

Strategy & Corporate Finance Practice

How to make the bold strategy moves that matter

What does it take to make a true performance leap? The authors of *Strategy Beyond the Hockey Stick* explain the key strategic levers their analysis has revealed, and how strongly you have to pull them.



In this episode of the *Inside the Strategy Room* podcast, McKinsey senior partners Chris Bradley, Martin Hirt, and Sven Smit continue their conversation with communications director Sean Brown about their recent book, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* (Wiley, February 2018). In this second of three podcasts, they discuss the factors that their research identified as being the most critical to strategic success. (This is an edited transcript. For more conversations on the strategy issues that matter, subscribe to the series on iTunes or Google Play.)

Sean Brown: From McKinsey's Strategy and Corporate Finance Practice, I'm Sean Brown. Welcome to Inside the Strategy Room. Today we continue our discussion with three senior partners about their research on the factors that most affect a strategy's success and the moves companies need to make to boost corporate performance.

In our last podcast, we discussed the authors' power-curve model, which graphs the world's largest companies' performance and shows that

the middle 60 percent of them make little, if any, economic profit. Today we'll try to answer the question, "How can these companies rise to the top quintile of performers that earn the lion's share of the economic profits?"

With me again are the three coauthors: Chris Bradley, based in our Sydney office; Martin Hirt, who works in greater China and coleads the global Strategy and Corporate Finance Practice; and Sven Smit, based in Amsterdam.

Sven, let me start with you. The book is grounded in four years of research covering more than 100 industry sectors, 60-plus countries, and about 2,500 companies—but you talk about just ten variables that determine a company's probabilities of success. How did you zero in on that number?

Sven Smit: First of all, we put many variables in and these ten are what the analytics showed matter the most. They have very high predictive power. Had the algorithm found five, we would have taken five. The ten variables fall into three buckets: one is a

Exhibit 1

Five levers move companies up the power curve.

Endowment is what you start with. It determines about 30% of your odds of mobility on the power curve.

Size of your company

To gain a significant advantage, you need to be in the top quintile in total revenue. Today, that means exceeding roughly \$7.5 billion.

Debt level

The threshold is to have a debt-to-equity ratio that is favorable enough to put you in the top 40% in your own industry.

Past investment in R&D

You need to be in the top half of your industry in your ratio of R&D to sales to gain a significant benefit.

Trends determine about 25% of your odds of upward mobility.

Industry trend

For your industry to be a lever, it needs to be moving up the industry power curve by at least one quintile over a 10-year period.

Geographic trend

You have to be in markets that are among the top 40% for nominal GDP growth.

Source: Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* (Wiley, February 2018)

description of the starting point of the company, another covers the trends that affect the company, and the third bucket is the moves the company makes.

Sean Brown: Can you explain what the company's starting point refers to?

Sven Smit: The reality is, you inherit what your predecessor did. I have talked to oil and gas companies and they say, "You know, it's not the investments that my predecessor made but that his predecessor made that are flowing the oil right now." That's the R&D concept: it matters what was done before you. If, as a CEO, you inherit a company with extremely high leverage, it means that you don't have investment capacity. If you inherit a company with low leverage and a good opportunity comes by, you actually have the money to take it. So, your starting point matters.

Martin Hirt: The first category are variables that are almost a given. If you come in as a new CEO, the company size is what it is. Your balance sheet, in terms of leverage ratio for example, is what it is, and your past R&D spending cannot be changed. We grouped those variables under "endowment"—things that you can't change but that do matter in terms of your probabilities of moving up and down the power curve (Exhibit 1). And that is intuitively clear: if you compare a very large-scale IT company in terms of its ability to generate economic profit, that is obviously on a different level than a mom-and-pop store selling ice cream. Therefore, size does matter. Size is relevant. Scale is relevant.

The second group of factors has more to do with the trends a company is exposed to. That includes industry trends—is the industry experiencing tailwinds or headwinds? And it includes geographic trends—is the company exposed to high-growth geographies? And then the third group of factors that we found are related to the strategy of the company, and are under the control of management.

Sean Brown: You say in the book that it's the third category that is most important. What are those factors?

Martin Hirt: There are five (Exhibit 2). Number one, the type of M&A program that the management pursues; number two, the speed of resource reallocation to higher growth areas within the current portfolio and new growth areas outside the portfolio; number three, the absolute amount of capital investment relative to the industry that the company is in; number four, the strength of the productivity program relative to the industry; and number five, the amount of additional differentiation achieved by the company relative to its industry. For each of these factors, we were not only able to determine how big their impact was on the company's mobility on the power curve but also how hard you needed to pull each of these levers to actually make a difference.

Sean Brown: How do these three categories of factors work together in the model you've developed?

Chris Bradley: It is the combination of your endowment, your trend, and your moves that determines the odds of your strategy. Let's put it this way: if I meet your average company and I know nothing else about you except that you are in the middle quintile of economic profit, I know your base-rate probability of a strategic breakthrough is 8 percent, or one in 12. That's how many companies go up the power curve over a decade.

But then, if later I discover just through asking a few more questions that you have a really positive endowment, you have an industry megatrend on your side, and you have terrific plans to achieve big moves, then I might upgrade your probability of success to 30, 40, 50, 60 percent. There are companies in our database whose predicted probability of moving up the power curve was 80 or 90 percent. Admittedly, very few companies manage to get all of their endowment, trends, and moves in the right place. But when you do, your odds of succeeding are incredibly high.

We can couple your endowment and your trends together into what you might call your inheritance, which is what are you given, and then your moves are what you can do about it. And out of our

Five big moves increase the odds of success.

1. Programmatic M&A	Make a steady stream of deals every year, each no more than 30% of your market cap but together adding up to at least 30% of your market cap over a decade.
2. Dynamic resources	Reallocate at least 60% of your capital expenditure among business units over a decade.
3. Big investment	Be one of the top 20% in your industry on capital spending to sales, which means spending 1.7 times the industry median.
4. Productivity	Improve productivity relative to your industry at a rate fast enough to put you in the top 30% of firms.
5. Differentiation	Improve your gross margin faster than 70% of your industry through your business model, segmentation, and value proposition.

Source: Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* (Wiley, February 2018)

ten variables, by the way, five are part of your inheritance and five are part of the moves, so really strong moves can overcome a poor inheritance.

Sean Brown: Your strategic moves give you an opportunity to beat even competitors who have a stronger position at the starting gate, right?

Chris Bradley: Yes. Big moves really can make a difference. And that's where CEOs' power lies, because the big moves are things they can do. Of course, they are hard moves to make. They take years. And you have to do them in a competitive world. But you can do them.

Martin Hirt: Let me give you an example on productivity. Every company does productivity

improvement, of course, but the question is how much. And we found that whether a company does a little bit of productivity improvement, quite a lot of productivity, or more productivity than the rest of the industry almost did not matter. It only started to matter when a company did 25 percent more productivity improvement than the industry median. So, if you are in an industry that does 2 percent productivity improvement per year, year on year, you only influence your probability of moving up the power curve if you do 2.5 percent every year consistently, so 25 percent more than the rest of the industry.

Another example: resource reallocation. Whether you reallocate a bit of resources or quite a bit to other places does not matter that much. It only starts to matter when you allocate more than 60

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— Martin Hirt

percent of your capital expenditure over a ten-year period to new growth areas outside the portfolio or high-growth areas inside the portfolio.

Sean Brown: Can you say a bit more about how the empirical analysis you did helps companies benchmark what they need to do to outperform competitors?

Sven Smit: If you look at the big moves in M&A and organic resource reallocation, the average of what a company does per annum that we found in the data is something like 2 percent to 3 percent. If you do ten years of 2 percent resource allocation, you get a 20-percent new company. That sounds good, but what we found is that the companies that make the big moves progress at 5 to 6 percent per annum on M&A, or 5 to 6 percent per annum on organic resource allocation, and they get 60-percent new companies.

That is a big move that we like. We find something similar in productivity and differentiation, which are margin-related. The companies that move their margins faster than their competition get the capacity to fund some of these investments. The analysis found that it was not good enough to be ahead of competition in your cost base, but moving your cost base down faster than your competition was.

If you are in a high-growth environment and you do a capital expenditure investment to try to outperform, you have to out-invest your competitors by 1.7 times — not 17 percent, 1.7 times. We did not know that was the number; the data told us. What’s interesting about the analytical findings is that not only do we know the levers now, but we know their calibration.

Sean Brown: So, there are five big moves that really matter, and it’s important how strongly you execute them. Does it also matter which or how many of the five you do?

Martin Hirt: What we know is that pulling one lever does not get you that much. It changes the odds, at best, a little bit when you pull one lever. Only the combination of two or more levers being pulled hard enough to make a difference starts to substantially increase the odds of a company moving up the power curve.

To show you how hard that is to do, out of 2,500 companies we looked at, over a ten-year period only one company was able to pull all five levers. Only one out of 2,500 of the largest companies in the world! So, pulling multiple levers is actually more important than the question of which one to pull. That’s very context-specific.

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Sean Brown: Can you give us an example of a company that went that route of pulling multiple levers and managed to rise on the power curve?

Sven Smit: In the book we talk about PCC, Precision Castparts, that is a multi-industrial holding company. At the starting point in 2004 they did not have the size, so they didn't get a lift from their endowment. They had reasonable trends; industrials did well over the past ten years. And then they fired up their resource allocation, M&A, differentiation, and productivity—four out of the five levers. Now, if we did not know anything about the company, their odds of moving from the flat middle quintiles of the power curve to the top would have been 8 percent. We modeled what they actually did, and they ended up with a 76 percent chance of moving to the top quintile—which is where they ended up. And so our model is pretty good at multiplying out all these factors.

Sean Brown: Your book talks about how the dynamics within the leadership teams and the biases people have tend to create inertia and get in the way of fulfilling strategic plans. Martin, in your experience working with clients, which of these five big moves are the hardest to make? And can you share some tips?

Martin Hirt: Resource reallocation certainly is one of the most difficult topics for management because careers are at stake, jobs are at stake, the future of the company could be at stake. It's not surprising it is maybe the move most fraught with the perils of the social side of strategy.

When I'm with a management team and ask the question, “Who of the present business-unit leaders believes that his or her business, in terms of future growth and profit potential, is in the lower half of the company's business units?”, guess how many hands go up? None, of course. Everybody believes their business has lots of upside potential. If you ask the question, “Of the portfolio of businesses the company has or is looking at, which is the one business that you believe has the best chance of succeeding?”, you get different answers. Then people often find it very easy to agree. And why is that? Because once you remove the social factor of their feeling personally threatened by admitting that their business has little potential, people have a relatively clear view on what is moving and what is not. And therefore, I think having an open conversation about what the few businesses are that are likely to succeed is a good starting point.

So, our individual biases, our behaviors, our agendas, and the social dynamics on the management team

get in the way of good strategic decisions and execution. It would probably be getting far ahead of ourselves if we claimed that we have a convincing and conclusive solution, but in our hundreds of conversations and our work with CEOs around the world, we have learned practices that they use to manage and guide them in the right direction.

I think the most profound step you can take is to bring the empirical data that we discussed into the room. You change the debate from one about the strategy of each business in isolation and instead have an empirical benchmark where you can say, “Your presentation looked great. We loved it. We believe in your business, but the facts are that the strategy you presented, because it lacks big moves, has no more than a 25 percent chance of succeeding, with success being defined as you achieving the targets that you just described or that we gave you. Meanwhile, your colleague had a miserable PowerPoint, but based on what was presented we believe, and the numbers would say, that there is a 75 or 80 percent chance of success. So, should we invest in the 25-percent strategy or the 80-percent strategy?” Simply by introducing a benchmark that allows us to compare strategies at some level, you change the debate.

Sean Brown: Betting your company and your career on big strategic moves sounds risky, though. Do the leaders you deal with worry about the downside of these moves not panning out and causing the company to actually drop down the power curve?

Martin Hirt: The big moves have an interesting characteristic. They are asymmetric in terms of their risk profiles, meaning that by pulling a lever harder, we improve the chances of a company going up the power curve and at the same time reduce the risk of it sliding down. So, it is not that you are loading the company with more risk. Bold, in our sense, is not crazy. Bold is deliberate and trying to derisk moves that get you to win.

The beauty of the analysis is that we can conclusively show the companies that do big moves move up and substantially lower their risk of falling

down. In fact, you could say that the riskiest strategy of any is to do no big moves, because that almost guarantees that they will slide down.

Sean Brown: Chris, this notion of a company's inheritance, Martin and Sven talked about it as a given, something you simply must work with. But part of that inheritance, or endowment, are the trends you deal with, and a company can change the trends it's exposed to by shifting to new geographies and industry segments, right?

Chris Bradley: We think of it a bit like driving a car in traffic. There are two levers you have: you can change lanes, or you can step on the accelerator. If you are in a slow-moving lane, you have fundamental limits on how much pushing the accelerator will actually work. So, any good strategy is a combination of changing lanes into the faster lane and stepping on the gas.

Changing lanes is what we call portfolio moves. That's things like rapidly reallocating resources to different uses, pursuing a programmatic approach to deals, and achieving extremely high opportunity creation in terms of capital spending. Getting better and stepping on the accelerator, we call those performance moves—for example, productivity improvement or differentiation that improves your relative gross margins. So, when we talk about moves, it's not isolated from where to compete. In fact, one could argue the levers that drive your where-to-compete decisions are in the long run a bit more important than the levers you pull to drive your performance. In other words, the first question of strategy, and our research keeps coming back to this, is not, “How do I get better at what I do?” but, “How do I do the right things?”

Sean Brown: Is there a recommended sequence to making the big moves?

Martin Hirt: There is no sequence to big moves that is generically applicable. It always depends on the context and the company's specific situation. There is no replacement for the CEO and management understanding the outside world, having a very clear

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perspective on where their company stands, and then shaping an agenda around big moves. It’s true that the choice of industry you play in is the single biggest factor determining the success of a company. And in that, the old truth, which we proved ten years ago in the book *Granularity of Growth* (Wiley, 2008), that the choice of where to play is the most important choice any company can make, still holds.

It is still highly context-specific to determine which moves, in what sequence, to do. That is why we typically go into client companies with a very systematic and highly prescriptive diligence that identifies the opportunities for value creation and tailors moves—in the choices, in their scale, in their timing and their sequence—to the company’s specific situation.

Sean Brown: Let talk a little bit about the global context right now. Companies are competing in a world full of geopolitical uncertainty, accelerating change, and digitization. How does that uncertainty factor into your analysis?

Sven Smit: First of all, this entire research was done across a cycle that includes the last recession, so in that sense it is robust. We are not looking at a period

of just going up; it has a recession built in and a significant one if you remember.

Chris Bradley: We always talk about uncertainty moving forward. I want to address something, though, that we touch on in the book, which is uncertainty going backward. We have this overconfidence about our understanding of history—you know, the classic, “When performance is good, it was superior management. When performance is bad, it was the weather.”

Now, that’s a bit playful, but if you listen to a lot of analyst calls, you will hear things like that all the time. It’s very difficult to think about the future, but we would argue that the starting point is to make sure you have decoded the past. The past is actually quite mysterious, and that is the beginning of a lot of the social side of strategy, because you end up having a story that you tell yourself about your performance.

Now in reality, the world is changing very fast. But the world is always changing. And if you really interrogate your history and understand it, you will see these forces at work very evidently in your results. Part of how I counsel my clients to get bolder about the future is to untangle what happened in the past and

understand how much of that came down to the trends they rode and the big moves they made. The first step is to know why you got where you are.

Sean Brown: Thank you, all. Any final thoughts?

Martin Hirt: You know, strategy is not deterministic. Strategy is a matter of probabilities. There is nothing that is certain, but improving the probabilities of success is what we set out to do. We now have an empirical understanding not just of what the ten factors are that matter, five of them being directly related to the strategy of a company, but we also know how much you need to pull each of these levers in order to make a real difference.

Chris Bradley: My final thought is, boldness is not reckless. Think about this analogy: if you're living on the side of a volcano and it starts erupting, running extremely fast is actually the safest thing you can do. And our evidence shows most companies are living on the side of a volcano, so moving fast, being really responsive, and going boldly is actually the safest approach.

Sean Brown: Thanks for joining us today.

On our next podcast we'll continue the discussion, with Chris Bradley explaining eight shifts companies can make to overcome the social dynamics and biases in the strategy room.

Chris Bradley is a senior partner in McKinsey's Sydney office, and **Sean Brown** is the firm's global director of communications for strategy and corporate finance, based in the Boston office. **Martin Hirt** is a senior partner in Greater China, and **Sven Smit** is a senior partner in the Amsterdam office.

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