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Viewpoint

Investing when interest rates are low

Projects that wouldn't have created value because interest rates were higher aren't necessarily attractive when interest rates drop.

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Call it investment limbo. After nearly three years of historically low interest rates, it's the rare company investment strategist who isn't puzzling over his or her next move. With interest rates near 40-year lows, some projects whose returns couldn't have matched the cost of capital just a few years ago now have allure. But if stronger economic growth pushes interest rates up, those projects could spill red ink. Similarly, planners must consider the chance that projects with lower returns on invested capital (ROIC) than they've become accustomed to might pay off—but would lower a company's average return.

In our experience, companies need to be aware of the temptations and traps that lurk in this environment. With signs of economic recovery becoming more widespread, it will take close analysis to determine if today's marginal projects will become tomorrow's winning growth plays—or if a turnaround in interest rates will threaten their value altogether. The smartest response, we believe, includes an objective look at real investment costs and a thorough reexamination of what

constitutes realistic returns. Only then can companies confidently assess investment options and pursue growth strategies rather than sit passively on the sidelines while competitors capture the best available investment opportunities.

Reexamining the cost of capital

If management teams could lock in today's low cost of capital as easily as a home owner locks in a long-term interest rate, investing would be easy. Since they cannot,¹ companies must be particularly careful in assessing a project's potential value. The best assessment should not only take into account both the real cost of capital and an estimate of inflation. It should also ensure that the same inflation rate is explicitly included in analyses of a project's cash flow as is used in estimates of cost of capital. The fact is that in general projects that were unattractive in the past do not magically become attractive just because interest rates drop.

This is a crucial point for many companies, particularly those whose various investment teams either don't interact or don't understand the varying approaches they employ to estimate a prospective project's cost of capital and approximate cash flow. As a result, companies sometimes overlook the fact that lower inflation rates should produce lower nominal cash flow forecasts, offsetting a lower discount rate. For example, in November the inflation expectations as reflected in ten-year US Treasury bonds were about 2 to 2.25 percent, nearly a full point lower than in January 1997. Companies evaluating investment projects in November, therefore, should have assumed a 2 to 2.25 percent inflation rate when calculating both the cost of capital and when calculating nominal growth rates and revenues. If a

team analyzing an investment updated its cost of capital calculations but not its growth and revenue calculations, its overall assessment of any given project would

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inevitably overstate the project's value.

Another critical point often overlooked by companies is that lower real interest rates on government bonds don't always lead to lower real

costs of equity. For example, with real government bond rates around 2 percent at the time of this writing—after more than 15 years of hovering around 3 percent—many companies also reduced their estimates of the cost of equity. Over the past year, we have seen nominal cost of equity estimates in the range of 7.5 to 8 percent.² However, recent research by some of our colleagues³ demonstrates that the nominal cost of equity is probably closer to 9 percent, including a 7 percent real cost of equity and a 2 percent expected inflation rate.⁴ Indeed, the real cost of equity appears to be more stable than the real risk-free rate, suggesting that while interest rates may decline, investors' demands for higher risk premiums likely offset the effect of interest rate declines on the nominal cost of equity.

Setting a better hurdle rate

Finance theory suggests that companies should invest in all projects that earn just slightly more than the cost of capital—the rate at which investors will discount cash flows to estimate a company's value. Even when the analytics are correct, companies are often concerned that such

low-return projects run a high risk of winding up destroying value, since they provide no margin for shareholders and will always run some risk of encountering negative developments.

Theory aside, there are valid reasons for companies to set hurdle rates above—and in some cases, even well above—the cost of capital. A better approach, we believe, is to base hurdle rates on a periodic assessment of industry microeconomic fundamentals to determine the likely range of returns for the industry over an appropriate cycle. This approach ensures that project teams are pursuing only the best opportunities available within a sector and not settling for projects that may be easier to identify and execute but that will yield lower returns.

For example, companies in industries such as pharmaceuticals and branded consumer products frequently earn returns on capital exceeding 30 percent after-tax. For these companies, it is harder to find and develop management talent than it is to get the necessary capital to pursue available opportunities. So it makes sense not to invest in projects with returns at only 10 percent—even though that may technically be more than the company's cost of capital.

Oil companies provide a good example of evaluating projects based on expected long-term industry fundamentals. While crude prices are relatively high today by historical standards, and constitute an equivalent to low costs of capital, the volatility in crude oil prices driven by short-term supply/demand fluctuations through the past 30 years has taught petroleum companies to use a crude price based more on

fundamentals to evaluate new projects. As such, today, most leading crude companies undertake their assessment at \$18 to \$20 per barrel, which is more representative of a longer-term average price for crude. If new developments are economically attractive at this price level, oil majors will likely proceed with an investment, even though the price is well below current oil prices.

Dealing with ROIC dilution

Companies also express concerns that investing today even in projects that are modestly positive on a net present value

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basis runs the risk of diluting average return on invested capital. Many projects developed when interest rates were higher now earn returns considerably above the current weighted average

cost of capital, and today's investment opportunities have difficulty matching them. Many managers are therefore reluctant to make such investments and are inclined simply to sit on their capital, waiting for a better investment environment.

That may be a dangerous practice. Investors value both growth and return on invested capital, and managers need to figure out the best trade-offs and communicate their decisions to the market. The decision to dilute a company's average return on capital is a difficult one and there are no universal solutions. We think companies should address this issue by asking themselves several questions: Have the long-term economics of the industry

declined as the industry matured, and do you therefore need to reduce your expected returns on capital? Does the stock market already incorporate its expectations of lower future returns in industry share prices? Will you get shut out of future growth opportunities by passing up investments today that will make you stronger over the long term? If a company answers yes to some or all of these questions, it might be time to start preparing for lower average returns on capital.

Getting the most out of today's low interest rates isn't as simple as refinancing a home. To navigate the crosscurrents of this low-interest-rate environment, companies require realistic assessment of their investment costs, their breakeven points, and their need to stay active with new investments rather than waiting passively for a new interest rate environment to improve their competitive position. **MoF**

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¹ While it is possible for a finite period to lock in the low cost of debt (through fixed interest rate obligations), it is not possible to lock in the cost of equity.

² Risk-free rate of 4 percent plus 3.5 to 4 percent equity risk premium.

³ Marc H. Goedhart, Timothy M. Koller, and Zane D. Williams, "The real cost of equity," *McKinsey on Finance*, Number 5, Autumn 2002, pp. 11–15.

⁴ The real cost of equity is very stable at about 7 percent, and the equity risk premium varies inversely with real interest rates.

