sectors remain wary. ○

¹ For announced M&A deals (not withdrawn) with greater than \$25 million in deal value.

² For announced M&A deals (not withdrawn) with greater than or equal to \$5 billion in deal value.

³ Increased activity in healthcare occurred almost exclusively in pharmaceuticals and healthcare products.

⁴ Werner Rehm, Robert Uhlener, and Andy West, “Taking a longer-term look at M&A value creation,” *McKinsey on Finance*, January 2012, mckinsey.com.

⁵ The deal value added, or announcement effect, is calculated by expressing the change in the market value of equity for two days prior to two days after the announcement, as a percent of the deal value. It is measured in excess of the market return over the same days.

⁶ The median deal value added for large deals in 2014 was 11.3 percent, while the mean was 11.9 percent.

⁷ Joseph Cyriac, Ruth De Backer, and Justin Sanders, “Preparing for bigger, bolder shareholder activists,” *McKinsey on Finance*, March 2014, mckinsey.com.

⁸ Stephen Hall and Conor Kehoe, “Breaking down the barriers to corporate resource allocation,” *McKinsey Quarterly*, October 2013, mckinsey.com.

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Bing Cao, Bin Jiang, and Tim Koller

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