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McKinsey on Finance

Perspectives for CFOs and other finance leaders

Growth for the long run

Inside: How to commit resources to growth and innovation amid uncertainty, how to get more value from separations and sustainability initiatives, growth trajectories for CFOs and finance, and more.

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McKinsey on Finance is a quarterly publication offering perspectives drawn from across—and beyond—McKinsey for CFOs, those who aspire to be CFOs, and other finance professionals.

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Item 1: This edition

Few challenges are greater than maintaining growth over the long term. As our research has shown, only one in ten companies was able to beat GDP growth and remain in the S&P 500 over a 30-year period. Nor is growth an absolute good—particularly if it destroys value over time. As no less an authority than Warren Buffett observed, "The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money." Simply put: Growing a company and sustaining value creation over the long run is hard.

Profitable growth requires the right mix of outlook, strategy, and capabilities—and the endeavor must be treated like a marathon, not a sprint. Allocating sufficient resources to innovation is critical. As we describe in "How top performers use innovation to grow within and beyond the core," the most successful organizations commit to innovation even in uncertain times.

Farsighted CFOs understand that sustained growth is impossible without a well-considered strategy. They don't prioritize short-term results; on the contrary, they're prepared to consider shrinking in the near term to grow over longer horizons, as we show in "What it takes to make separations a competitive difference-maker." Effective organizations also think strategically about their sustainability initiatives and moor them in the company's distinct competitive dynamics. In "Sustainability: Sources of value creation," we provide a framework for companies to approach risks and opportunities as they invest in their unique environmental, social, and governance priorities.

For CFOs, long-term growth is also a personal journey. A panel of former senior finance leaders provides their suggestions on what it takes to go from good to great in "Faster, smarter, bolder: How midtenure CFOs shift into a higher gear." And in a comprehensive, one-on-one discussion, Sarah Friar, the CFO of OpenAI, shares insights on her career so far and perspectives on what an AI-powered finance function of the future looks like.

Over the years, we've found that even the smartest CFOs with the best of intentions can fall prey to human and organizational decision biases that can frustrate growth and value creation. In "Biases in decision-making: A guide for CFOs," we present a compendium of the most common decision biases and tips for how to overcome them.

Finally, this edition's "Looking back" feature examines how the amount of "dry powder" has grown—and what that might mean for M&A activity in the near and immediate term.

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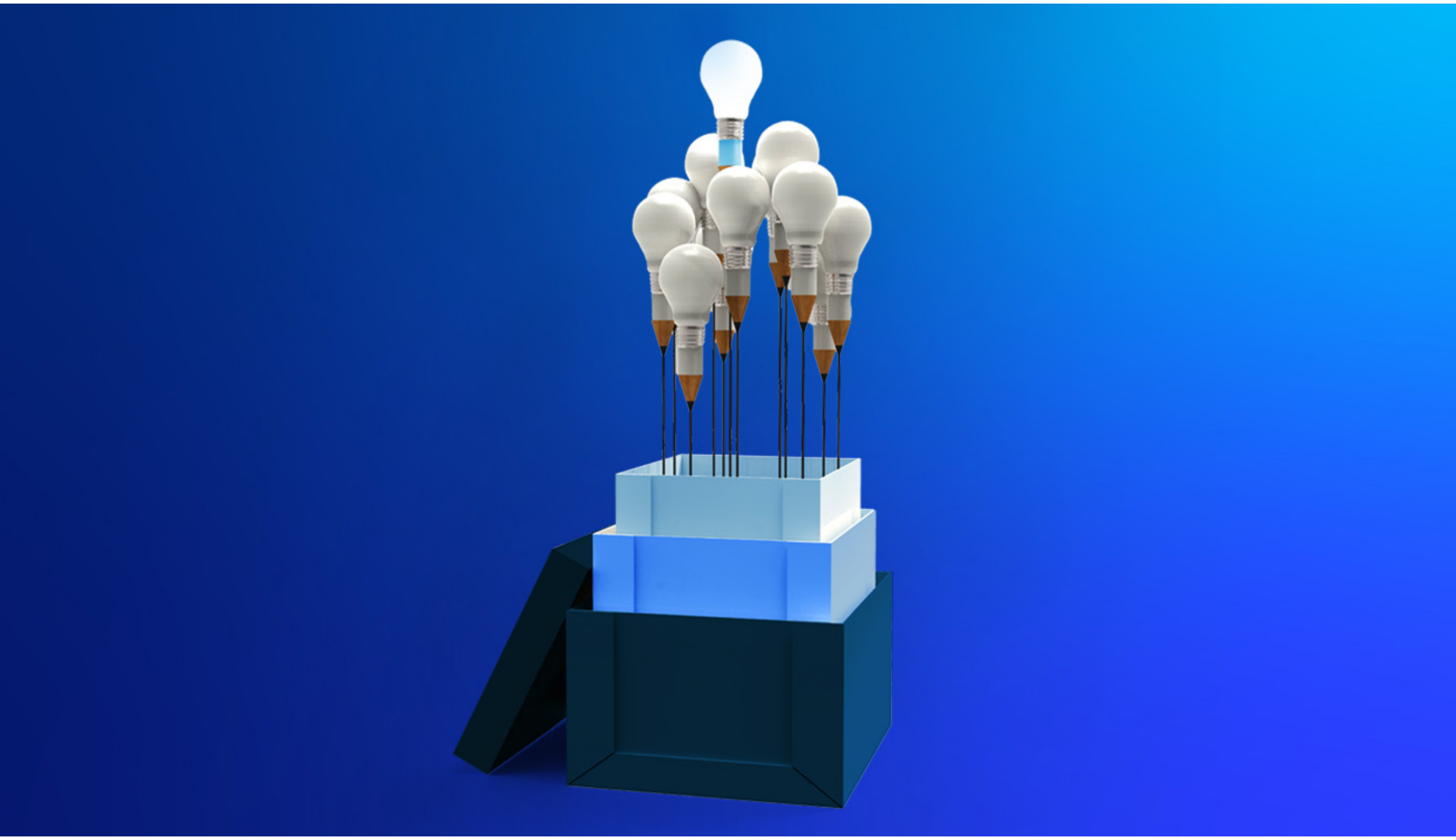
How top performers use innovation to grow within and beyond the core

While innovation is critical to all companies' growth, the most successful organizations use it to both expand their lead within their industries and disrupt new ones, even in uncertain times.

by Marc de Jong, Matt Banholzer, and Rebecca Doherty
with Laura LaBerge



Innovation and growth are inherently linked. Companies that build new businesses and develop new offerings, processes, or business models are better able to capture growth opportunities[1] and hedge against disruption[2] in a highly uncertain business environment.

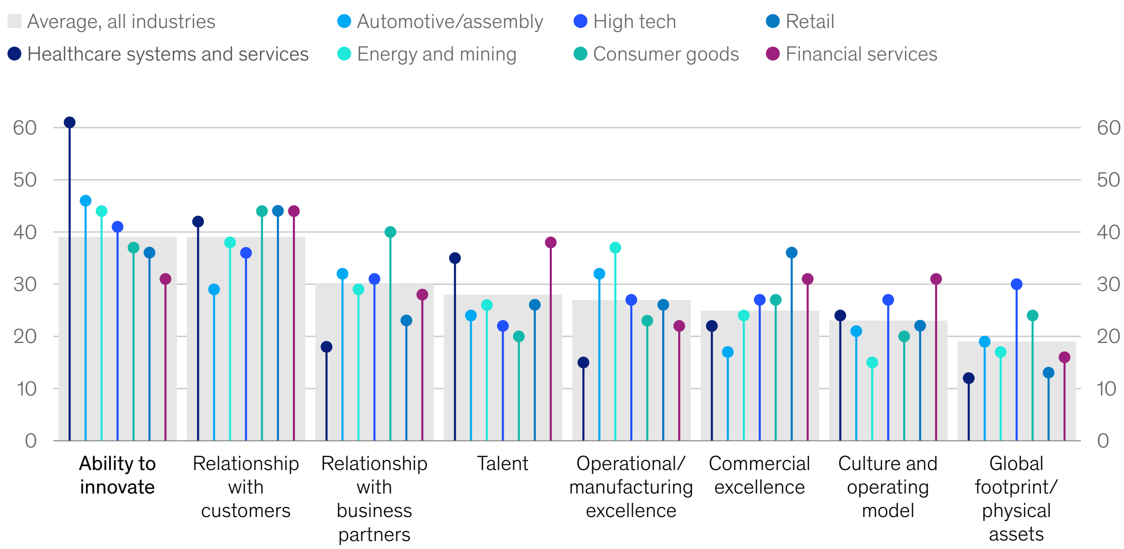
This conclusion was forcefully reinforced in our recent survey of 1,039 companies around the world. The largest share of respondents identified the ability to innovate as the most important strategic factor for generating growth over the coming 12 months (Exhibit 1).

While we found some variation by industry, innovation capabilities were consistently among the top three growth levers. In sectors undergoing significant disruption—energy, for example, where supply disruptions and large investments in sustainability require companies to evolve their businesses—innovation is particularly important. But even in industries where the evolution of business models is a less urgent need, such as retail, nearly a third of the respondents identified innovation as a top three source of competitive advantage.

Exhibit 1

The biggest sources of competitive advantage vary by industry, but innovation is consistently identified as a top three growth factor.

Share of respondents citing factor as source of organization's competitive edge,[1] %



[1]Respondents were able to select more than one option.
Source: McKinsey 2024 Strategic Growth and Innovation Survey, Feb 2024 (n = 1,039)

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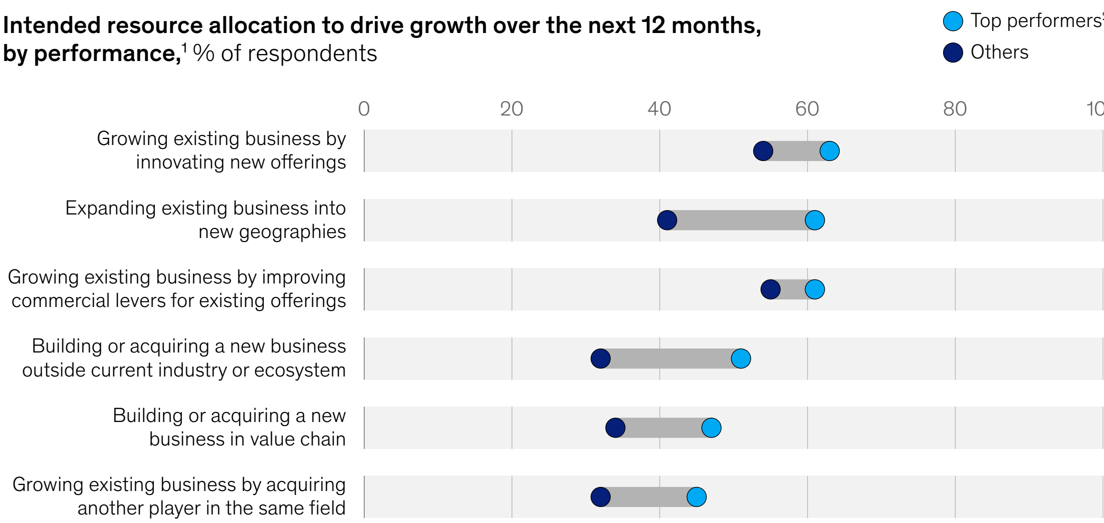
[1] Matt Banholzer, Rebecca Doherty, Alex Morris, and Scott Schwaitzberg, "Innovative growers: A view from the top," *McKinsey Quarterly*, November 1, 2023.
[2] Matt Banholzer, Michael Birshan, Rebecca Doherty, and Laura LaBerge, "Innovation: Your solution for weathering uncertainty," McKinsey, January 10, 2023.

Exhibit 2

Top economic performers are pulling all growth levers harder than their peers.

Intended resource allocation to drive growth over the next 12 months, by performance,[1] % of respondents



[1]Respondents were able to select more than one option.
[2]Companies whose executives report increases of at least 15 percent revenue and EBIT over the previous three years.
Source: McKinsey 2024 Strategic Growth and Innovation Survey, Feb 2024 (n = 1,039)

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What distinguishes top economic performers[3] from the broader group, however, is their comprehensive approach to innovation and growth—both within and outside their current industries or geographies (Exhibit 2). In our survey, top performers cited innovating new offerings as their number-one investment priority for accelerating growth over the next 12 months. They were also more than 63 percent more likely to innovate at scale by building or acquiring new businesses outside their current industries and 50 percent more likely to expand geographically compared with their lower-performing peers.

Innovation spurs growth within and beyond the core

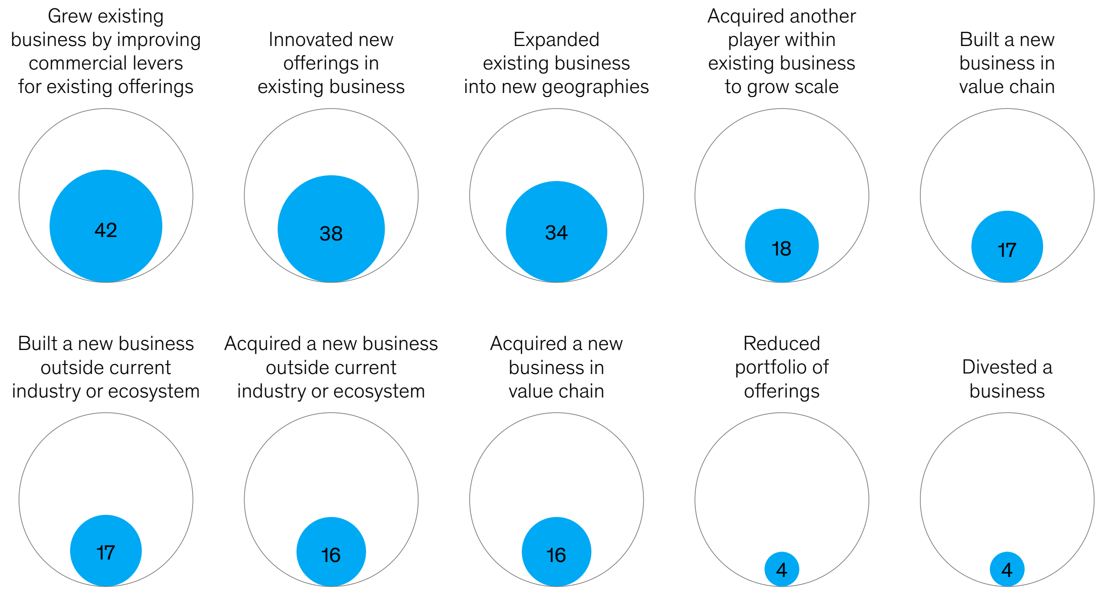
On average, 80 percent of corporate growth comes from within a company's core industry,[4] and innovation is critical to that growth. While overall industry momentum and commercial levers such as pricing and marketing are critical, the next two largest factors, noted by 38 and 34 percent of our survey respondents, respectively, are innovation of new offerings within the core business and expanding into new regions (Exhibit 3).

[3] Companies whose executives reported increases of at least 15 percent revenue and EBIT over the previous three years.
[4] *Courageous growth: Six strategies for continuous growth outperformance*, McKinsey, October 23, 2023.

Exhibit 3

While growth levers within the core generate the most value, those outside the core contribute meaningfully.

Share of respondents selecting lever as a top three contributing factor to year-over-year growth during past fiscal year, %



Source: McKinsey 2024 Strategic Growth and Innovation Survey, Feb 2024 (n = 1,039)

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Innovation not only gives companies new revenue streams within their core businesses but also potentially steepens the entire sector's growth trajectory. For example, Taiwan Semiconductor Manufacturing Company's disruption of the integrated semiconductor industry by supplying manufacturing services to other players, combined with its innovations that increase chip computing density, has both raised its revenues by 17 percent annually between 1995 and 2023[5] and contributed to boosting the sector's growth. Similarly, Apple famously helped redefine the music industry by introducing the iPod and its associated apps and created entirely new platforms with the iPad and Apple Watch, all of which bolstered its ascent to the number-two spot among the world's most profitable companies.[6]

Top-performing companies put as much effort as other firms do into growing the core. What differentiates them from their peers is their use of innovation to venture beyond their industries. As technology continues to break down traditional industry barriers, the need to innovate outside

[5] McKinsey's Value Intelligence Platform.
[6] *Datarails Blog*, "The 5 most profitable companies and how they maximize profits," blog entry by Shmuel Gordon, updated October 6, 2024.

the core deepens. For example, in our research, top performers were 78 percent more likely than their peers to build new businesses in different industries and 68 percent more likely to acquire one in another sector.

This pattern holds true when we narrow the lens to the top 20 global companies by average five-year economic profit (Exhibit 4). Fourteen of them accelerated growth through significant innovation investments within their core businesses or by creating entirely new markets outside their core—sometimes both—underscoring the importance of innovation-led growth. These moves often occurred over numerous years, even entire economic cycles.

How top performers accelerate growth through innovation

Each of the top 20 companies followed a clear path of strategic advantage in choosing their innovation investments to both maximize the upside potential and limit risk. They based their strategies on evergreen principles of innovation:

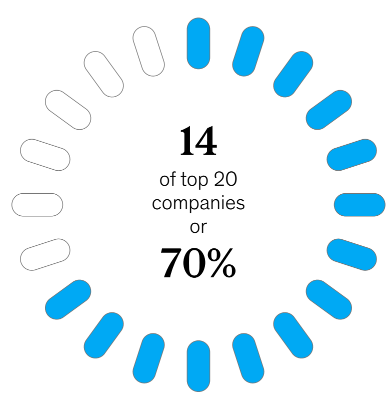
— *Commit to an innovation aspiration.* Companies that pursue growth even during downturns consistently outperform their peers, our research shows. Their leaders foster an aspirational mindset by building an innovation culture and ensuring employee ownership of growth initiatives.

— *Discover new ways to extend your strengths.* Top performers master ways to take their unique strengths and deploy them profitably outside their immediate ecosystems. Where are your manufacturing capabilities, intellectual property, customer relationships, and other

Exhibit 4

Seventy percent of top 20 companies by economic profit globally have innovated to expand the overall size of their market or to create a new one.

Number of top 20 companies by average economic profit[1] that have innovated to expand or create a new market



[1]Top 20 companies by average economic profit, five-year average (2019–23). Berkshire Hathaway not applicable as a pure investment vehicle.
Source: S&P Capital IQ; McKinsey Value Intelligence Platform

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strengths truly distinctive? AI tools can facilitate these searches,[7] revealing more granular growth pockets faster than traditional methods. Following your competitive advantage essentially extends your core business to adjacent or even breakout opportunities but with less risk.

— *Accelerate into tailwinds.* If you operate in an industry with high growth momentum—thanks to rapid innovation, as in the semiconductor or biotechnology sectors, or significant headroom for growth, as is the case with emerging technologies—focusing on gaining more market share in that sector by innovating new offerings or acquiring new capabilities is a less risky (and likely more profitable) growth path than moving into an unfamiliar sector. Companies in mature or highly competitive markets, on the other hand, can bolster their growth by exploring high-growth markets elsewhere.

— *Evolve and disrupt your own business, even the entire ecosystem.* Many of today's top companies didn't just ride industry tailwinds—they created them. For example, defense technology unicorn Anduril Industries is challenging the industry's conventional "cost plus" acquisition model in the public sector by fostering an open ecosystem of partners to build customized, interoperable solutions.

— *Scale faster by hardwiring M&A into your innovation capabilities.* Many leading organizations acquire capabilities, such as technologies or intellectual property, to accelerate their growth. They define growth opportunities they want to capture, develop lists of capabilities required to win in those spaces, and then assess which capabilities they already have, which they should build organically through innovation, and which they need to buy. Such capability maps help business leaders chart paths into areas of strategic importance and reduce the risk of falling behind competitors.

Every company that aspires to outgrow its peers in revenue and profit could benefit from these practices. However, the organization's competitive context, health, and performance will determine the right mix and intensity of each innovation lever.

Top performers understand that investments in innovation are the best way to secure growth in an uncertain economic environment. By innovating new products, processes, and business models as a means of both expanding their core businesses and breaking into new sectors, they not only emerge as leaders of their industries but also create entirely new businesses that grow the economic pie for all.

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[7] Chris Mulligan, Nicholas Northcote, Tido Röder, and Sasha Vesuvala, "The strategy-analytics revolution," McKinsey, April 26, 2021.

What it takes to make separations a competitive difference-maker

Companies that are effective at separations can significantly outperform their peers. Our latest survey highlights the opportunities, and complexities, of achieving a successful separation.

by Andy West, Anna Mattsson, and Jamie Koenig
with Anika Becker

Every business has a best owner, which may—or may not—be your company. But recognizing that it's time for a separation (which we define as spin-offs, split-offs, carve-outs, and other sales of businesses in a company's portfolio) and actually *executing* separations effectively are very different propositions. Successful companies not only understand the separation imperative but also anticipate the challenges involved and take practical steps to meet them. As a result, they tend to create more value for a broader range of stakeholders.

How do they do it?

To learn more, we surveyed a broad range of experienced leaders and practitioners across a range of industries, geographies, and company sizes.[1] We asked hard questions and received frank, thoughtful answers. To a large extent, the responses confirmed many long-held principles about separations. But they also revealed a few surprises. In this article, we'll share the most compelling lessons.

The key findings

The survey found critical differences between programmatic dealmakers and companies that take different approaches to M&A. It also highlighted how important speed can be to an effective separation. In addition, the survey revealed that separations can be a lot more difficult to execute than they may initially appear—even for sellers that are determined to just "sell and forget," intending to let the buyer sort details out.

Successful companies not only understand the separation imperative but also anticipate the challenges involved and take practical steps to meet them. As a result, they tend to create more value for a broader range of stakeholders.

[1] We interviewed a diverse set of 83 separation experts comprising C-suite leaders as well as functional and project leaders from various industries. The survey was conducted in May 2024.

Active management wins

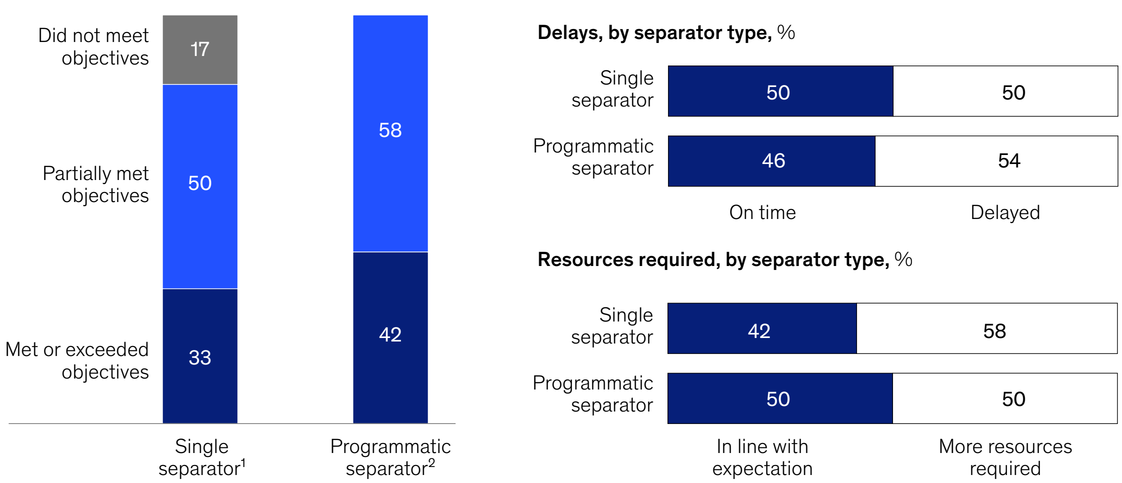
Companies that regularly refresh their business portfolio, our survey found, reported better outcomes compared with those that undertook only a single separation. This underscores the value of accumulated experience and is consistent with our historical research. Moreover, respondents whose companies took a programmatic approach to deals managed to achieve at least partial success in their separation objectives, whereas 17 percent of nonprogrammatic dealmakers did not meet their goals. Active dealmakers reported that they maintained better control over resource limits. This indicates that these companies are more adept at balancing speed and value creation, as well as accurately gauging the resources needed for successful separations (Exhibit 1).

Interestingly, survey respondents from companies that conducted only one separation during the past three years reported that their companies are less likely to engage in further separations in the next few years (Exhibit 2). However, this excludes external factors potentially fueling separations, such as an activist campaign.

Exhibit 1

Companies that take a programmatic approach to separations achieve the best success rates.

Value objectives achieved, by separator type, %



All programmatic separators achieved their separation objectives at least partially, compared with 17% of single separators that failed to achieve their objectives . . .

. . . despite programmatic separators not outperforming single separators in avoiding delays, but keeping resources in check

[1]Only 1 separation in 3 years.
[2]More than 5 separations in 3 years.
Source: McKinsey Separation Survey 2024

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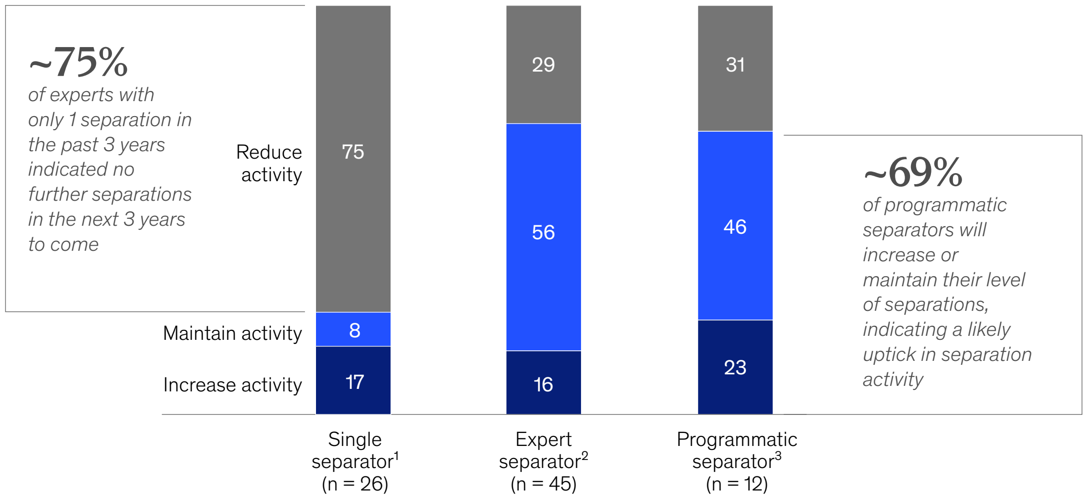
Exhibit 2

Programmatic separators plan to continue separations.

Plans for future separation activity, by separator type, %



[1]Only 1 separation in 3 years.
[2]2 to 5 separations in 3 years. Figures do not sum to 100%, because of rounding.
[3]More than 5 separations in 3 years.
Source: McKinsey Separation Survey 2024

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Speed matters

Speed matters for the success of a separation. Prior analysis of spin-offs, for example, shows that companies that closed within seven months of a spin-off announcement had a combined positive three-year median excess TSR of 1.8 percent, while companies that took 19 months or longer to close generated excess TSRs of –19.1 percent. Companies that closed within eight to 12 months and 13 to 18 months of the separation announcement had excess TSRs of –0.8 percent and –4.3 percent, respectively.

Board deliberations can be a critical source of delay across separation categories. Our survey showed that only 23 percent of separations occurred without board-related delays. Delays in board decisions are strongly correlated with broader project setbacks. Survey participants shared that when board decisions are delayed, 55 percent of separations wind up being delayed as well, compared with just 11 percent when board decisions are timely. Strikingly, board-induced delays often lead to resource overruns; 59 percent of survey respondents reported cost overruns, compared with 26 percent who reported overruns when there were no board delays (Exhibit 3). These findings underscore the importance of early board clarity for successful separations.

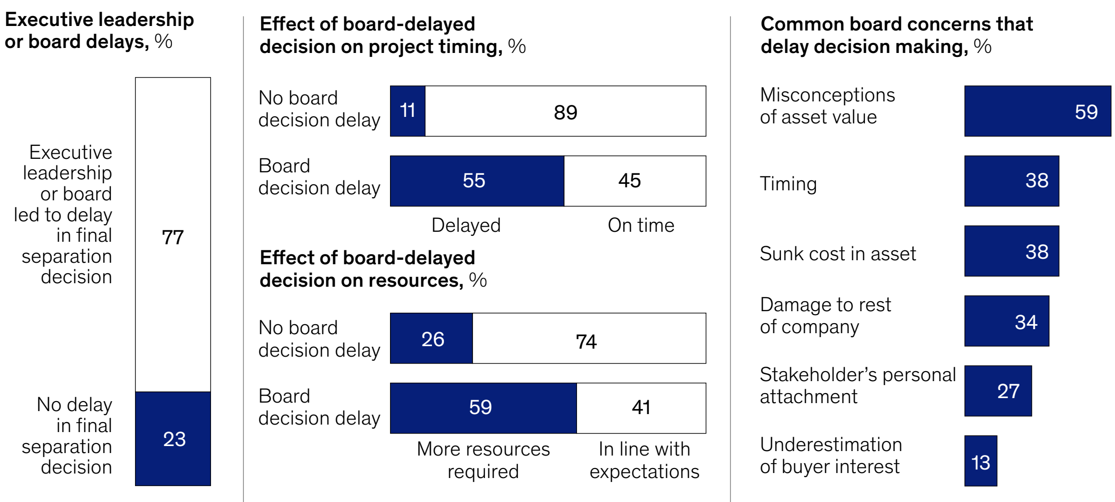
A closer examination of board hesitation reveals several key concerns. The most frequently mentioned issues include valuation concerns of the involved assets, followed by the timing of the separation in relation to market conditions, sunk costs in the assets to be separated, and potential negative impact on the remainder of the company. These diverse concerns highlight the complexity of both internal and external perspectives that the board must consider. To ensure a successful separation, these issues should be addressed early and directly, with clear, data-driven arguments and thorough planning. Only then can the board make an informed decision.

Consider the case of a European chemical company, ChemCo, which attempted to separate its commodity and specialty businesses. Although the executive board quickly supported the move, the supervisory board hesitated due to concerns about high "dis-synergy" costs and potential effects on employees. It was only after presenting detailed analyses and directly addressing the supervisory board's concerns that the company could proceed with the separation. However, this process delayed the separation by several months, ultimately resulting in the withdrawal of interest by a potential buyer. As a result, ChemCo in its entirety became the target of a hostile takeover, as opposed to a strategically managed separation with ChemCo in control.

Exhibit 3

Board concerns should be addressed early to avoid delays and resource overruns.

Source and effect of separation delays



23% of respondents did not see a delay in the final separation decision of the board

Delays in the board decision often lead to nonrecoverable delays for the separation as a whole, as well as to resource overruns

It is important to ensure the board has clarity on the value creation hypothesis early and their concerns are addressed, focusing on the most frequent reasons

Source: McKinsey Separation Survey 2024

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Transitions can be harder than they first appear

For many sellers, it's tempting to approach separations as "sell and forget." Yet that approach often fails to maximize value creation, for seller and target alike. It's hardly a given that *both* NewCo and RemainCo will outperform their peers.[2] Separations are complex, and success often hinges on the effectiveness of preclose activities in laying a solid foundation for both companies. Navigating the often-opposing interests of both sides is crucial for a smooth transition. It may even be said that separations are like amicable divorces—at least until sticking points materialize. Understanding the sticking points between RemainCo and NewCo is essential for leaders to manage these transitions effectively and avoid common pitfalls.

Our recent survey highlights the pressing issues companies face during separations, and the most frequent sticking points. Notably, 42 percent of survey participants reported that they struggled with the duration and pricing of transitional service agreements (TSAs). This includes a lack of clarity on which TSAs are needed due to the separation not being far enough along, service levels not being clearly defined, or differing views on the cost of services in the newly transactional relationship.

However, TSAs were not the only reported sticking point in transactions (Exhibit 4). Significant numbers of respondents also faced challenges with talent allocation, technology architecture, and target forecasts and business plans. The wide range of issues underscores the challenging discussions between RemainCo and NewCo, which often must be proactively managed for a successful transition.

Separations are complex, and success often hinges on the effectiveness of preclose activities in laying a solid foundation for both companies.

[2] See Jan Krause, Anthony Luu, Robert Uhlaner, and Andy West, "Achieving win–win spin-offs," McKinsey, October 11, 2021; and Obi Ezekoye and Jannick Thomsen, "Going, going, gone: A quicker way to divest assets," McKinsey, August 6, 2018.

Exhibit 4

Separations are complex, and there are many sticking points that leaders commonly underestimate.

Separation sticking points, by type and perspective

RemainCo perspective	Typical sticking points	NewCo perspective	Frequency seen,[1] %
"Shorter-duration TSAs[2] and penalties drive lower costs and allow better planning"	TSA duration and pricing	"Flexible TSAs and no penalties allow more agility and flexibility"	42
"All relevant team members should go with the asset"	Talent allocation	"Want only best players and 'A-team'"	37
"Stick with existing architecture to reduce risk and shorten TSAs"	Technology architecture	"Optimize the technology platform during the change"	35
"Optimistic is better, so acquirer and investor interest is robust"	NewCo forecasts/ business plan	"Conservative is better, so higher likelihood to outperform"	34
"Leverage where appropriate existing design, setup, and people to limit stand-up costs"	Operating model setup	"Apply a cleansheet design; invest pre-spin to be best in class"	28
"Stranded costs should be avoided by all means necessary"	RemainCo stranded costs	"RemainCo stranded costs are none of our concern"	23
"Continue to control all joint customer accounts"	Customer accounts	"Manage key accounts to build relationships, especially for top customers"	22
"Larger debt loading drives larger RemainCo proceeds"	Debt loading and liabilities	"Lower debt loading enables more flexibility"; "Protection from liabilities"	19
"Retain best assets"	Asset boundary	"Want only assets that fit nicely into a cohesive strategy"	14

TSA duration and pricing, talent allocation, and technology architecture are biggest sticking points between NewCo and RemainCo

[1] Experts were given a list of typical sticking points and asked to select up to 3.
[2] Transitional service agreements.
Source: McKinsey Separation Survey 2024

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A deeper dive into the two biggest sticking points—TSAs and talent allocation—provides more color.

Separation-related agreements. TSAs and long-term agreements (LTAs) are often essential for ensuring business continuity and facilitating a smooth separation for both RemainCo and NewCo during transitions. TSAs can provide additional flexibility, especially when the transaction outcome is uncertain or when there isn't enough time to fully establish the target's new operating model.

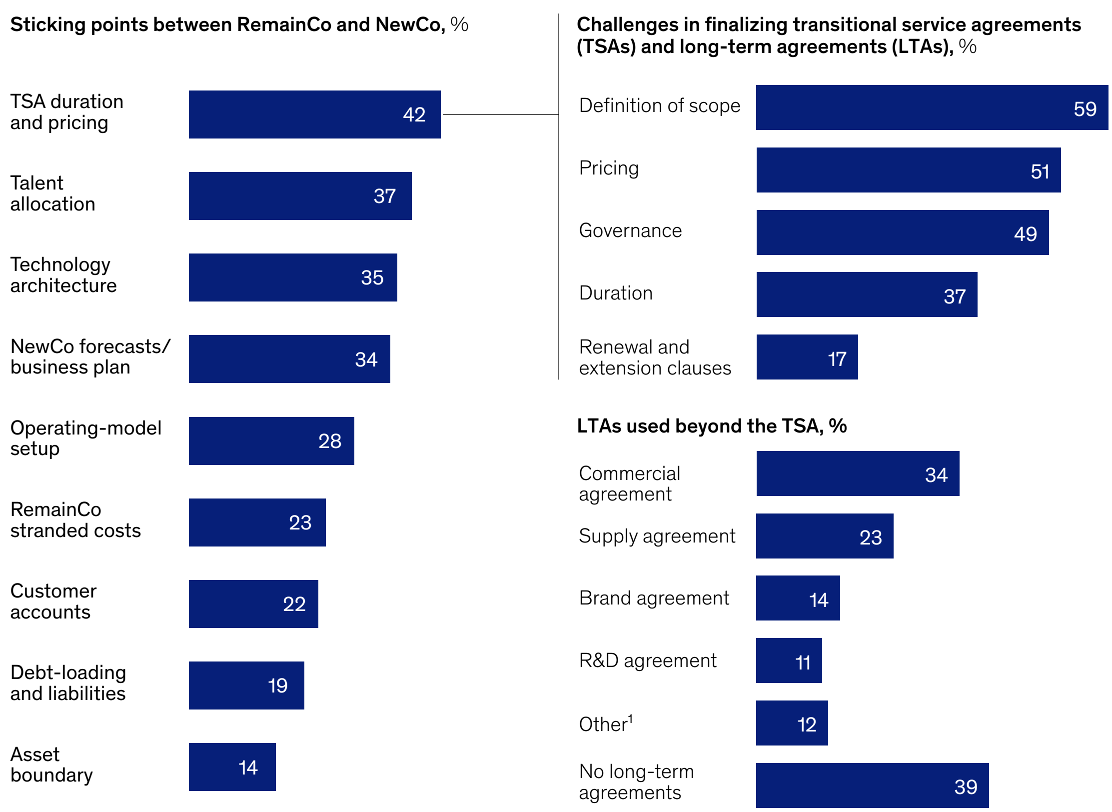
The separation survey highlights that one of the most prevalent challenges between RemainCo and NewCo is negotiating TSAs, with 42 percent of survey respondents identifying it as a top three issue (Exhibit 5). This difficulty stems from the newly transactional nature of the relationship, making it complex to negotiate the scope, pricing, and governance of TSAs—issues encountered by four out of five survey respondents in their last separation.

The challenge intensifies when LTAs need to be negotiated, as they bind the separated companies together for a longer period. Despite this complexity, LTAs are frequently used, particularly in the form of commercial agreements (34 percent) and supply agreements (23 percent). Only 39 percent of experts reported not using any LTAs in their last separation. Given that these agreements are long-lasting and will be established between two soon-to-be independent entities, it is crucial to negotiate them with the same rigor as one would with any other third-party agreement.

Exhibit 5

Transitional service agreements are a major sticking point in separations.

Significant sticking points in service agreements



[1]Including manufacturing service agreements, intellectual property agreements, HR agreements, etc.
Source: McKinsey Separation Survey 2024

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In divestitures, some employees might feel underappreciated. Effective leaders credibly frame the separation as a chance for new opportunities for all employees, not just those rated in the top 5 percent of performance.

While TSAs and LTAs can be critical for maintaining business continuity, they often present significant negotiation challenges and may impede the full potential of transformation. Ideally, reliance on these agreements should be minimized. However, if they are unavoidable, it is imperative to negotiate them at arm's length to ensure fairness and efficacy.

Talent allocation. Talent matters—even if it is leaving. Both the seller and acquirer want "A-team" employees to ensure that they are set up for success. However, as soon as talented personnel have been identified and allocated between RemainCo and NewCo, the question is how to retain and even excite high-potential employees during the separation. Our survey suggests that NewCos benefit from talent retention mechanisms; half of NewCos with such mechanisms in place reported that they met or exceeded their objectives, compared with just one-quarter of those without such mechanisms. From our experience, this is often the case in divestitures, where some employees might feel underappreciated. Effective leaders credibly frame the separation as a chance for new opportunities for all employees, not just those rated in the top 5 percent of performance.

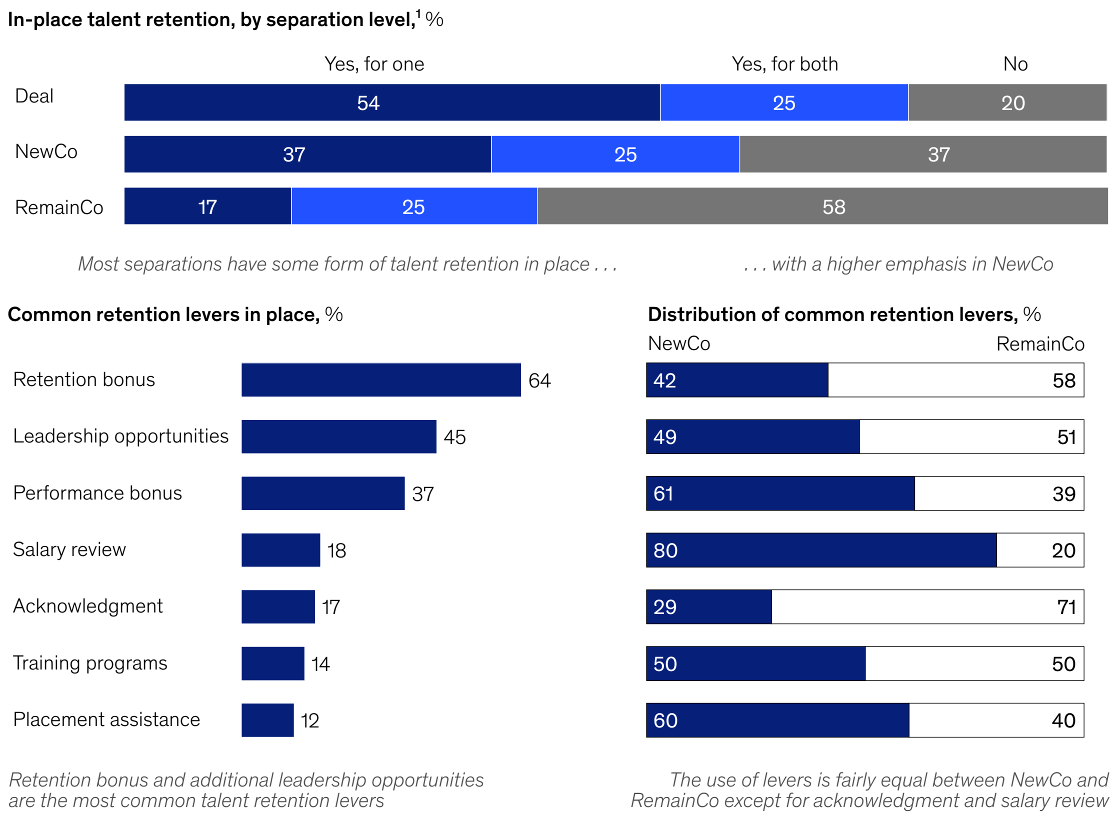
The survey highlights just how central talent is to a deal's success. More than 80 percent of respondents indicated they had at least one form of talent retention in place, though with greater emphasis on NewCo than on RemainCo. The most common levers for talent were monetary incentives (such as retention and performance bonuses) and career development, including opportunities for a greater leadership role. Survey responses were similar for both RemainCo and NewCo in this regard, except for acknowledgment for the separation effort and salary reviews (Exhibit 6).

Survey responses also strongly suggest that talent retention programs can significantly increase the chance of NewCo meeting or exceeding its objectives. RemainCo is clearly affected, too, though the effect appears to be more limited.

Exhibit 6

Talent matters in separations—for both NewCo and RemainCo.

Talent challenges during a separation



[1]Figures may not sum to 100%, because of rounding.
Source: McKinsey Separation Survey 2024

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Achieving operational excellence

Taken together, survey responses support our own broader observations—separations should be part of a well-considered strategy, but creating value from separations takes work. Companies that adopt a programmatic approach to M&A tend to outperform their counterparts, achieving higher excess TSR and demonstrating the value of accumulated experience. The survey underscores the importance of timely board decisions, as delays often lead to broader project setbacks and resource overruns. Addressing board concerns early with data-driven arguments is crucial for a successful separation. As one survey respondent shared, “We wished we would have moved faster.”

The complexities identified by survey respondents highlight several critical insights for companies that seek to achieve a successful separation:

— *Proactive management is essential.* The potential for conflict among the parties is real, even when separations begin amicably. Without careful and strategic oversight, these negotiations can quickly become contentious, jeopardizing the success of the separation.

— *Strategic use of TSAs.* Companies often rely on TSAs to ensure that operations are not interrupted after a deal has closed. However, these agreements should be used as tools, not crutches. Minimizing TSAs with built-in time limits can help address stranded costs and promote self-sufficiency. Moreover, since TSAs are more likely to be needed in cases with greater entanglements, the likelihood of stranded costs is also likely to be higher. Although TSAs are not the reason for these costs, they can delay the timely addressing of stranded costs.

— *Comprehensive planning and execution.* Effective separation management requires a detailed road map, rigorous planning, and clear communication. This includes addressing talent allocation, technology architecture, and business forecasts to ensure both RemainCo and NewCo can operate independently and successfully from day one.

— *Proactive risk management to secure valuation.* Judicious forethought and proactive management can create conditions that add up to a higher valuation and propel better business outcomes. Identifying potential disruptions and mitigating risks, such as operational disruptions and technology disentanglement, are crucial for maintaining transaction value.

— *Leadership and orchestration.* Successful separation programs require engagement and orchestration across multiple workstreams. A steering committee provides strategic direction, while the separation management office orchestrates and drives separation design, planning, and implementation across workstreams. This structured approach ensures that all aspects of the separation are meticulously planned and executed with a value creation mindset.

Successful separations don't happen by chance. Our recent survey demonstrates that thoughtful companies not only make hard strategic choices to commit to separations; they also then follow through on execution—addressing potential disruptions, mitigating risks through detailed planning and coordination, and creating conditions that encourage better outcomes. As economic conditions continue to rapidly change, value-creating separations should be more important than ever.

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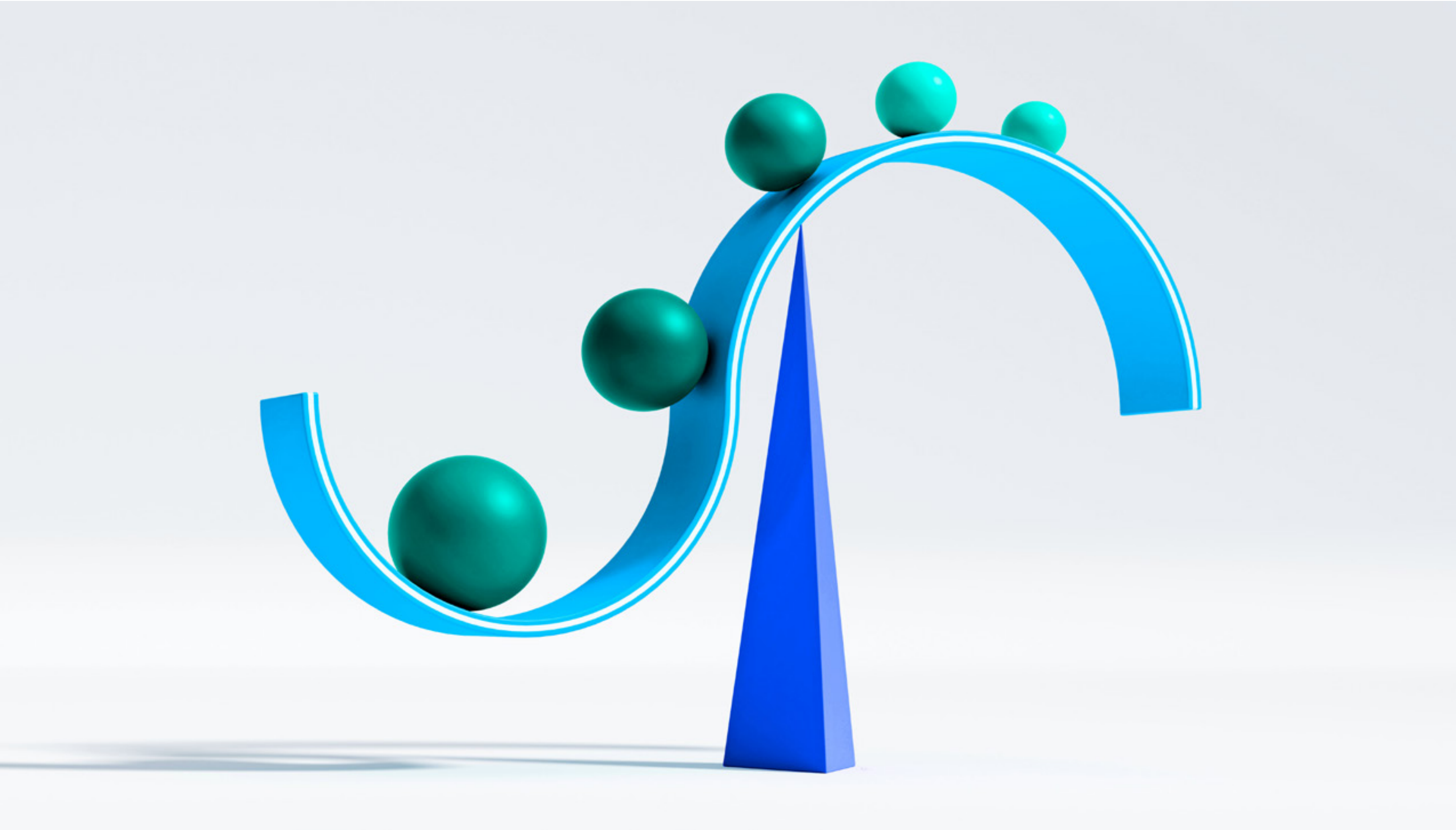
The authors wish to thank Dominik Schildknecht, Ivan Vuckovic, and Marc Silberstein for their contributions to this article.

Sustainability: Sources of value creation

Value at stake provides a framework for companies to approach risks and opportunities from sustainability.

by Anna Granskog, Michael Birshan, and Robin Nuttall with Alex Harman



Every senior management team today is investing in sustainability. The priorities of each business typically vary across sustainability dimensions: for some, environmental concerns are paramount; for others, social initiatives are the most important concern. And across industries and geographies, achieving effective governance and meeting compliance requirements are absolutely essential—although, in our experience, companies invest in sustainability not just because they are compelled to do so but because they choose to make a positive difference for their many stakeholders.

The resources allocated to sustainability activities—not just capital but also management time and attention—are often enormous. Yet the investments can also become a black box: what returns do they generate, and what is the value at stake? In this article, we provide a framework to analyze the business case for sustainability activities, both in terms of playing *defense* (by mitigating against key threats to expected value creation) and *offense* (by capturing new opportunities such as revenue growth and green business building). Since the totals can vary significantly across industries, we present some nonexhaustive examples from different industries to illustrate how the approach works in practice.

Valuation principles

From a corporate finance perspective, the value a company creates comes down to the amount of free cash flow it generates over the long term.[1] Past results are informative, but they aren't destiny. Particularly for mature businesses, the base case can often be in decline, not least as a result of market forces and competition—challenges that extend beyond sustainability considerations. When assessing sustainability, the demand for unsustainable products will likely decrease (particularly if the price is approximately equal), and the probability of regulatory penalties, potential for litigation judgments, and possible reputational risks will likely increase—including the risk of losing consumers by misjudging their expectations. Free cash flow could decrease over the long term if sustainability investments miscalibrate stakeholder concerns.

The resources allocated to sustainability activities—not just capital but also management time and attention—are often enormous.

[1] Of course, each company has a unique cost of capital, which means that companies with the same amount of free cash flow can have very different valuations. But the fundamental principle applies: the more free cash a company generates over the long term, the higher its intrinsic valuation.

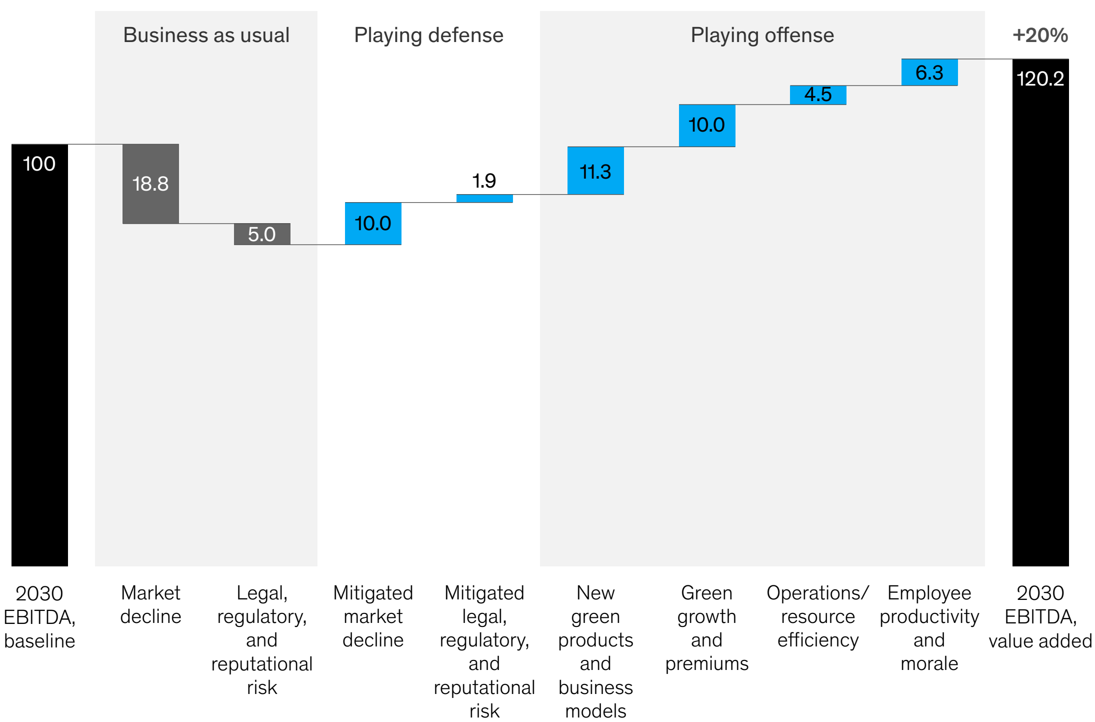
Measuring the full value at stake from sustainability requires a multistep approach (see sidebar, “Methodology: A five-step approach to calculate value at stake”). In this analysis, for simplicity, we describe the effects of playing defense and offense on EBITDA, net of any investments required. Specifically, we sum the amounts, which are best measured as a range, that, on *defense*, can be preserved by (1) mitigating market decline and (2) mitigating legal, regulatory, and reputational costs and that, on *offense*, can be increased by (3) expanding revenue by launching sustainability businesses, (4) capturing growth and price premiums (including from new sustainability products), (5) greening operations and their supply chains, and (6) benefiting from higher employee productivity and morale (Exhibit 1).

Standard business principles apply: managers should resist the urge to make easy assumptions, such as expecting that every sustainability initiative will be value creating or anticipating straight-line growth for new, sustainability-friendly products. Moreover, as in all new initiatives, there are case-by-case questions as to whether it is better to be a first mover or a fast follower.

Exhibit 1

Value at stake in sustainability is the value saved from playing defense plus the value created from playing offense.

Illustrative EBITDA case example, $ million



	Mitigated market decline	Mitigated legal, regulatory, and reputational risk	New green products and business models	Green growth and premiums	Operations/ resource efficiency	Employee productivity and morale
Capital expenditure needed, $ million	1.2	0.8	2.0	0.2	0.4	~0
Share of total value at stake, %	23	4	26	23	10	14

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Methodology: A five-step approach to calculate value at stake

There are five essential steps to determine a company's specific value at stake from sustainability:

1. *Assess materiality:* Companies should begin by conducting a strategy-based materiality assessment (using sustainability reporting standards such as the Sustainability Accounting Standards Board or Global Reporting Initiative) to identify their most important sustainability metrics. These will typically be sector specific; metrics could include, for example, CO_2 emissions, energy consumption, employee attrition, and revenues from green initiatives. Also, companies should analyze their historical financial and sustainability performance and set out their base case forecast.

2. *Benchmark sustainability performance and set ambition:* A meaningful assessment compares a company's assessment of its performance on key sustainability metrics with those of its peers. But the value at stake is not simply a matter of keeping up with competitors. Rather, companies should be clear about what they aspire to achieve—for example, best in class in energy consumption, top quartile in water consumption, or other clear standards–and why.

3. *Identify key levers and develop scenarios for each one:* Each element of a company's operations has at least some external consequence, and there are almost innumerable sustainability efforts that a company can take. Ultimately, however, the lion's share of value at stake from sustainability for each company comes down to a few bespoke levers. The costs of each lever and variable impact should be clearly laid out.

4. *Quantify offense and defense:* The value at stake for each key strategy lever should be quantified on both defense and offense and disaggregated by each of the defense and offense subcomponents—that is, on defense: (1) mitigated market decline and (2) mitigated legal, regulatory, and reputational risks; and on offense: (3) new sustainability products and business models, (4) sustainability growth and premiums for existing products, (5) sustainability operations for resource efficiency, and (6) employee productivity and morale. Costs are critical, of course, but they shouldn't be a barrier to investing in sustainability initiatives if the benefits are even greater.

5. *Synthesize impact and create a road map:* Senior leaders, particularly the CEO and CFO, can proactively allocate resources toward *future value* that has not yet been captured and champion initiatives that help achieve the greatest impact. To ensure that the analysis is both comprehensive and achievable, companies should identify their most important value drivers, recognize what is feasible given the company's competitive and financial conditions, ensure that there is no double-counting in sustainability initiatives, and identify the value that has already been realized.

New businesses may see all or a part of their first-mover advantage competed away or their products become commoditized, even if they are, for a period of time, protected by patents or other intellectual property rights. The first environmentally friendly laundry detergents, for example, were sold at a significant premium, but the high price points could not be sustained indefinitely. The first green products were also usually more expensive to produce; they did not necessarily generate high margins despite their price premiums.[2]

[2] See *The hard stuff: Navigating the physical realities of the energy transition*, McKinsey Global Institute, August 14, 2024; "How playing offense on sustainability can power e-commerce performance," McKinsey, March 26, 2024; Michael Birshan, Lisa Leinert, Tomas Nauclér, and Werner Rehm, "A different high-growth story: The unique challenges of climate tech," *McKinsey Quarterly*, January 26, 2024; Marcelo Azevedo, Anna Moore, Caroline Van den Heuvel, and Michel Van Hoey, "Capturing the green-premium value from sustainable materials," McKinsey, October 28, 2022; Rob Bland, Anna Granskog, and Tomas Nauclér, "Accelerating toward net zero: The green business building opportunity," McKinsey, June 14, 2022; and Stephan Fuchs, Stephan Mohr, Malin Orebäck, and Jan Rys, "Product sustainability: Back to the drawing board," McKinsey, February 7, 2022.

Yet companies are right to play offense and need to continue to be bold; if they don't move quickly, a more sustainability-minded competitor could capture the value instead. Products that were marketed as sustainable averaged 28 percent cumulative growth over a recent five-year period, versus 20 percent for products that weren't.[3] These dynamics will likely endure. Demand for green steel, for example, currently far outstrips supply—and is forecast to continue to do so for at least a decade.[4] New opportunities will likely emerge across industries, as they always have before, and companies can capture more value by adopting a forward-looking approach now.

Some managers, when presented with this defense- and offense-minded approach, may ask, "What about capital expenditures—how will we pay for these initiatives?" A technical answer is that one can apply the analysis in net present value (NPV) terms. Rather than summing to operating profit at a point in time, one can consider a waterfall of discounted amounts that sum to enterprise value. A more comprehensive answer is that immediate-term *net* costs for sustainability may be lower than they first appear—though it should be acknowledged that every analysis is bespoke.

Sustainability regulation also imposes costs, and whether or not the investments required to comply with these regulations generate benefits under a traditional ROI analysis is irrelevant; companies must meet regulatory requirements. Socially responsible choices may not necessarily maximize value in the long term—at least, not with certainty. The result of multiple, iterative choices to meet stakeholder needs manifests in higher or lower free cash flows.

Value from defense and offense: Three industry examples

The total value at stake and the contribution of each sustainability category, as calculated by our methodology, varies by individual company as well as by geography. Usually, it varies most significantly by industry (Exhibit 2).

Extractive industries, for example, face great challenges on defense, to protect existing value; other industries could struggle to find enduring competitive advantage from offense-minded initiatives. A look at three industries—consumer, chemicals, and pharmaceuticals—illustrates the distinctions.

Consumer

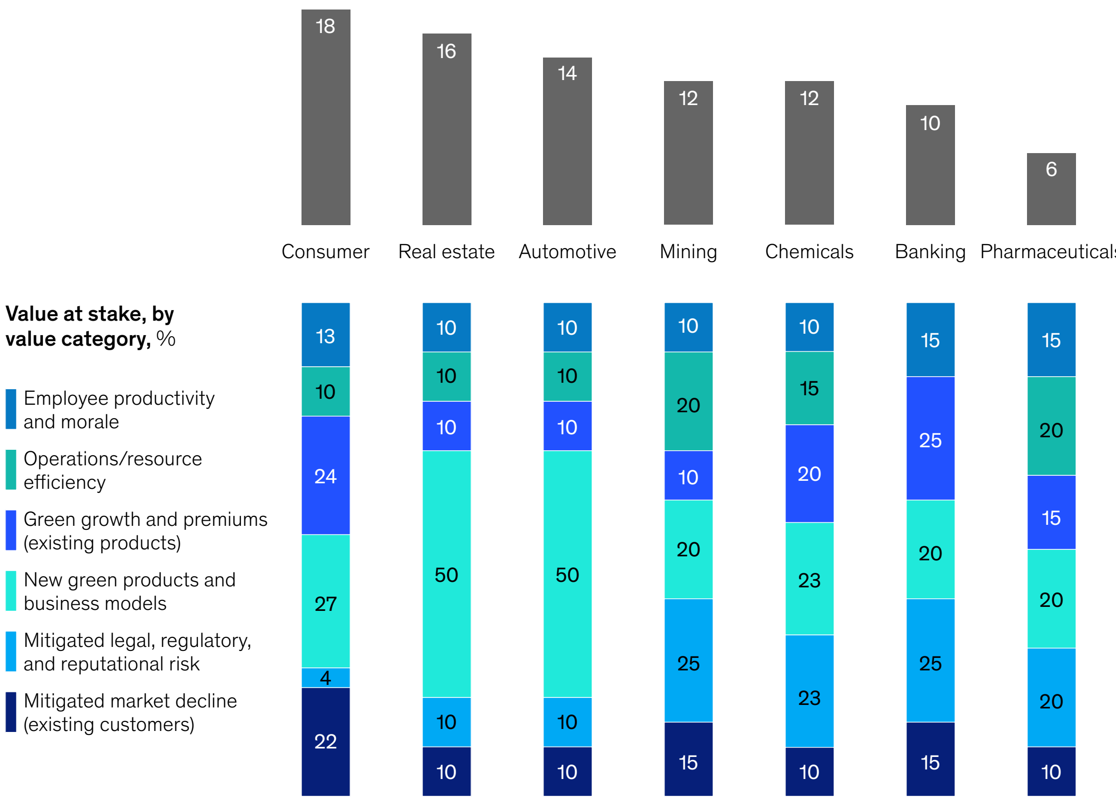
Companies in the consumer sector have one of the highest rates of value at stake (VAS) compared with companies from other industries. The magnitude is driven primarily by rising expectations that products will meet sustainability norms and standards, low switching costs, an increasing number of green alternatives, and the existence (so far and for some products) of green premiums. By our analysis, the business-as-usual case from a company's changes in market share and increases in legal, regulatory, and reputational risks would represent 18 percent of EBITDA by 2030.

[3] "Consumers care about sustainability—and back it up with their wallets," McKinsey, February 6, 2023.
[4] Julia Attwood, "Green steel demand is rising faster than production can ramp up," BloombergNEF, June 26, 2024. It should be acknowledged, of course, that pricing is not a one-way ratchet; the supply of green materials is expected to grow and the size of green premiums should be expected to over a longer term.

Exhibit 2

Value at stake ranges from about 5 to 20 percent, while the contribution per category varies across industries.

Environmental, social, and governance value at stake, by industry, 2030, % of base case EBITDA



Note: Figures may not sum to 100%, because of rounding.

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On the defense side, companies will clearly need to mitigate against sustainability-driven market and demand declines. More than in other industries, consumer companies face a high likelihood that at least some consumers will change their purchasing patterns based purely on sustainability factors. Research shows that no other industry has a higher percentage of what we call sustainability-conscious consumers.[5] Compared with carbon-intensive sectors, the risks for consumer companies of not being sustainability-conscious enough are relatively lower, as are risks from other regulatory causes (consumers may buy fewer of your products, but regulators will probably not shutter your factory). Even so, regulations—such as those

[5] See, for example, Tjark Freundt, Cornelia Grossmann, Sascha Lehmann, and Yvonne Staack, "Talk is cheap: How much will consumers really pay for green products," McKinsey, April 25, 2024; and "Consumers care about sustainability—and back it up with their wallets," McKinsey, February 6, 2023.

that address certain ingredients—could be material on a company-by-company basis. Many food companies are shifting to alternative ingredients for several products. Similar dynamics affect food companies that are moving to sustainable cocoa.

On the offense side, consumer companies have significant opportunities to create value. Consider green business building. One leading retailer is responding to market demand for reuse and recycling by launching an initiative to sell secondhand clothes and accessories at its flagship store, and several fashion companies are creating vintage (used) businesses. Sustainability-friendly products have achieved disproportionately higher growth; between 2018 and 2022, consumer-packaged-goods (CPG) products with a connection to sustainability demonstrated a 1.7 percentage-point advantage in CAGR—a significant amount in the context of a mature and modestly growing industry—over non-sustainability-marketed products.[6] Resource efficiency is also additive to EBITDA for consumer companies.

One CPG company, for example, is on track to fulfill its aim of being carbon negative in its operations by 2030, avoiding more than $400 million in cumulative costs and saving approximately $200 million annually through manufacturing, logistics, and other efficiencies. Leading organizations are also now deploying digital-twin technology to model net-zero value chains and translate this into reality through their supplier engagement.[7]

In our experience, the impact of sustainability on employee productivity is generally lower than in sectors that are demonstrably purpose-driven (such as for healthcare companies or green energy businesses). Yet there have been remarkable successes, such as one retailer's program to support working adult learners through reduced fees, coaching, and college credits. The initiative helped to reduce the company's turnover rate by 10 percent—its lowest level in five years.

Chemicals

Companies in the chemical industry have a significant rate of VAS. While the amounts are, relatively, not as great as those for companies in industries such as consumer and real estate, the amounts are material and can be, depending on the business, existential: there are large variations depending upon the type of chemicals a company produces. The baseline, "do nothing" case is that value will decline, particularly for chemicals used in producing carbon-intensive products, such as construction materials, mining, and packaging. Not only will demand for these chemicals likely erode, but regulatory fines and other costs, in particular taxes on CO_2, are expected to rise. In parallel, because sales for chemical companies are largely B2B, many corporate customers have their own sustainability challenges, targets, and commitments and will need appropriate chemicals to produce green products that enable them to meet their needs. Chemical companies that fail to meet customer demand may lose market share.

On the defense side, several chemical companies are allocating resources to mitigate risks in notable ways. The Saudi chemical company SABIC, for example, has a global corporate social responsibility strategic tool called RAISE (Reputation, Audience, Innovation, Strategy, and Endurance), which it uses to invest in programs that promote company values and to inform its resource allocation into its core strategic areas—science and technology education,

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[6] "Consumers care about sustainability—and back it up with their wallets," McKinsey, February 6, 2023.
[7] Thomas Weskamp and Christof Witte, "Making everyday products greener," McKinsey, November 17, 2022.

environmental protection, health and wellness, and water and sustainable agriculture.[8] Another global chemical company used insights from its expanded customer engagement to develop a portfolio sustainability assessment (PSA) methodology. Early results indicate that more than 75 percent of its identified initiatives are either at an advantage or highly differentiated in at least one sustainability impact category. Many chemical companies also include climate-related risks and opportunities in their enterprise risk management (ERM) programs to identify, measure, and mitigate their bespoke CO_2 risks.[9]

On the offense side, sustainability may offer chemical companies substantial opportunities, especially for “green chemicals,” green business building, and talent attraction and productivity. Likely, the opportunities will vary by region; Europe is expected to be a clear frontrunner, and differences will be evident worldwide. BASF, for example, contributed CO_2 capture technology to Japan’s first demonstration of blue hydrogen and ammonia production from domestically produced natural gas.[10] And several chemical companies maintain university partnerships to improve company R&D and enhance talent recruitment.[11] Moreover, providing green materials can currently yield substantial price premiums (Exhibit 3).[12]

Exhibit 3

While the willingness to pay premiums varies across commodities, segments appear ready to pay extra premium for all materials.

Price premium in 2030, %

	Price premium in 2030, %	Current maturity of green/recycled premiums
Recycled plastics and biopolymers	10–20+	Existing and highly differentiated between bio and different recycled options
Steel	5–11	Emerging for flat steel (especially EU); recycled content expectations nascent
Aluminum	5–7	Existing (but low) for primary low carbon; recycled content expectations but no willingness to pay (yet)
Nickel	3–6	Nascent interest, limited willingness to pay; focus on access vs carbon footprint
Lithium	3–5+	Nascent interest, limited willingness to pay; focus on access vs carbon footprint
Glass	3–5+	Nascent, but limited/no premia as of yet
Copper	2–4	Nascent, but limited premia given low impact on customers’ Scope 3; focus on access

Note: Includes respondents who are “ready to pay higher extra premium to secure supply” and “ready to pay some extra premium to secure supply.”
Source: McKinsey Global Survey of decision makers in materials sales and purchases, Mar 2024

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[8] *Sustainable growth for a better world: 2022 sustainability report*, SABIC, May 30, 2023.
[9] *Unlocking possibilities: 2022 sustainability report*, LyondellBasell, April 24, 2023.
[10] “BASF contributes CO_2 capture technology to Japan’s first demonstration of blue hydrogen and ammonia production from domestically produced natural gas,” BASF press release, February 28, 2023.
[11] *Speeding up to circularity: 2022 annual report*, Covestro, March 2, 2023.
[12] “Positioning for success in the chemical markets of the future,” McKinsey, June 4, 2024; “The resilience of steel: Navigating the crossroads,” McKinsey, April 18, 2023; and Marcelo Azevedo, Anna Moore, Caroline Van den Heuvel, and Michel Van Hoey, “Capturing the green-premium value from sustainable materials,” McKinsey, October 28, 2022.

Chemical companies are also improving their resource efficiency: one major firm, for example, realized cost reductions and entity synergies of more than $1 billion in a single year from initiatives such as optimizing crude oil procurement, increasing energy efficiency, and rethinking process units. While it's an open question whether green products will continue to trade at a premium, many currently do, including for sustainable aviation fuel (in which premiums exceed 200 percent),[13] green ammonia, ethylene, methanol, plastics, food additives, and fertilizers.

Pharmaceuticals

Sustainability, particularly in the social and governance dimensions, is highly material for pharmaceutical companies. There are substantial challenges from potential fines from regulators (the only other industry that experiences more fines is banking), universal CO_2 reporting and reduction requirements, and the need to continue to attract and retain highly educated employees, a subset of the population that, at least in the United States, tends to be more supportive of sustainability priorities.[14]

In terms of playing defense, multiple pharmaceutical companies are making substantial efforts to strengthen their community standing, such as by investing to reduce disparities in healthcare access, encouraging volunteer work and stronger community involvement, and working with a diverse range of partners across their value chains.[15] Many pharmaceutical companies also self-report the revenue impact of sustainability-conscious customers to the CDP (a not-for-profit formerly called the Carbon Disclosure Project)—estimating an average yearly revenue impact of about 1.2 percent. Payors are also increasingly demanding sustainability commitments as a precondition for participating in tenders. For example, the UK National Health Service requires all suppliers bidding for contracts above £5 million per annum to publish a carbon reduction plan for their emissions from the sources included in Scopes 1 and 2 of the GHG Protocol, and a defined subset of Scope 3 emissions.[16]

Regulatory fines erode pharmaceutical companies' EBITDA by an additional 0.75 percent on average over a ten-year period.[17] Pressure could increase across a range of concerns, including data privacy, animal rights (a common part of product testing), and emissions and waste from manufacturing and packaging. Many pharmaceutical companies are looking to mitigate these risks in multiple ways. Several large players have already achieved significant reductions in Scopes 1 and 2 GHG emissions in the past five years. Another leading company uses only approved animal vendors, contractually bound to legal and company standards, that are regularly audited by the company for appropriate animal welfare and care. There are numerous additional examples across companies and risk categories.

On the offense side, pharmaceutical companies are seeking opportunities for sustainable and inclusive business building. For example, the past few years have seen remarkable growth in women's healthcare and the dawn of FemTech, with several businesses valued at more than $1 billion. Multiple companies are also investing substantially in animal health and wellness,

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[13] See Dieter Holger, "Sustainable aviation fuel leader talks green premiums and impact of tax incentives," *Wall Street Journal*, July 19, 2023.
[14] See Lydia Saad, "ESG not making waves with American public," Gallup, May 22, 2023.
[15] See, for example, Anas El Turabi, Anjali Menon, Lucy Pérez, and Gila Tolub, "Health equity: A framework for the epidemiology of care," McKinsey, March 21, 2022; and David Schwartz and Ahmed Youssef, "Partnering for health equity: ALJ Health's Akram Bouchenaki," McKinsey, May 13, 2022.
[16] "Carbon reduction plan requirements for suppliers," NHS, March 29, 2023.
[17] Analysis based on media reports, public company filings, and S&P Capital IQ.

developing veterinary medicines, vaccines, and diagnostics for both livestock and pets. In some cases, companies have realized green premiums, such as for recycled high-density polyethylene (rHDPE), high-intrinsic-viscosity recycled polyethylene terephthalate (high-IV rPET), and bionaphtha. Moreover, companies are achieving greater resource efficiency. One India-based leader recently achieved a 48 percent year-on-year increase in profit after tax, which it attributed in large part to reduced materials costs as well as supply chain improvements.[18] Finally, pharmaceutical companies are achieving notable improvements in employee productivity and retention from initiatives such as employee health and training programs.

There are clear, common sources of value from sustainability. The value at stake ranges across industries, and in practice, companies take different combinations of initiatives on both offense and defense. The alternative, do-nothing approach, by contrast, is a value destroyer—and falls short for society, as well.

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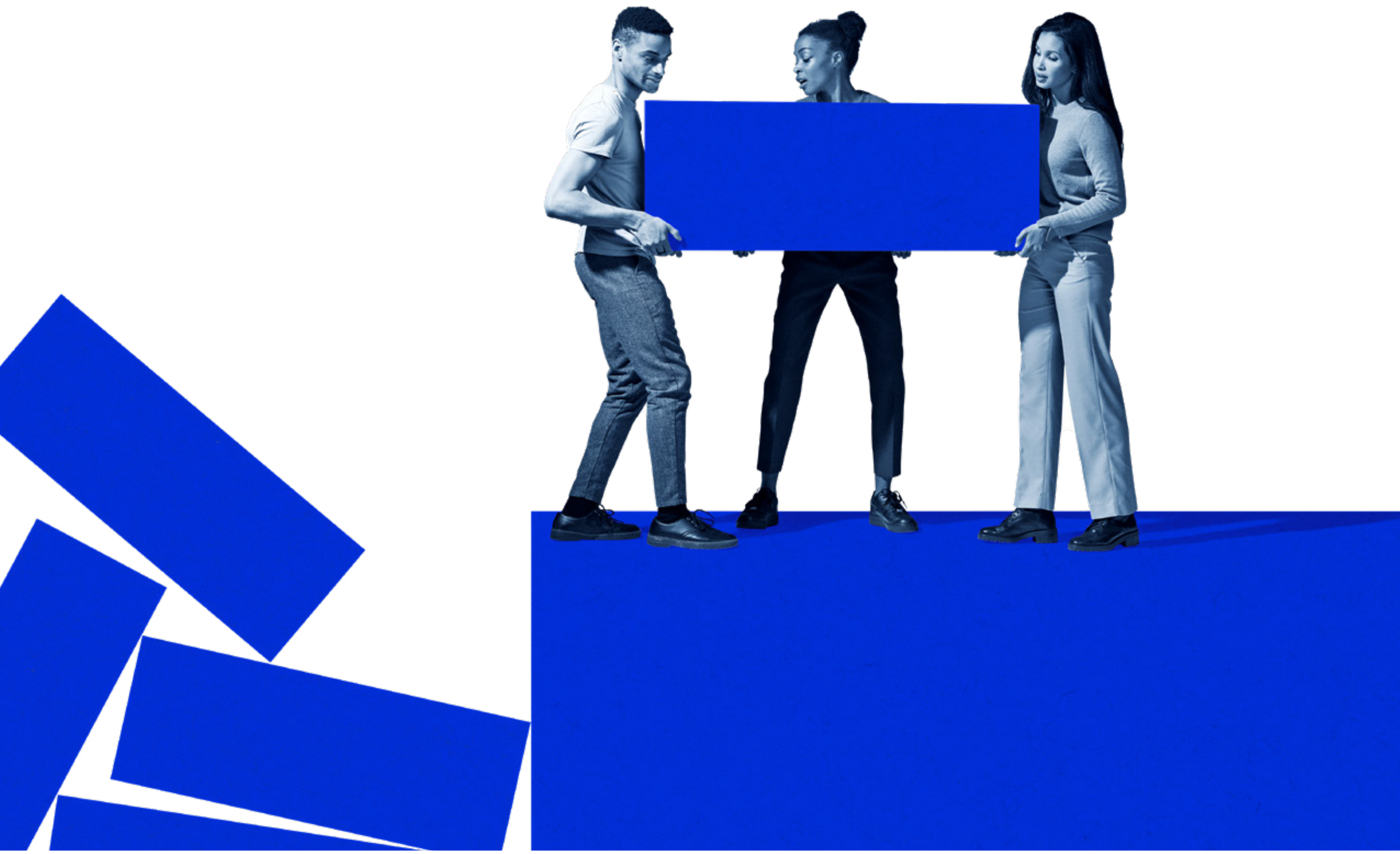
[18] Anjali Singh, "Alembic Pharma Q3 results: Profit up 48% as raw material cost declines," *Business Standard*, February 5, 2024.

Faster, smarter, bolder: How midtenure CFOs shift into a higher gear

Former finance leaders offer advice on how CFOs can go from good to great in the middle years of their tenure.

by Christian Grube and Cristina Catania
with Ankur Agrawal and John Kelleher



A decade ago, automaker Audi AG was growing rapidly, but its financial data and IT infrastructure weren't keeping up. "Our processes were stuck in the past," recalls Axel Strotbek, then roughly halfway into his ten-year stint as CFO of Volkswagen's upscale brand. Regional finance departments relied on disparate systems and data, so siloed information made it difficult to provide the real-time updates that business leaders wanted. "We had to think more holistically about the entire world of finance, not just the islands of pricing, accounting, or treasury," says Strotbek.

His solution was an ambitious standardization and digitization program to create an IT backbone that could support the finance function as the company evolved. Audi management thus had to peer into the future and understand what the industry and the company's products would look like and what capabilities finance would require. "We asked ourselves, 'Where do we want to go, and how do we get there?'"

If the early years of a CFO's tenure are about dousing any fires, scoping out the challenge, and pulling together the core team, midtenure is when the best finance leaders get bold. Much as top midtenure CEOs focus on sustaining performance momentum, midtenure CFOs must guard against organizational complacency by becoming prime movers of change.

To understand how CFOs can find that higher gear, we interviewed eight former finance leaders about their midtenure moves. As the role's scope and the attendant pressures grow, CFO tenures have been shrinking—they now average 3.5[1] to 4.5[2] years in large companies—so we defined midtenure as two years in and after. Our broader goal is to chart how CFOs can succeed at every stage of the role's life cycle: becoming a high-potential candidate, making a strong start, raising the finance function's performance in the middle years, and transitioning to the CEO role. The

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–**Axel Strotbek**

Former CFO of Audi AG and Volkswagen Group China. He is a member of the ZF Friedrichshafen board and chairs the board of Codasip.

[1] *CFOs and the C-Suite: Staying Power, Pay, and Pain Points*, Datarails.
[2] "Fortune 500 C-suite snapshot: Profiles in functional leadership," Spencer Stuart, December 2023.

interviews, combined with our research and experience serving CFOs, point to four midtenure priorities: revitalizing the finance function, collaboratively finding a new strategic aspiration, reevaluating and developing the finance team, and expanding the focus beyond finance.

Reinvent the finance function—and yourself

Strotbek's challenge at Audi reflects a common pattern: with the organization chasing growth, functional processes lag behind. It's not surprising, then, that many midtenure CFOs seek to reimagine how the function operates.

"Particularly in the early days, we typically focused on investments in growth before infrastructure," says Karen McLoughlin, former CFO of Cognizant Technology Solutions. "It was intentional, but it meant that infrastructure sometimes lagged, until you would start to feel pain points." Her predecessor had directly managed some administrative functions, such as real estate and procurement, but as the company grew that wasn't sustainable. Accordingly, during a finance revamp she undertook, she delegated oversight of some nonfinance functions so her team could focus on areas of strategic importance.

To find the optimal structure and ways of working, several former CFOs we interviewed looked outside for inspiration, visiting other companies to see how they approached cybersecurity, performance management, or M&A. They also tried to establish objectively how their organizations compared with peers. When Arun Nayar, former executive vice president and CFO of Tyco International, set the aspiration of making his finance team the world's best, for example, his first step was to benchmark the function's practices and capabilities: "Were we number two or number 35?"

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–**Karen McLoughlin**

Former CFO of Cognizant Technology Solutions. She sits on the boards of Agilon Health and Best Buy.

Any significant overhaul is bound to encounter opposition that the CFO needs to deftly, but assertively, navigate. As part of Nayar's transformation of the function, he wanted to move processing work offshore, but this turned out to contravene Tyco's contractual commitments with the US government—a major client. After working with the outsourcing provider to redact the data so that it met the government's privacy constraints, the respective teams of both Nayar and the chief information officer wanted to move forward, but the CIO himself was unwilling to take the risk. Nayar believed in the move strongly enough to take the issue to the CEO, who sided with him. (The CIO's fears proved unfounded and the two remain friends.)

As CFOs strive to reimagine their function, they should also reinvent themselves. External input can be valuable for polishing skills, reexamining beliefs, or reaching big decisions. Chris Kreidler, who served as CFO at both Sysco Corporation and C&S Wholesale Grocers, developed networks of key shareholders and investment bankers he could use as sounding boards. He recommends asking yourself, "Who can I go to who would be willing to honestly tell me, 'I think you guys are screwing up' or 'I think you're missing a trick here'? The external world will come calling with its agenda if you wait too long, but if you take the initiative, you will establish communication lines so you can learn from and influence those people."

Warwick Bray, the former CFO of Telstra, found ideas and support through an informal network of Australian CFOs. "Each time I met with one of my CFO peers, we discussed insights, resource allocation, balance sheet optimization, and performance monitoring," he recalls. "It was most

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–**Chris Kreidler**

Former executive vice president and CFO of Sysco Corporation and C&S Wholesale Grocers. He is a board director of Alyasra Foods, BradyIFS, Soul Foods, and TrueBlue.

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useful.” A banking CFO, for example, advised Bray to always consider the momentum case—how the business would develop without new interventions—when he assessed forecasts from various parts of the organization.

Richard Mayfield, who served in several divisional CFO roles at Walmart before becoming the CEO of its largest regional unit, used reverse-mentoring to help him improve as a leader. He suggests picking two or three people you trust and telling them, “I need you to keep an eye on me because I’m trying to work on this, and I need you to drag me aside and say, ‘That didn’t work and here is why.’” He adds, “The most valuable feedback is in-the-moment feedback because it’s the most real.”

Collaborate with the CEO on a new strategic aspiration

Success can engender complacency in organizations. The CFO has the power to replace that complacency with a new ambition. An outside-in perspective—through the lens of an activist investor, for example—can serve as a form of independent due diligence on the company and help the leadership team see its blind spots. “You have to keep reexamining what the enterprise needs,” says Nayar. “If three years ago you started the journey in a certain direction, is that direction still the right one? Has the environment changed? Has the competition or technology changed? Has the government changed?” The idea, he adds, is to think about what it would take to attract a new investor. “If you’ve taken the stock price from $11 to $50, how do you take a $50 investment today and make it $100?”

A focus on growth doesn’t come naturally to most finance people, however. “CFOs tend to be good on the cost side but less good on growth, which is harder and more complex,” says Mayfield. “But you’re reading data all the time on the whole business, and that translates into

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Former executive vice president and CFO of Tyco International and CFO of global operations at PepsiCo. He serves on the boards of Amcor, GFL Environmental, and Rite Aid.

an understanding of how, where, and why value gets created. The best CFOs are strong on cost and efficiency, and even better on customers, markets, and positioning the business for long-term growth.”

The CFO should also dispel the common perception of finance as an obstacle to investment. Marjorie Lao, the former CFO of LEGO Group and Tandberg (now part of Cisco), advised her team that “our job in a meeting is not necessarily to be the person who says no but to say, ‘Yes, as long as we do this’ or ‘Yes, under these conditions.’ That’s a mindset change from finance as resource guardian to finance as business enabler.”

Identifying and executing that next growth curve requires a strong relationship between the CFO and the CEO. “A good CFO is a business partner to the CEO,” says Nayar. The finance leader should fully support the chief executive in public but be willing to offer frank criticism in private.

Reevaluate your team and develop future leaders

A few years into your tenure, the function’s priorities will probably have changed—especially if the organization is trying to ignite a new growth phase. Consequently, you may need different capabilities on the team. People who excelled in a business with $500 million in revenue might not be as well suited to a $2 billion company. “Don’t fall into the trap of thinking that a person who was successful to date will be successful in the future,” urges Nayar. He adds, “You need to be able to differentiate between good talent that’s committed to your vision versus just good talent. And you need a backbone to make those changes, because some very senior folks may no longer have a role. People will tell you, ‘This person has 40 years of legacy experience; can we do without them?’ The answer is, ‘Yes, we can.’”

However, unlike CEOs, who can build their own teams, CFOs may have to navigate constraints. As an outside hire, Kreidler was asked to move cautiously on finance staff changes. Accordingly, he ended up deferring team realignment until his midtenure even though he had decided within

‘Our job in a meeting is not necessarily to be the person who says no but to say “Yes, as long as we do this” or “Yes, under these conditions.” That’s a mindset change from finance as resource guardian to finance as business enabler.’

–**Marjorie Lao**

Former CFO at LEGO Group and senior vice president and CFO at Tandberg (now part of Cisco Systems). She sits on the boards of GoTo (GoJek/Tokopedia) Indonesia, Logitech, and MYT Netherlands.

three months which people he wanted to move out of their roles. “I was not going to be given permission to let anybody go, but over time all of those people ended up in different spots, so I could bring more experienced talent into the positions that really mattered,” he says. Now, when he coaches other CFOs, he advises them to assess talent quickly, identify what the future organization will look like, and get HR on board as a partner. “Then you can choose whether you rip off the Band-Aid or do it over time.”

Grooming future leaders and your potential successor is another major priority for midtenure CFOs. To help team members close their skill and experience gaps, many finance leaders rely on rotations. Christopher Halmy, former CFO of Ally Financial, for example, not only swapped the leaders of financial planning and analysis (FP&A) and capital but also appointed a new head of investor relations to expand his relationships with the external community. “Importing and exporting talent helped create financial discipline within the organization,” he says. These two- to three-year rotations not only served to develop the talent bench but “reset the timeline” on the ambitions of his potential successors.

At LEGO, Lao divided her potential successors into tranches: those who could take over immediately, those who were one to three years out, and those who needed five years of development. But she spent as much time working with executives next level down. “I wanted to help them understand their potential and develop it by providing guidance on the next roles they could or should be taking,” she says. She also strove to expose these subordinates to areas to which they normally wouldn’t have access. Take stakeholder management: while she couldn't bring her subordinates to full board meetings, she did take them to board committee meetings. Before the meetings, she would brief subordinates on the agenda and on how those issues related to each individual's area of responsibility. Then, after the meetings, she summarized the key questions discussed.

Strengthening potential successors' financial prowess is only part of the equation. "Beyond a certain level of your career, broader business knowledge and leadership capabilities become critical," says Mayfield. "You need empathy to read people and understand what makes them tick, and you need to know how to build, lead, motivate, and coach a team."

Most of the former CFOs we interviewed expressed pride in their work helping to develop future CFOs. When Nayar reflects on the biggest accomplishment of his career, he comes up with the number 12: "I have 12 people I worked with who are CFOs today at publicly traded companies." In McLoughlin's case, that number is 15. Early in her career, a manager observed that McLoughlin gave her team members enough space to try new things but also reeled them in when necessary. "I've always tried to live by that," McLoughlin notes.

Expand your horizons beyond finance

When Lao first became CFO, she was encouraged to tell each of the company's business leaders that finance needs a seat at their tables. That struck her as the wrong approach. "If you are mandating that business leaders invite your finance people into their discussions, it means that we, as finance, have not established our credibility and shown them the value we can create."

To raise the performance of the entire organization, you must broaden your lens, but where you focus it depends on your company's life cycle and financial position (exhibit). Nayar, for example, worked with the board and the CEO to change Tyco's corporate structure from a holding company to an operating-company model, which entailed merging some businesses and spinning off others. "As the finance leader, you have insights into which parts of the organization are working and which are not," he says. "You can take those insights, recrunch the numbers, and say, 'This is a better way forward.'"

'Importing and exporting talent helped create financial discipline within the organization.'

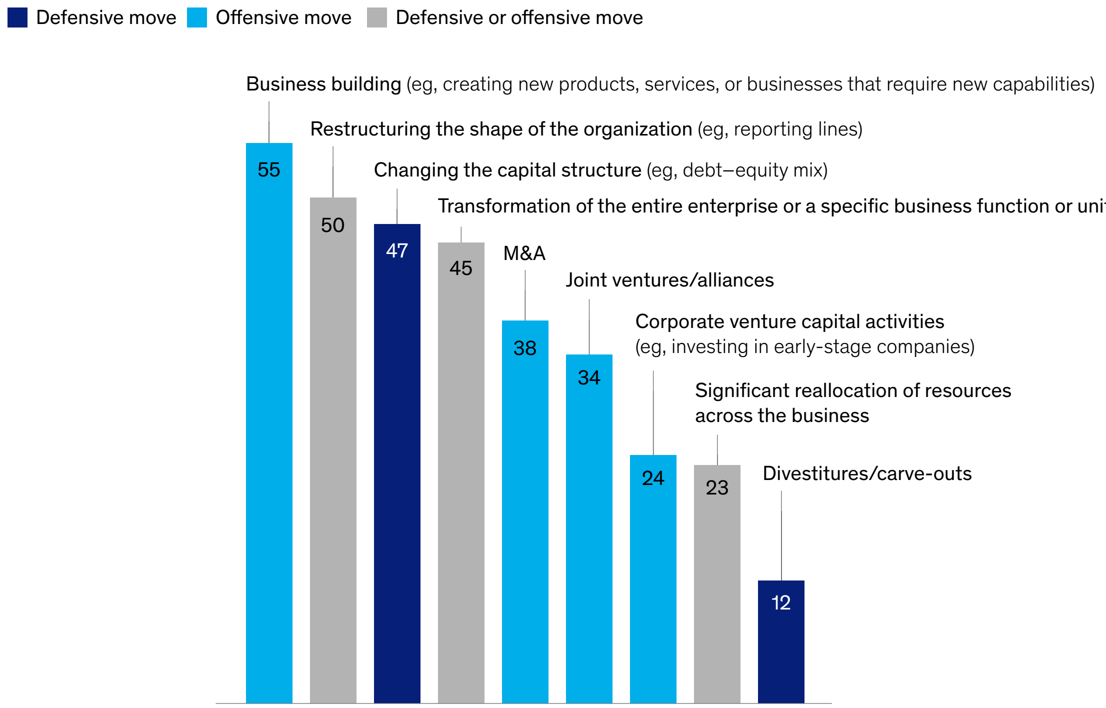
–**Christopher Halmy**

Former CFO of Ally Financial. He sits on the boards of Burford Capital and Mercury Financial.

Exhibit

CFOs expect their organizations to make both offensive and defensive moves in the year ahead as part of efforts to build resilience.

Strategic actions that CFOs expect their organization to make within the next 12 months,
% of respondents (n = 136)



Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

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But working across the organization may require a different approach than the CFO uses in managing the finance function. Mayfield oversaw several large projects during his four stints as finance leader, but they mostly involved his functional line control. By contrast, when he was put in charge of an enterprise-wide transformational initiative, he found the old methods weren't sufficient. "It was all about influencing skills," he says.

To spark ideas and gain a sense of what's possible, several former CFOs recommend joining the board of a noncompeting company. That can not only be a valuable learning experience—showing you how others steer their way through digitizations, expansions, or transformations—but can also help you view your own company from the perspective of an owner or an overseer of management. "Nonexecutive director roles are useful for learning to influence in a different way," says Mayfield. "You still need to help lead the organization strategically, but you have to do that without line control and accountability." Some CEOs and boards, feeling that their CFOs' time should be spent in-house, discourage such external engagements. "I think that's a miss," says Kreidler. "Not only do you get to see how another company runs but you see the interactions with

‘Nonexecutive director roles are useful for learning to influence in a different way. You still need to help lead the organization strategically, but you have to do that without line control.’

–**Richard Mayfield**

Former CEO of Walmart of Mexico and Central America, Canada, and the United Kingdom and CFO of Walmart International. He sits on the board of The Very Group.

the board in a different light.” That experience can help CFOs to understand how boards think and to be more effective at conveying management’s message.

One of the most valuable cross-enterprise tasks a CFO can undertake is breaking down silos between corporate functions and business units. As part of Audi’s digital transformation, Strotbek developed close working relationships with other senior leaders, ensuring that the finance organization collaborated with engineering, production, and sales. In the investment-driven auto industry, where portfolio and product management are priorities, such partnerships were essential. Strotbek also didn’t shy away from speaking up when he noticed issues in other functions. “When we saw problems with R&D budgets, for example, I met with the CTO once a month, just the two of us,” he recalls, bringing in other functional heads to help resolve specific concerns. “We made sure that we were aligned and not fighting against each other.”

Your middle years as CFO are the time to establish your legacy in the role. “You have to be able to not just continue to do well what has been done in the past but go to the next step,” says Nayar. By revitalizing the finance function, helping to raise your company’s strategic aspiration, expanding your team’s capabilities, and tackling projects beyond finance, you can centrally contribute to the organization’s success and establish a track record that can help you fulfill your future ambitions.

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The finance function of the future

Tech veteran and OpenAI CFO Sarah Friar shares her insights on generative AI and opportunities for finance leaders.

Today, every CFO is thinking about gen AI. But few have the leading-edge vantage point of Sarah Friar, who, in June 2024, was named the CFO of OpenAI. She was previously the CEO of Nextdoor and, before that, the CFO at Square (now Block, Inc.), where she oversaw its IPO in 2015. Friar has also held senior roles at Salesforce, Goldman Sachs, and McKinsey, and currently serves on the boards of Walmart and Consensys. Recently, she shared her insights with McKinsey senior partner Lareina Yee on leading through this era of intense technological adaptation—and what gen AI means for the future of the finance function and business leadership.

Lareina Yee: You are leading finance at OpenAI, where an important part of the conversation is using gen AI to automate activities like many of those within the finance function. What has that experience been like? How are you envisioning the finance team of the future?

Sarah Friar: It's really fun to get to work on building a platform of the future, where you have a tool that can do increasingly complex tasks and empower people to work more efficiently and creatively. What that means in our finance function is that we're using ChatGPT to do things like unify data from different sources and code AP [accounts payable] invoices. That shortens our close, which is something all controllers think about.

Investor relations is another good example of where we're using gen AI in the finance function. We just finished a financing round, and in the middle of a deluge of in-bound diligence questions, we were feeling underwater, so we built an investor relations custom GPT. We fed it the knowledge of all the diligence questions we had answered up to that point, and we fed it our management presentation. We also told it not to look externally for answers, as there is a lot of incorrect information published about OpenAI. And now we have an investor relations GPT that allows us to answer questions in seconds that previously took hours or a whole day.

Things like that have changed my life. Also, the technology has expanded the skill set of the team. For example, in finance, it's very useful to have someone who can write code or help with SQL [structured query language] queries, but that is not a common skill set in finance. Instead of asking for help from our technical organization, we can now just ask ChatGPT to assist in writing that SQL query. This has really advanced our team from number crunching to being a better business partner.

Lareina Yee: If all of that is possible now, what will the finance function look like in five years? What things do you hope you'll be able to do with gen AI?

Sarah Friar: I really hope we will move completely to the point of being the home for business insights, driving the business to go bigger and faster. Today, there's still so much in the finance department that is the look back, not the look forward. I hope in five years we'll look back at how we do things today and feel like today's methods are so outdated. I want to be able to look at my team and see that everyone is in that mode of forward-thinking and insight-driven work, and that a lot of the work we do today becomes rote work that gen AI does for us.

Looking beyond titles

Lareina Yee: You've had many different roles in your career. You were recently the CEO of Nextdoor, and before that, you went from being the CFO to the COO and CEO at other companies, and now you're back to the CFO role. Can you talk about some of these decisions?

Sarah Friar: I tell myself what I often tell people I'm mentoring, and that's to forget about titles—just do your best work and get yourself into the places in a company where your skill set and the ability to have impact that matters overlap. You want to get to where you can have the most potent impact.

The reason I made the shift to OpenAI is easy: I'm in the crucible of the AI transformation. It was not a hard decision. Even my kids were kind of impressed and interested because everybody's talking about what's happening at OpenAI. To get under the hood and actually see where the research is taking us is such a privilege. Another thing that's important to me is being a leader in a human sense—it's important that we have diversity around these tables as we build technologies that are literally world-changing.

As for the CFO role, it's still probably one of my favorite jobs because "CFO-ing" is about driving strategy and empowering people. When I'm doing my one-on-ones here at OpenAI, and I've done more than 80 already, I always ask, "What can I do to accelerate you?" That is the most important thing for me to take away from every one-on-one I do with my colleagues. I like being the person who is figuring out how to say "yes."

Lareina Yee: There are certain sets of capabilities that you've acquired over time that allow you to be at the center of driving substantial change. Can you tell us a little bit about some of those capabilities that are timeless, irrespective of the shifts in technology?

Sarah Friar: First and foremost is knowing how to break down and solve problems, and how to communicate. Next is being strategic. A lot of people don't really define strategy well. Their tactics become their strategy, as opposed to having a strategy that they put alongside tactics. I think these two skills have always helped me in whatever role I'm in to really help drive a business.

'I always ask, "What can I do to accelerate you?". . . . I like being the person who is figuring out how to say "yes."'

And then I'd say the skill of understanding where community meets kindness and humanity is important, so I'm not losing who I am to the circumstances of my work. I actually asked ChatGPT about this the other night, when someone asked me to type in the prompt, "ChatGPT, based on what you know about me, what's the thing I might not know most about myself?" What an interesting prompt, right?

The answer it returned was about how growing up in Northern Ireland still continues to shape the person I am today. I love that answer because it reminded me that the culture of where I grew up really is important. For example, I see how my parents' investment in their community has come full circle now that they are the older generation, and people in their community check on them. They feel really supported by it.

So I think about the community I'm building in my work in relation to that. Maybe it's my community in my company or the community of my ecosystem. Or it's how we are now in a world where OpenAI has become synonymous with AI. How do we build a community where it's a world of possibilities and opportunities, rather than something that is more fear-driven?

What's next for gen AI in business?

Lareina Yee: How do you see gen AI reshaping business generally in the future, and what use cases are you seeing now and in the future?

Sarah Friar: I was in New York with customers, so I'll share some thoughts about that. Morgan Stanley is a great example of a company that's organizing their huge knowledge base, particularly in areas like research, and using it to automate operations. They use it to do a better job of getting information out to clients, by generating summaries of video meetings and drafting follow-up emails. With that kind of automation, wealth managers can focus more on customers, rather than having to think first about the steps they need to take to send customers follow-up emails.

Klarna is another. They've been very loud and proud about how their new digital-shopping system built on our API is helping customers find the right products at the best prices, and also how much they're saving on customer service. And Mercado Libre was at our event last week, so I got to hear their CTO [chief technology officer] say to the whole crowd that they're using ChatGPT to autonomously manage customer service decisions. That involves about $450 million annually on our platform, so that's a lot of money that is being touched by our technology, and also cost savings.

Square is yet another. Their customer service team has one of my favorite objectives: "Turn questions into commerce." So if you have an inbound question from a customer who needs something fixed, you can also use that interaction to provide them with added value that helps their business thrive and bring in more revenue. The more we think about customer service as moments where you're going to help the customer do even more, it's a win–win. For businesses, AI is already helping do this.

Lareina Yee: OpenAI launched new reasoning capabilities recently, and that brings us to the topic of agents and what is called "agentic technology," where AI is making decisions and

‘On my own as a CFO, I can think about what scenarios might play out if my revenue went down 10 or 20 or even 40 percent. But being able to interrogate a model with a natural-language overlay would be incredibly powerful for CFOs everywhere.’

learning from experience to achieve goals without direct human supervision. Can you help us understand how the new reasoning capabilities lead to agentic technology?

Sarah Friar: We launched a new set of models with reasoning capabilities: o1-preview and o1-mini. These models create the ultimate path toward a form of AGI, or artificial general intelligence, that benefits humanity. The reasoning capabilities eventually become agents, or agentic technology. With this, the model can reason in places where historically we would have tried to code in software, but it involved too many exceptions and so it reached dead ends.

With agentic technology, AI can take actions in the world and make some decisions for you. It might be something as simple as, “Order something for dinner tonight that my family might eat.” And then you can extrapolate that kind of decision-making out to longer-duration things, like a credit process at a bank—it goes from a customer having a need for money in their bank account that they’re now spending to grow their business.

The exciting next thing after that will be agentic innovation, where you’re contributing to new knowledge in the world, doing things like curing diseases that we have not been able to tackle, or helping solve climate change problems. This is the moment where innovation is happening. And we’re on that continuum.

Lareina Yee: What does that mean for how teams work together in our workspaces?

Sarah Friar: It is going to be fascinating to see how the world of work changes, especially when you add in multimodal communications. With advanced speech today, for example, we’ve rewired ourselves to talk with our thumbs; my teenagers are certainly experts at talking with their thumbs. But now we’re moving back into a world with multimodal communication, where interacting with technology can feel more human because we’re using different methods together to communicate.

This can be phenomenal, for example, for older generations. My mom has really bad macular degeneration, so she cannot type with her thumbs, nor can she read most things on a small-screen phone. But if she could interact with technology verbally, that's just a more natural way for her to communicate given her limitations.

Lareina Yee: Like during the pandemic, we changed the physical location of work, but we didn't totally change modalities and times.

Sarah Friar: If something like COVID happened again, and you had the AI we are about to have, as a CFO, instead of calling your team and saying, "We need to scenario plan really fast," you could pair reasoning to your financial model and talk to it in a natural way and say, "Hey, GPT model, what would happen if no one walked into my store for six months? How would my company survive?" On my own as a CFO, I can think about what scenarios might play out if my revenue went down 10 or 20 or even 40 percent. But being able to interrogate a model with a natural-language overlay would be incredibly powerful for CFOs everywhere.

Lareina Yee: In a crisis, to your point, what you want is your people taking action that only humans can do, and not doing the scenario planning that a machine could do.

Sarah Friar: Exactly.

Lareina Yee: Based on your own career, what advice would you give a young woman who's a budding engineer or who has maybe been in the workforce for a while and is thinking of trying something new?

Sarah Friar: Number one, go for it. You might fail, but you'll learn from it. Absolutely go for it. Second, network like crazy. It's a great way to learn and make something happen. Every time you meet with someone, always end by asking, "Who are two other people you would introduce me to?" It's a forced multiplication of your network. There may not be something in that moment, but things come together with time. I've found there's a serendipity, where a year or so later, something comes up and I remember, "Oh, that person who I met."

Also, women often suffer from believing they have to do something for you first, before they ask for something from you. But the research shows that if I ask for something from you first, you're actually way more invested in my success. So make the ask. It's how you're going to get things done.

Sarah Friar is CFO of OpenAI. **Lareina Yee** (Lareina_Yee@McKinsey.com) is a senior partner in McKinsey's Bay Area office and coleads McKinsey's alliances and ecosystems initiatives.

This interview is excerpted from "What an AI-powered finance function of the future looks like," McKinsey, November 2024.

Comments and opinions expressed by interviewees are their own and do not represent or reflect the opinions, policies, or positions of McKinsey & Company or have its endorsement.

Biases in decision-making: A guide for CFOs

Cognitive biases affect human decisions. Here's a primer on the most common decision-making challenges—and practices that organizations can implement to overcome them.

by Tim Koller

When it comes to making decisions, human beings have built-in biases. So do companies and other organizations. In any number of ways, these biases can stall, skew, or deny the kind of clear-sighted decisions that are at the heart of strategic management. To effectively tie strategy to value creation, management should make tangible efforts to overcome these biases.

The late Nobel Prize–winning psychologist and economist Daniel Kahneman laid the foundation for what we now call "behavioral economics" and "behavioral finance." While his focus was primarily on individual decision-making, we had the opportunity to ask how it might apply to organizations. We asked him, "If people don't behave in an economically rational way, is there any hope for organizations?" His response: "I'm much more optimistic about organizations than individuals. Organizations can put systems in place to help them." Managers can develop rules and processes that help overcome inherent decision-making biases.

Drawing on Kahneman's insights, a group of McKinsey colleagues has proposed (or adopted from others) a number of techniques to help organizations understand and improve their decision-making in resource allocation. In this article, we discuss four common biases that can affect organizational decision-making, along with some potential remedies.

1. Groupthink

Groups of decision-makers tend to engage in groupthink, an overemphasis on harmony and consensus. This can get in the way of examining all the options objectively, leading to weaker—and sometimes disastrous—decisions. Arthur Schlesinger Jr., one of President John F. Kennedy's advisers, wrote this about his participation in the debate over the Bay of Pigs invasion of Cuba, which failed: "In the months after . . . I bitterly reproached myself for having kept so silent in the Cabinet Room."

A variation of this bias occurs when participants don't speak up because they feel the subject under discussion does not fall under their area of responsibility or expertise. At one global agriculture company, executive committee members tended to speak up during strategy conversations only if their business areas were being discussed. The tacit assumption was that colleagues wouldn't intrude on other colleagues' areas of responsibility—an assumption that deprived the committee of their insights.

The weight of evidence strongly supports that decisions are better when there is rigorous debate. One research effort found that for big-bet decisions, high-quality debate led to decisions that were 2.3 times more likely to be successful. Extensive study has explored the importance of vigorous debate in improving decision-making.

Ideally, a company dedicated to pursuing long-term strategic success should have a culture of dissent where rigorous debate is the norm. But most companies need to take more active steps to stimulate debate. The key ingredient is to depersonalize debate and make it socially acceptable to be a contrarian. Here are some useful techniques:

— *Assign a devil's advocate.* At a strategy discussion, assign someone the task of taking an opposing point of view. Make sure this contrarian's contribution is more than just offering opinions. The focus should be on calling attention to potential alternate scenarios or highlighting missing information important to the debate.

— *Bring diverse perspectives to the discussion.* More than 150 years ago, John Stuart Mill wrote in On Liberty, “The only way in which a human being can make some approach to knowing the whole of a subject is by hearing what can be said about it by persons of every variety of opinion.” More recent research has proved his point. Diversity means drawing on the opinions of people from different disciplines, roles, genders, and races in important discussions. Bring in more junior people with special expertise, create an environment where it is safe for them to speak up, and ask them for ideas.

— *Encourage debate with secret ballots.* Use a secret ballot at the beginning of the debate, not the end. Once a proposal has been presented and before it is debated, ask participants to vote on the idea in secret. The request could be for a yes or no vote on a project or for a ranking of investment priorities. When the results are revealed, assuming participants discover at least one other person shares their views, the knowledge will likely make them more comfortable expressing their opinions.

— *Set up a red team–blue team activity for large investments.* Arrange two teams to prepare arguments for opposing outcomes. While undertaking the preparatory work and analysis for this approach is expensive, it can make a difference for particularly large decisions with high uncertainty.

2. Confirmation bias and excessive optimism

Confirmation bias and overoptimism are two distinct biases. However, the same set of techniques applies to both, so we discuss them together.

Confirmation bias is the tendency to look for evidence that supports your hypothesis or to interpret ambiguous data in a way that achieves the same result. For business decisions, this often takes the form of “I have a hunch that investing in X would create value. Therefore, let’s look for some supporting facts that will back up our hunch.” The universal foundation of the scientific approach to addressing a hypothesis is the opposite: You should look for disconfirming evidence.

The universal foundation of the scientific approach to addressing a hypothesis is the opposite: You should look for disconfirming evidence.

Overoptimism is the tendency to assume that everything will go right with a project, even though past projects tell us that such smooth outcomes are rare. A classic example is the construction of the famous Sydney Opera House, whose schedule and budget were both overly optimistic. The project was completed ten years late and cost 14 times the original budget.

Some of the techniques used to overcome groupthink, such as the use of opposing red and blue teams, can help here. The simplest approaches are to avoid developing hypotheses too early in the process and to actively look for contrary evidence. Other potential correctives for confirmation bias and overoptimism include the following two methods:

— *Conduct a 'premortem.'* A premortem is an exercise in which, after a project team has been briefed on a proposed plan, its members purposely imagine that the plan has failed. The very structure of a premortem makes it safe to identify problems.

— *Take the outside view.* Build a statistical view of a project based on a reference class of similar projects. For instance, a group at a PE company was asked to build a forecast for an ongoing investment from the bottom up—tracing its path from beginning to end and noting the key steps, actions, and milestones required to meet proposed targets. The group was then asked to compare that ongoing investment with categories of similar investments, looking at factors such as relative quality of the investment and average return for an investment category. Using this outside view, the group saw that its median expected rate of return was more than double that of the most similar investments.

3. Inertia (stability bias)

Inertia, or stability bias, is the natural tendency of organizations to resist change. One study found that spending allocations across business units among the companies it studied were correlated by an average of more than 90 percent from year to year. In other words, the allocation of spending to business units essentially never changed. The same study showed that companies that reallocated more resources—the top third of the sample—earned, on average, 30 percent higher TSR annually than companies in the bottom third of the sample.

The solution to inertia bias is relatively straightforward. Rank initiatives across the entire enterprise by potential value creation. In addition, ensure that the budget you are building is rooted in the current strategic plan, not last year's budget. The essential idea is to ignore the influences of past allocations or budgets as much as possible. In practice, you may be unable to shift resources as quickly or as much as you should. But trying to ignore the past is a starting point and will help you minimize inertia.

4. Loss aversion

Research shows that most executives are loss averse and unwilling to undertake risky projects with high estimated present values. The primary solution to overcoming loss aversion is to view investment decisions based not on their individual risk but on their contribution to the risk of the enterprise as a whole.

That's easy in theory, but executives are typically concerned about the risk of their own projects and the potential impact on their careers. That's why those decisions should be elevated to executives with a broader portfolio of projects whose risks cancel each other out. Often, the decisions must be pushed up to the CEO.

To be most effective, companies also should encourage middle-level managers and other employees to propose risky ideas. Companies can do this by eliminating risks to the employee. Many employees censor themselves because of concerns that their careers will suffer if their idea for a project fails. To overcome this concern, it's important to agree on the various risks up front with the top leadership and conduct "postmortems" on projects, particularly to identify causes of failure. If a project fails because the decision to go ahead with the project turned out to be incorrect (which should happen frequently), that failure should not bear on the manager responsible for the project. The responsible manager should only be accountable for the quality of execution of the project.

Jeff Bezos, founder of Amazon, puts it this way: "I always point out that there are two different kinds of failure. There's experimental failure—that's the kind of failure you should be happy with—and there's operational failure. We've built hundreds of fulfillment centers at Amazon over the years. . . . If we build a new fulfillment center and it's a disaster, that's just bad execution. That's not good failure. But when we are developing a new product or service or experimenting in some way, and it doesn't work, that's OK. That's great failure."

Decision biases can prevent good ideas from turning into value-creating actions. The list of best practices for decision-making is long and can be daunting, but executives can begin by recognizing four foundational biases and taking time-tested steps to address them. Adding new refinements over time will move any company closer to the goal of managing strategically for the long term.

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This article is adapted from the eighth edition of Valuation: Measuring and Managing the Value of Companies *and is presented here with the permission of John Wiley & Sons.*

Looking back

To what degree does an abundance of capital affect M&A activity in PE?

Financial investors currently have an abundance of "dry powder"—that is, capital that they can deploy for potential transactions (exhibit). Multiple PE funds face a defined timetable, increasing pressure to exit, and urgency to deliver higher investor returns.

The share of PE transactions peaked in 2021, at 27 percent of total deal volume. Since then, investors have been pushing for deals even when that could lead to potential "must sell" situations.

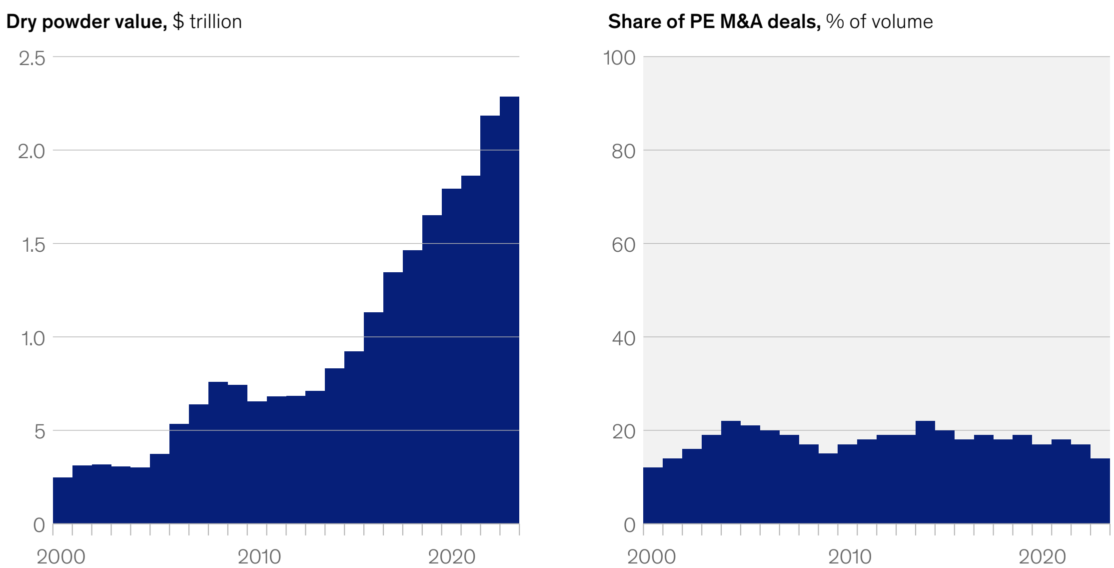
For more than two decades, private investors' share of all M&A deals has represented between 12 and 22 percent of total deal volume. Because that percentage is a function not just of their own dealmaking activity but also that of corporate dealmakers, it's uncertain whether the recent trajectory will plateau at the lower end of that range, return to the higher end, or perhaps set new highs (or even lows).

PE's overall share of M&A activity nudged slightly upward in 2024 at 15 percent of deals worldwide in excess of $25 million—one percentage point higher than 2023, and two percentage points lower than 2022.

Exhibit

PE funds are holding more 'dry powder,' and their share of deals is below historical highs.

PE and private investors' 'dry powder,'[1] 2000–23



[1]Includes all PE (buyout, growth, venture capital, and "other" category).
Source: Dealogic; Preqin; McKinsey analysis

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