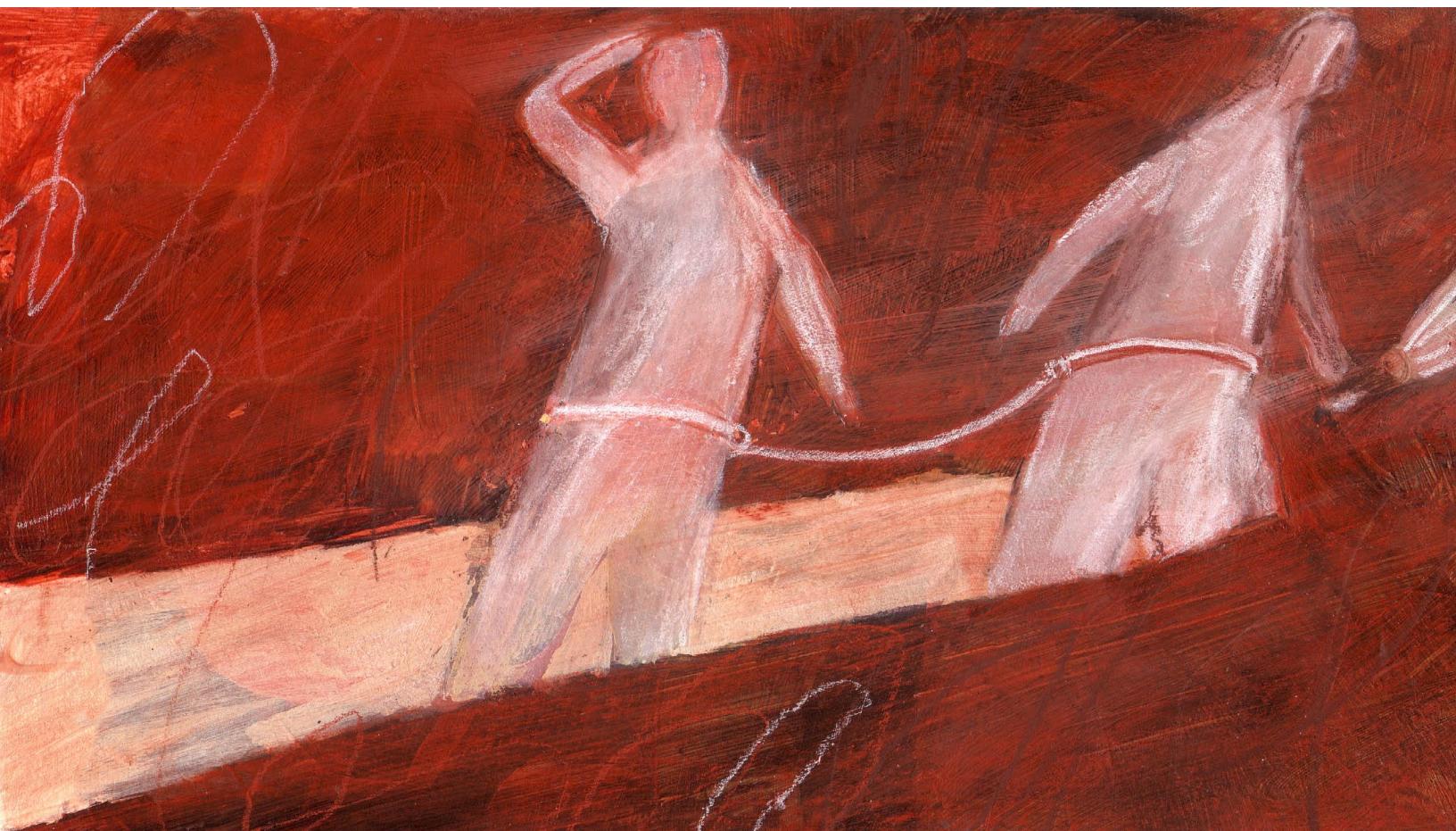


McKinsey on Finance



**Perspectives on
Corporate Finance
and Strategy**

Number 19, Spring
2006

The misguided practice of earnings guidance 1

Companies provide earnings guidance with a variety of expectations—and most of them don't hold up.

Inside a hedge fund: An interview with the managing partner of Maverick Capital 6

What should a company do when a hedge fund shows up among its investors?

Balancing ROIC and growth to build value 12

Companies find growth enticing, but a strong return on invested capital is more sustainable.

Toward a leaner finance department 17

Borrowing key principles from lean manufacturing can help the finance function to eliminate waste.

Balancing ROIC and growth to build value

Companies find growth enticing, but a strong return on invested capital is more sustainable.

Bing Cao, Bin Jiang, and Timothy Koller

Growth might be the lifeblood of a business, but it isn't always the best or most sustainable way to create value for shareholders. Return on invested capital (ROIC) is often just as important—and occasionally even more so—as a measure of value creation and can be easier to sustain at a high level.

When a company's ROIC is already high, growth typically generates additional value. But if a company's ROIC is low, executives can create more value by boosting ROIC than by pursuing growth (Exhibit 1). A close look at companies with high price-to-earnings multiples shows that many have extraordinary returns on capital but limited growth. This scrutiny suggests that, contrary to conventional wisdom, investors recognize (and will pay more for) the anticipated returns of companies with a strong ROIC, despite their limited growth prospects. This observation doesn't mean that growth is undesirable; unless companies keep up with their industries, they will likely destroy value. But they shouldn't pursue growth heroically at the expense of improvements in ROIC.

After identifying the largest publicly listed companies in the United States (by revenues) in 1965, 1975, 1985, and 1995, we examined their long-term patterns of growth and ROIC.¹ The median ROIC for the 1965 group remained stable, at about 9 percent, over the next 40 years. We

observed the same pattern for the groups from 1975, 1985, and 1995. In other words, ROIC tends to remain stable over time (Exhibit 2).

Growth, by contrast, is fleeting. The median inflation-adjusted growth in revenues for the top 500 companies in 1965 started out at 7 percent and steadily declined to 2 percent over the next 10 years, hitting a cyclical low of 0 percent by year 17. For the next 20 years, growth hovered at around 2 percent—a figure below the level of US GDP growth.² We observed a similar general pattern of decay in median real growth for the top 500 companies in 1975, 1985, and 1995.

Moreover, pattern analysis at the industry³ level further shows the importance of managing ROIC. A comparison of ROIC⁴ for the top 500 companies of 1965 shows that it remained steady in most sectors and even increased in some—particularly those with strong brands or patent-protected products (household and personal goods, for example) and pharmaceuticals and biotechnology (Exhibit 3, part 1). Growth, by contrast, almost always declined, except in pharmaceuticals (Exhibit 3, part 2).

A close look at individual companies finds similar patterns; companies with high levels of ROIC tend to hold on to that advantage, whereas high-growth companies rarely do. Exhibit 4 looks at the probability that a company will migrate from one level of ROIC to another over the course of a decade. A company that generated an ROIC of less than 5 percent in 1994, for instance, had a 43 percent chance of earning less than 5 percent in 2003. As the exhibit shows, low and high performers alike demonstrate consistency throughout the 40-year period. Companies with an ROIC of 5 to 10 percent had a 40 percent probability of remaining in

¹The performance of each set of companies was tracked as a portfolio until 2004.

²Real GDP growth averaged around 2.5 to 3.5 percent a year from 1929 to 2005.

³Defined by the Global Industry Classification Standard (GICS).

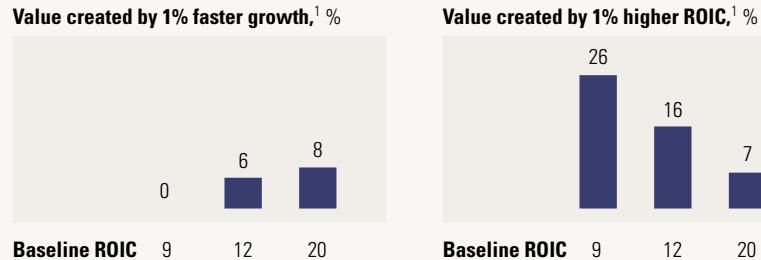
⁴Measured by the median ROIC of companies that survived in subsequent years.

(continued on page 16)

EXHIBIT 1

Value, compared

Improving returns on invested capital creates more value than growth (except when ROIC is already high).



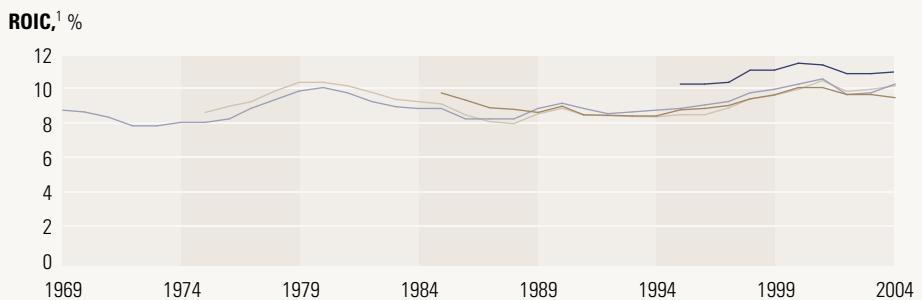
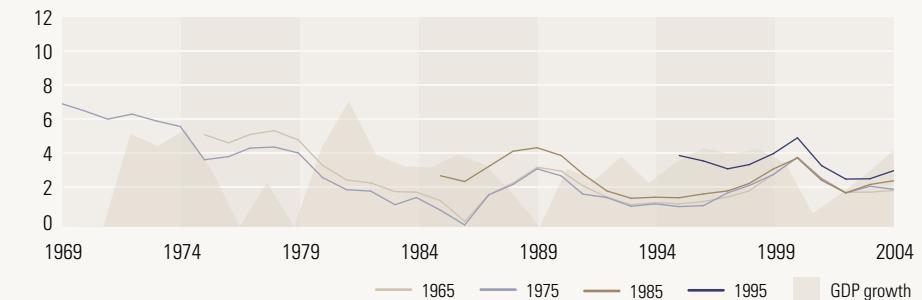
¹Assumes 9% weighted average cost of capital.

EXHIBIT 2

A more sustainable measure

Median for top 500 publicly listed US companies by revenues in 1965, 1975, 1985, and 1995

Returns on invested capital (ROIC) is sustainable over time, but growth inevitably declines.

**Real revenue growth, %**

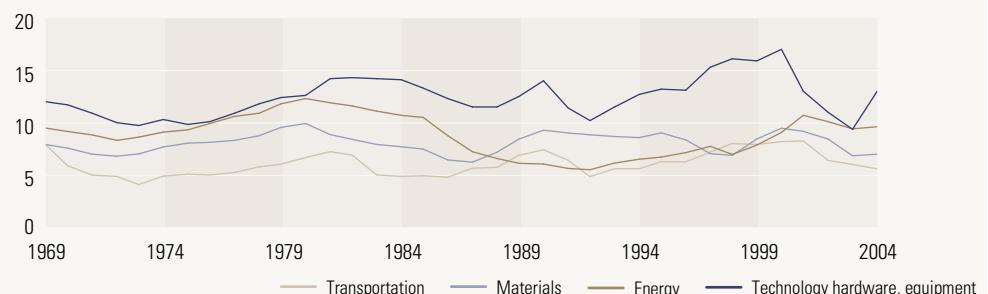
¹ROIC shown is 7-year simple average, including goodwill; growth shown is 7-year compound annual growth rate for revenues adjusted for inflation.

EXHIBIT 3: Part I

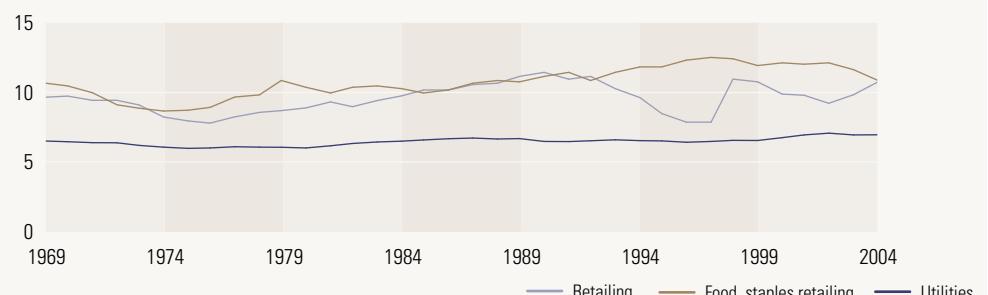
Industry variations in ROIC

Top 500 publicly listed US companies by revenues, 1965 portfolio, ROIC by industry,¹ %

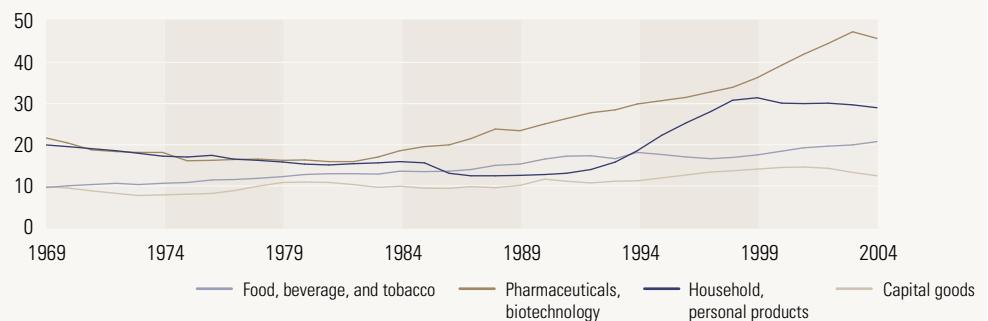
4 sectors saw averages fluctuating cyclically, within an industry-specific tight range.



3 had remarkably stable returns.



4 saw averages improve.



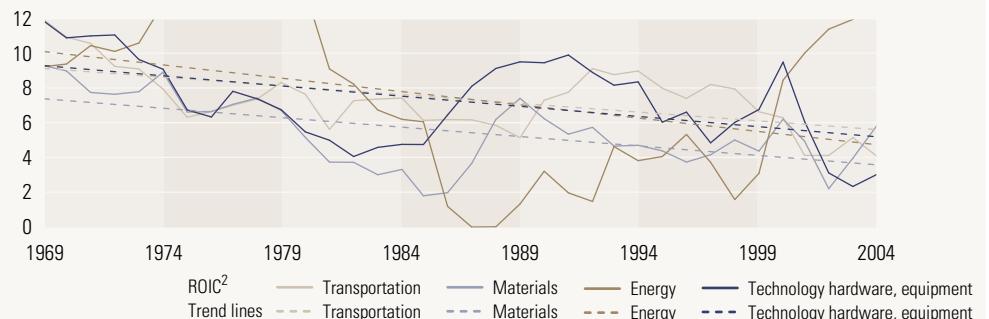
¹Industries defined by Global Industry Classification Standard (GICS); excludes sectors with <5 companies in 2004; portfolios for 1975, 1985, and 1995 display similar patterns.

EXHIBIT 3 : Part 2

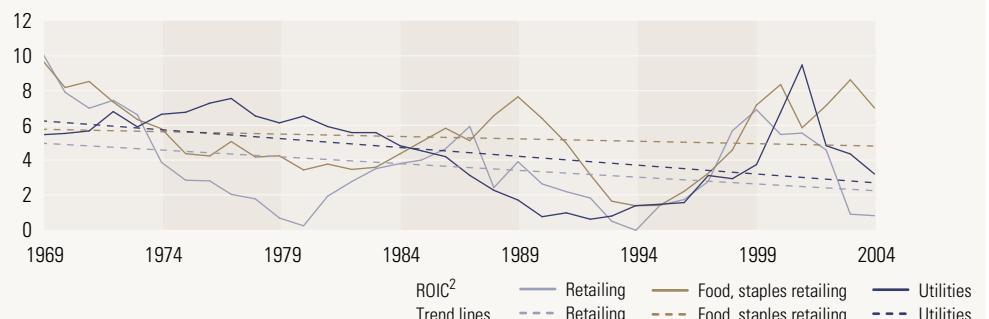
Industry variations in growth

Top 500 publicly listed US companies by revenues, 1965 portfolio, growth by industry,¹ %

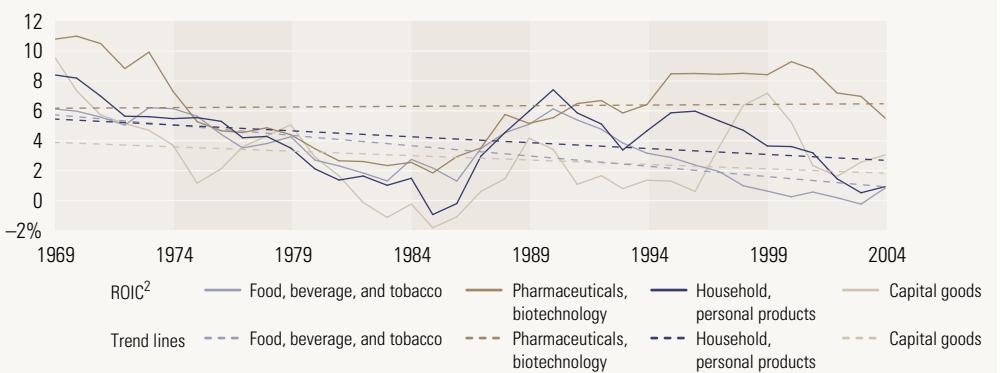
But there is no escape from a decline in growth for cyclical sectors ...



... and stable sectors.



The pharmaceuticals sector is the only apparent exception.



¹Industry defined by Global Industry Classification Standard (GICS); excludes sectors with <5 companies in 2004; portfolios for 1975, 1985, and 1995 display similar patterns.

²Return on invested capital.

EXHIBIT 4

Individual companies can sustain a high ROIC . . .

3-year average ROIC, without goodwill, of all publicly listed US companies with real revenues >\$200 million, %

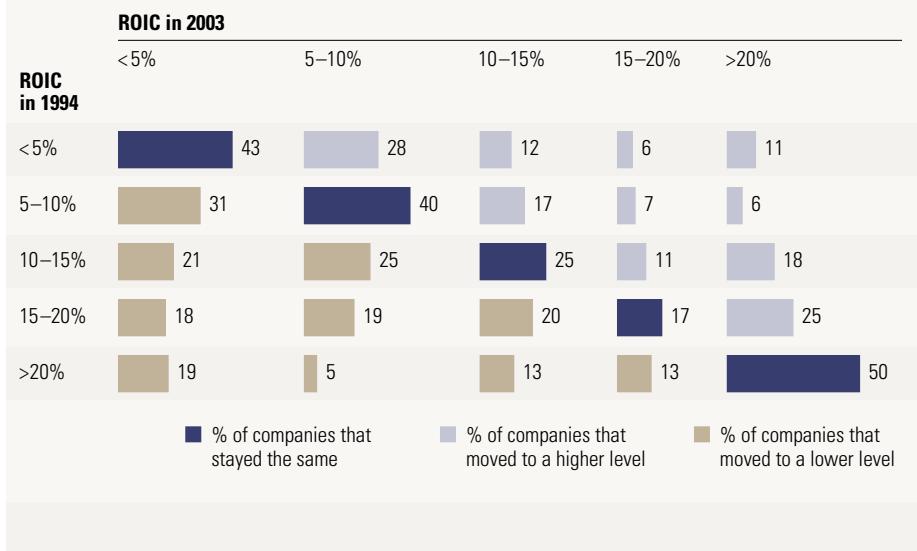
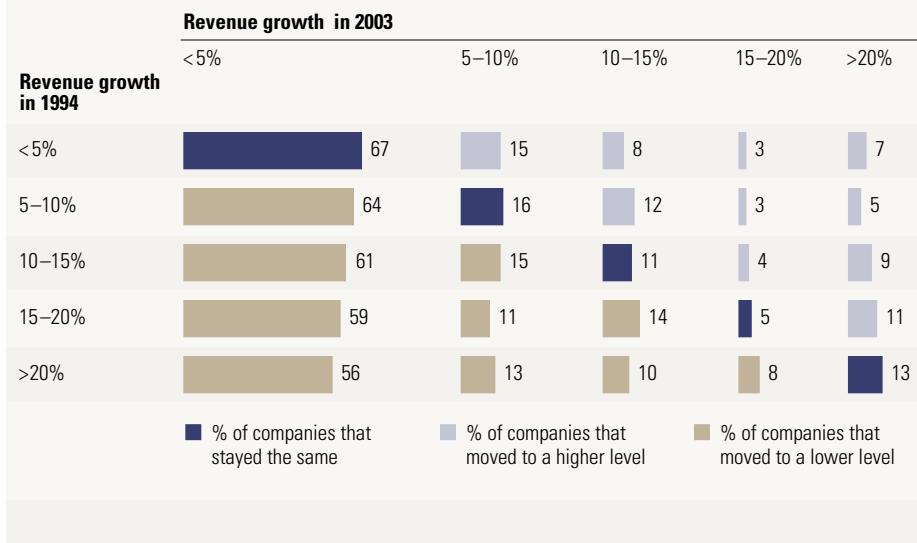


EXHIBIT 5

. . . but cannot sustain growth

3-year compound annual growth rate of real revenues of all publicly listed US companies with real revenues >\$200 million, %



the same group ten years later; companies with an ROIC of more than 20 percent had a 50 percent probability.

But when it comes to growth, companies are very likely to experience substantial declines (Exhibit 5). Of companies that grew by more than 20 percent in 1994, for example, 56 percent were growing at real rates of less than 5 percent ten years later. Only 13 percent of the high-growth companies maintained 20 percent real growth ten years on, and acquisitions probably drove most of it. **MoF**

Bing Cao (Bing_Cao@McKinsey.com) and **Bin Jiang** (Bin_Jiang@McKinsey.com) are consultants and **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in McKinsey's New York office. Copyright © 2006 McKinsey & Company. All rights reserved.

Copyright © 2006 McKinsey & Company