OCTOBER 2013
McKinsey Quarterly

Never let a good crisis go to waste

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New research shows that actively reallocating corporate resources is even more important in a downturn than it is in good times.

The vast majority of organizations are surprisingly slow to reshuffle their resources. When we conducted a large-scale analysis of the reallocation patterns of multibusiness companies, for instance, we found that most of them awarded each business in their portfolio an unchanging percentage of total corporate capital year after year between 1990 and 2005. Yet the returns were higher and the volatility lower at organizations that reallocated more actively.

When we present these findings (which we highlighted in a previous *McKinsey Quarterly* article[1]) to senior executives, they often ask us about the impact of the financial crisis and the downturn that followed. Surely, they argue, a tougher economic environment has led to more pronounced changes in resource-allocation patterns as companies were forced to look for new sources of value.

In fact, this proves not to be true. When we extended our analysis through 2010, thereby covering a full 20 years of performance by 1,500 companies, we found that the downturn had virtually zero impact on patterns of reallocation.[2] There was apparently no

[1] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012, mckinsey.com.

[2] Resource allocation is measured as 1 minus the minimum percentage of capital expenditure received by distinct business units over the 20-year period from 1990 to 2010. We used Compustat data on 1,508 US-listed companies that reported capital expenditure in a minimum of two distinct four-digit Standard Industrial Classification (SIC) codes.

greater aggregate corporate appetite for it in the tough recent years than there had been in the previous 15.

Yet the executives' instincts are right: dynamic resource allocation became more critical than ever during the downturn. Compare the performance of companies in the top third of our pool (high reallocators) with the performance of those in the bottom third (low reallocators). As Exhibit 1 shows, the gap between the total returns to shareholders (TRS) of the high reallocators, on the one hand, and of the low reallocators, which evolved their allocations only modestly over the 20 years, on the other, increased from 2.4 percentage points to 3.9 percentage points as a result of the extra five years. That may not sound like such a big gap, but 3.9 percentage points of annual incremental returns to shareholders implies that an investor's stake in our sample's typical high reallocator was worth more than twice as much as a stake in an average low reallocator by the end of the 20-year period (assuming all dividends were reinvested).

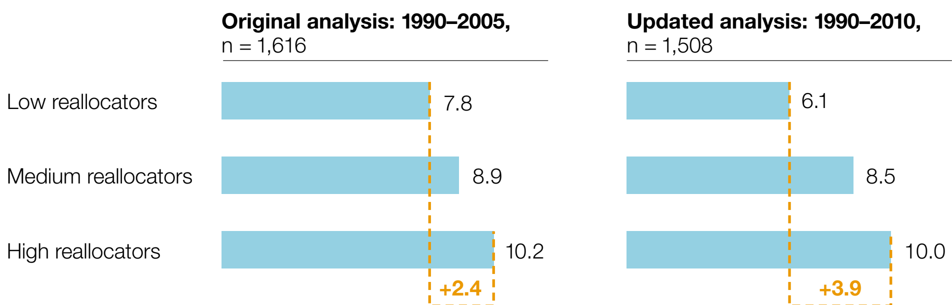
When we looked at companies sector by sector, the same broad pattern emerged: whether in basic materials, energy and utilities, information technology, or consumer products and retailing, the median TRS was consistently greater for the high reallocators than for the low ones.

A similar story is apparent in the corporate-survival statistics. Over the new, longer period of our study, the survival gap between

Exhibit 1

Companies that actively reallocated their resources continued to perform better through the 2007–10 economic downturn.

Median TRS CAGR for US companies, by degree of reallocation,[1] %



[1]TRS = total returns to shareholders; CAGR = compound annual growth rate. Degree of reallocation measures share of capital expenditure shifted between business units over given period; low reallocators = bottom third by reallocation activity, medium = middle third, and high = top third.

Source: Standard & Poor's Compustat; McKinsey analysis

high and low reallocators increased to 22 percent, up from 13 percent in the original period.

In addition, since our data now cover both of the major global economic downturns of the past 20 years (for our purposes, 1999 to 2002 and 2007 to 2010), we can divide companies into those slow to respond by reallocating resources in the two crises, those that actively reallocated in only one, and those that did so in both. The results speak for themselves (Exhibit 2). On average, a company that was a high reallocator during both downturns had a TRS 3 percent greater than a company that was a high reallocator in only one and 4.5 percent greater than a company that wasn't in either.

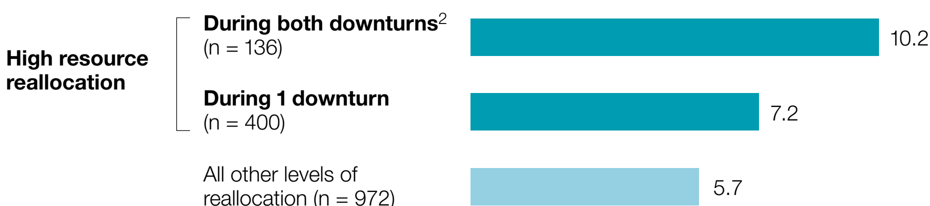
Realizing the benefits of resource reallocation during a downturn often requires shifting capital and other resources from one existing business to another: when times are tough, there is generally less new capital around, either in the form of growth in retained earnings or of new debt and equity capital. From 2007 to 2010, for example, the volume of new capital available to corporate-management teams in our sample declined by over 15 percent.

In these circumstances, it is more incumbent than ever on companies to make difficult trade-offs between the funding of promising growth opportunities (which require nurturing with more capital) and of mature or underperforming ones (which may need pruning). We found that high reallocators in our sample tended to reallocate existing and new resources equally; low reallocators, by contrast, had a much harder time taking resources away from existing lines of

Exhibit 2

Companies that reallocated their resources during tough times enjoyed significantly higher returns.

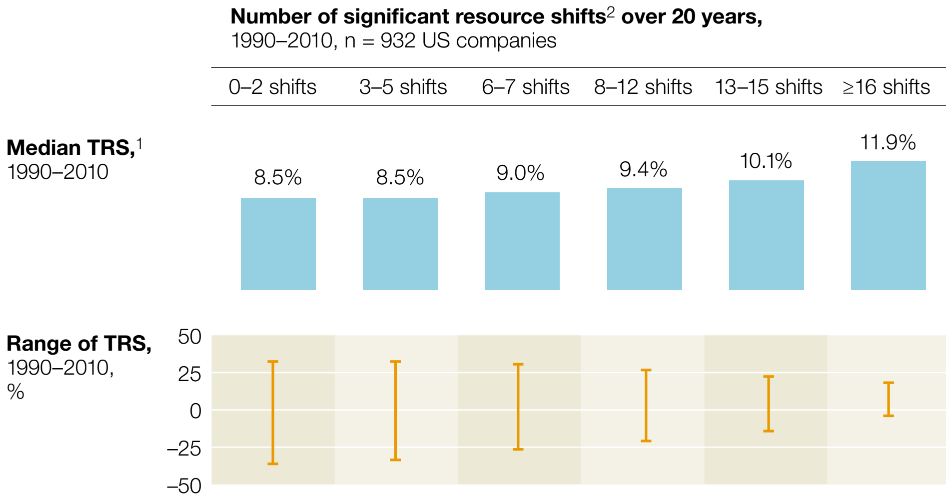
Average TRS for US companies, 1990–2010,[1] %



[1]TRS = total returns to shareholders; low reallocators = bottom third by reallocation activity, medium = middle third, and high = top third.
[2]Downturn periods defined as 1999–2002 and 2007–10.

Exhibit 3

Companies that consistently reallocated their resources experienced higher and less variable returns.



[1]TRS = total returns to shareholders.
[2]A significant shift is one that moves >5% of total capital-expenditure allotment.

business and tended predominantly to reallocate new resources. The willingness to rob Peter to pay Paul is one of the hallmarks of a dynamic top team.

This is not to say, however, that sharp, one-time swings of focus in response to a changing external environment generally make sense. Rather, our new data suggest that markets most reward companies that do not overreact to short-term signals by making large, abrupt changes in business focus but instead pursue multiple, stepwise shifts in resources, year after year, in pursuit of a clear strategy. That approach tends to produce better returns and lower volatility than one or two Herculean changes to a corporate portfolio (Exhibit 3).

These results suggest to us that resource reallocation is a muscle that requires exercising in good times and even more in bad times. Companies should be on their guard against inertia at all stages of the cycle—and may need to be particularly ruthless in a downturn, especially when new sources of capital dry up. ○

The authors would like to thank Reinier Musters for his contribution to the development of this article.

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