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McKinsey on Finance

Perspectives for CFOs and other finance leaders

In the right hands

Inside: Pursuing buy-side carve-outs, disentangling divestitures, budgeting amid uncertainty, investing in innovation, communicating with investors, and leading the AI revolution.

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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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This edition: In the right hands

Across corporate finance today, the most important decisions hinge on ensuring that assets, capital, ideas, and technology are in the position to create the greatest value. This issue of *McKinsey on Finance* explores what it means to put businesses, resources, and strategies "in the right hands" so that they can thrive.

The issue opens with a special package on acquisitions and divestitures, where the principle is clearest. Our series on buy-side carve-outs by Anna Mattsson, Kameron Kordestani, Rui Silva, and Julia Berbel explores how giving a divested asset a new home can unlock potential. These transactions depend on careful stewardship from CFOs, integration leaders, and chief human resources officers, who must guide people, processes, and capital to ensure a successful transition. We then turn to an excerpt from the eighth edition of *Valuation: Measuring and Managing the Value of Companies* (John Wiley & Sons, May 2025) that looks at how companies can manage the costs and complexities of disentangling a business so that the parent organization is well positioned after a sale.

Two features in this issue tackle pressing challenges for finance leaders. In the first, Andy West, Christian Grube, Cristina Catania, and Matthew Maloney contend that budgets can keep pace with accelerating uncertainty if CFOs tie them to strategy, ground them in real data, and align their timing with business needs. In the second, Matt Banholzer, Tim Koller, Enes Gokkus, and Laura LaBerge demonstrate that innovation spending is too important to cut, even in uncertain times. The authors explain how leading companies reassess portfolios, back promising projects, and take smarter risks to achieve more with less.

We also talk with the CEO of Sanofi about taking the company's AI ambitions into his own hands. He describes how the company has built AI systems that cut across functions rather than sit in silos, enabling capital and resources to move quickly to where they matter most. For CFOs, his story illuminates how AI can help a finance function guide effort and money to a company's highest priorities.

An article about our latest investor survey explores how companies can ensure that they communicate clearly about both long- and short-term stories. The survey findings show that investors prize hard data on fundamentals, such as returns and profitability, but also expect those numbers to tie to a clear equity story that explains how a company will create value over time. And finally, in our latest *Bias Busters* entry, Aaron De Smet and Tim Koller look at the "framing effect," revealing how asking the wrong question can lead to the wrong answer.

Each article takes on a different challenge, but all reflect some aspect of the same general idea: Financial leadership depends on using discipline and expertise to direct resources to the right hands. In doing so, finance teams can help their companies achieve their current objectives while preparing them for the demands and opportunities that lie ahead.

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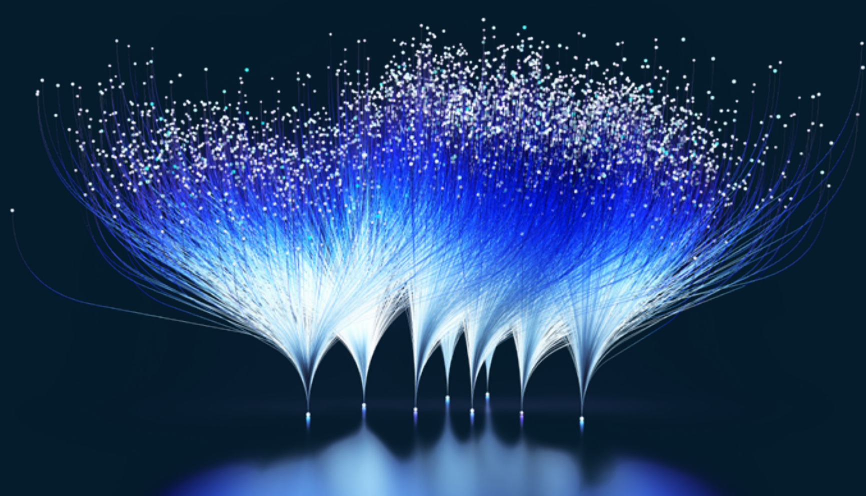

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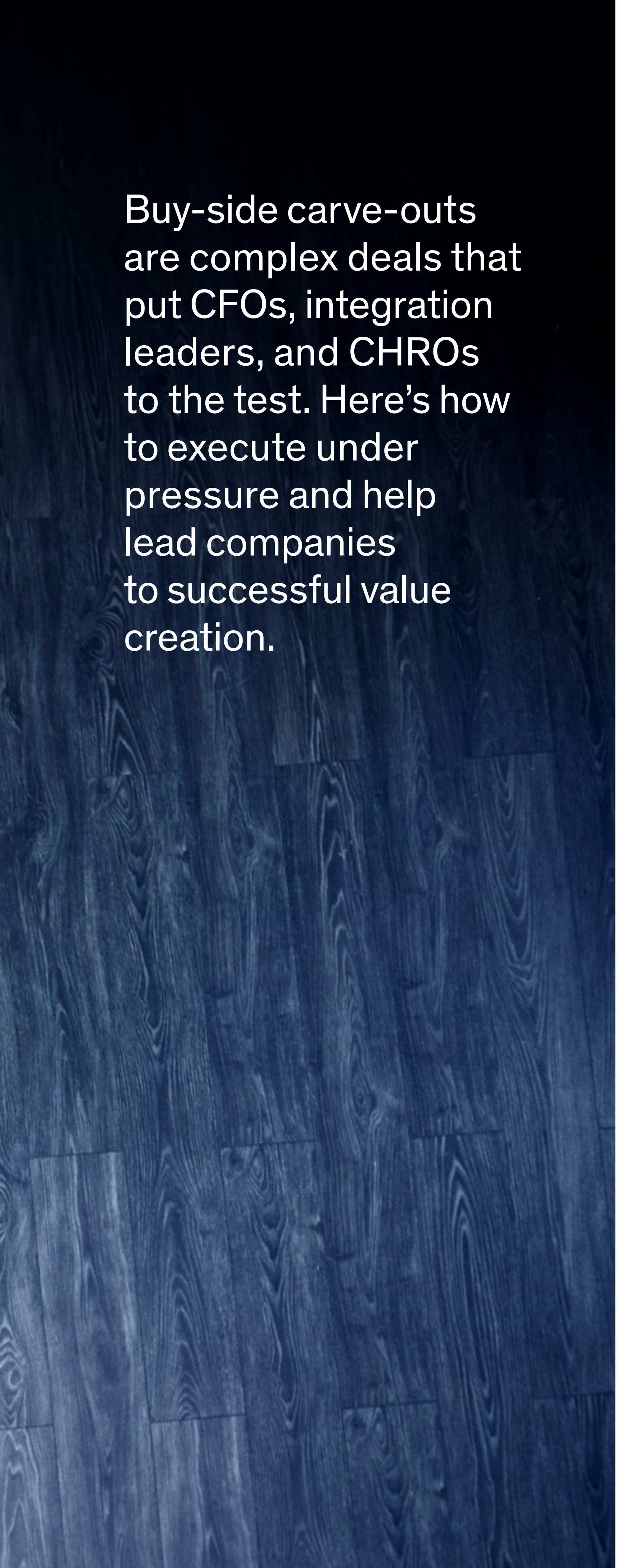
A buyer’s guide to carve-outs



Buy-side carve-outs are complex deals that put CFOs, integration leaders, and CHROs to the test. Here's how to execute under pressure and help lead companies to successful value creation.

In a buy-side carve-out, a company acquires a business unit that is being separated from its former parent. McKinsey's proprietary research shows that buy-side carve-outs account for 28 percent of all M&A transactions.[1] It's not hard to understand why there is a high interest in these targets: Sellers often divest noncore, deprioritized assets to buyers who are generally in a better position, with a better strategic fit, to reap value from them.

But as desirable as they may be, buy-side carve-outs are not easy. Leaders on the buyer's side face a host of complexities as they pursue these deals: For CFOs, the task is to manage financial risks and help turn potential into lasting value. Integration leaders must bring new assets on board while navigating sellers' often-conflicting interests. And the chief human resources officer plays a critical role in ensuring that employees of the carved-out entity feel excited, motivated, and ready to contribute as they join the buying organization.

Before we dive into best practices for each type of leader in a buy-side carve-out, a word about the term itself. "Carve-out" is a term in transition. Historically, a carve-out referred to when a company sells a portion of shares in a business unit to investors in an IPO and, typically, lists the unit on an exchange. More recently, a carve-out has referred to any asset or set of assets being separated from an organization. The more recent usage of the term implies that carve-outs can either be sold to another organization (the buyer) or left as a stand-alone to form a new separate entity (fully independent or operating under the original parent company).

The following articles focus on buy-side carve-outs, in which another organization buys the carve-out and the buyer must then successfully integrate it. By calling it a buy-side carve-out, we mean that we are looking at it from the perspective of the organization buying it.

[1] Considers all transactions above $100 million between 2018 and 2023, excluding acquisitions of minority stakes (in other words, where there was no change in control) and physical assets (meaning that the target company did not involve common stock and/or the target was a physical asset, such as a cell phone tower or a piece of real estate).

What CFOs need to get right in a buy-side carve-out

CFOs can tackle dis-synergies and stranded costs, among other complexities, with flexible models and well-structured TSAs.

by Anna Mattsson, Kameron Kordestani, and Rui Silva
with Julia Berbel

In a buy-side carve-out, CFOs occupy the hot seat. These deals are full of moving parts, all of which converge in the finance function. It's up to the CFO to keep the deal grounded in value creation while building the flexibility needed to manage uncertainty.

CFOs must identify dis-synergies and potential stranded costs that can erode value if left unaddressed. Then they have to keep these challenges in mind as they pursue two of their most critical tasks in a buy-side carve-out. First, they must build flexible financial models that can adapt as new information emerges. Second, they are tasked with ensuring that transitional service agreements (TSAs) are appropriately scoped, priced, and executed to support operational continuity when and after the deal closes. Complicating matters is the fact that financial models for the deal and TSA negotiations influence one another in real time, requiring constant recalibration as assumptions shift.

To be sure, integration planning shouldn't come at the expense of setting clear financial targets or building detailed synergy plans ahead of close. While functional teams prepare for day one, the central value capture team can begin advancing long-term priorities. CFOs play a vital role in staying focused on the deal's original value goals while navigating the challenges that most often derail integration efforts.

Synergy issues and stranded costs

One of the CFO's most crucial responsibilities in a buy-side carve-out is to identify potential dis-synergies and stranded costs. These issues should be surfaced during due diligence, but they also need to be addressed and mitigated as more information becomes available, just before deal close and during integration.

Dis-synergies refer to the negative financial or operational impacts that result from separating the business from the seller and integrating it into the buyer's organization. For example, suppose a buyer is acquiring a yogurt brand from a dairy company. The dairy company buys milk in bulk to produce all its products, so the milk's unit price is low. If the buyer is not a dairy company and therefore doesn't buy a lot of milk for any other product it sells, it will likely end up paying a higher unit price for milk. This will affect the real profitability of the business once it transitions to the buyer.

Stranded costs arise when resources inherited from the seller are no longer fully utilized in the new setup. Suppose the same dairy company is selling a piece of equipment it used to make an entire line of dairy products. If the equipment is sold to the buyer as part of the carve-out, the buyer may end up with equipment that is operating at half capacity and at a loss.

Throughout the integration process, CFOs can manage dis-synergies and stranded costs in two key ways. They can continuously pressure test and update financial models as new cost information comes to light, and they can use their financial oversight to shape TSAs that support the deal's value creation goals.

Getting a clear financial picture

Part of what makes buy-side carve-outs particularly challenging for CFOs and their teams is the difficulty of building an accurate financial baseline for the future combined organization. A seller may prepare the target's stand-alone financials to be as marketable as possible, potentially differing from what the buyer is getting. Even months after the deal closes, CFOs often struggle to get a clear picture of the target's financial performance. For example, a consumer company failed to realize that the seller's low operating costs resulted from underinvestment in equipment maintenance and logistics. To address existing customer pain points and improve service, the buyer would need to make significant upgrades—resulting in higher ongoing costs than anticipated.

Depending on the separation process's complexity level and, in particular, the enterprise resource planning entanglement between the carve-out and the seller, the buyer may need to rely on old-fashioned, manual modeling tools—such as Excel—to build an apples-to-apples financial baseline.

CFOs can only develop a sharp view of the new company's full value creation potential once they have confidence in the financial baseline. But in a carve-out, that baseline is often incomplete; the business isn't a stand-alone entity at the time of acquisition, which is why TSAs are required. While TSA costs can be a moving target, they offer a useful proxy for estimating the costs that are not yet visible in the carve-out's baseline but that the buyer will ultimately need to absorb.

This baseline model can then be updated as teams gain clearer insight into the asset's financials, potential dis-synergies, stranded costs, and the evolving terms of TSA agreements. The value capture team—which owns the value creation model—can work closely with functional and business integration teams to ensure the model stays current and that value capture plans and targets are adjusted as needed.

CFOs and their teams can also plan for different financial-baseline scenarios. They can use the flexible model to run what-if scenarios and to determine how value capture plans and targets would be updated in each case. Scenarios can include additional TSA costs, dis-synergies, or unexpected needs for additional third-party spending, among other issues the buyer might encounter.

Using TSAs to protect continuity and manage financial risk

TSAs are among the most operationally important and financially sensitive components of a buy-side carve-out. They often involve complex interdependencies, rushed timelines, and high dollar values. Despite their temporary nature, they can have significant consequences for business continuity and the overall success of the deal.

CFOs are typically the final authority on what the buyer will ask for and agree to in the TSA contract. They must judge which services truly warrant inclusion, how long they should last, and how much they're worth.

Consider what can go wrong when an important TSA is overlooked: One acquirer opted not to use a TSA for payroll and onboarded all employees from the acquired company on day one. But key dependencies around system requirements were missed, leading to payroll failures and widespread employee dissatisfaction in the first pay cycle after closing.

While TSA costs eventually disappear, they're often replaced by new cost structures on the buyer's side, making the financial baseline a moving target. Gaps in identifying entanglements, scoping and negotiating TSA terms, implementing the agreements, or exiting them on time can lead to more than just operational disruptions. They can have a direct and meaningful impact on the CFO's ability to deliver on the deal's value creation goals.

CFOs contribute to the following four main phases of the TSA life cycle.

Set the scope and priorities for TSA coverage and spend

In most cases, the buyer will need a TSA to gain access to people, services, or systems from the seller for a limited time until it can build the capabilities itself. Consider a hypothetical example of a bank buying a call center unit from a telecom player. In the long term, it will likely make sense to fully incorporate the call center team into the bank, perhaps by moving staff into the bank's

In buy-side carve-outs, CFOs must build flexible financial models that can adapt as new information emerges.

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existing call center space. However, the bank might need time to find the proper space to fit the new employees. As a short-term solution, the bank can enter into a TSA with the seller to continue to use its office space until it finds a longer-term solution. The same logic typically applies to corporate-center services (such as finance and human resources), contracts, machinery, production lines, and other resources. Returning to the example of the dairy company, the buyer could use a TSA to continue using the seller's equipment or milk procurement process until the buyer can find a more cost-effective solution.

Other agreements and arrangements may also be needed, including a reverse TSA (where the buyer provides services to the seller) or a manufacturing services agreement (where the buyer uses the seller's manufacturing facilities). For example, an automotive acquirer included a training clause allowing its executives to "phone a friend" (limited to a reasonable amount, such as one hour per week for the first three months postclose) in the event they had any questions for the seller.

Shape TSA terms to reflect the buyer's true needs and cost structure

By the time the deal is signed, there is usually a first draft of the TSA contract. This draft is typically rushed and completed with limited input from business, functional, and local teams, even though they often better understand entanglements with the parent business. Once the deal is signed, it is essential that teams work together to finalize a TSA that addresses all the buyer's needs to avoid any day one disruptions. At the same time, the buyer must stay close to the TSA rationale and pricing, as TSAs tend to be a significant cost line in the P&L.

Clarify how TSAs will be implemented and used across teams

Once there is alignment on the TSAs, specific employees who run the processes should be identified and trained in how to provide or use services across both organizations. There should be an established governance structure and regular meeting cadence to ensure performance tracking, smooth interaction, and a simple way to manage change requests and escalations.

Time TSA exits to protect value and avoid hidden costs

Exiting TSAs in a timely manner can often accelerate value capture efforts and provide short-term profitability uplift. However, exiting a TSA too quickly sometimes leads to business disruptions, creating unforeseen or unnecessary costs. It's important for CFOs to carefully weigh which TSA exits to prioritize based on rigorous analysis of business risks, opportunity costs, and savings. It is best practice to start developing TSA exit plans long before the deal closes.

Buy-side carve-outs test a CFO's ability to manage complexity while maintaining a clear line of sight to value. Coping with dis-synergies and stranded costs is essential. It's also vital to build financial models that can adjust to new information and to ensure that TSAs are properly scoped and structured to support operational continuity without inflating long-term costs. By guiding both efforts with discipline and foresight, CFOs can help ensure that deals deliver on their strategic and financial promise.

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How buyers can successfully navigate integrating a carve-out

Integration leaders on the buy-side of a carve-out face three primary tasks to successfully bring new assets into the fold.

by Anna Mattsson, Kameron Kordestani, and Rui Silva with Julia Berbel

It's hard enough to successfully integrate organizations after an M&A. For organizations on the buy-side of a carve-out, the deal brings the added complexity of integrating partially separated assets while coordinating closely with sellers who may have different timelines, priorities, or incentives. Day one and business continuity risks are high in these deals, making it crucial to work out a profusion of planning and resourcing details.

Integration leaders play a crucial role in buy-side carve-outs. They can come from numerous backgrounds, including business unit and technology roles. Whatever these leaders' experience, their priorities in integrations are the same: to forge a positive relationship between the buyer's and seller's teams, scope and provide resources for work streams, and prepare for day one and postclose integration.

Why carve-outs are more complicated on the buyer's side than the average acquisition is

It's often said that three is a crowd, and integration leaders would likely agree. In a regular M&A transaction, an integration management office (IMO) collaborates with a target management team to make all integration-related decisions. The two parties are aligned on the single objective of making the integration successful. In a buy-side carve-out, however, the buyer's IMO needs to collaborate with the seller's separation management office (SMO), whose objective is to accelerate the separation so that it can focus on its core business. A seller may try to dispose of low-performing or noncore talent and noncore assets or technology. It may feel that it doesn't need to go the extra mile to support integration-planning activities or share much data prior to deal close.

There's also business continuity risk from critical cut overs, such as contracts being reassigned or split, people being transferred, processes being rerouted, and systems being separated or cloned on or right before day one. For example, when an acquirer forgot to update its insurance policy following a deal close, the target's sales force members could no longer drive their cars to customer meetings. In these deals, any mistake—even a seemingly small one—can create disruptions that lead to frustrated employees, irritated customers, or regulatory penalties, among other consequences that aren't so easily overturned.

Finally, there are often more areas of work requiring planning and resourcing than with a typical integration. Examples include planning and negotiating for transition service agreements (TSAs), transferring data among the three parties, tracking and managing last-minute deal perimeter changes, and needing to approach a deal's close in different ways in different markets.

Priorities for capturing a deal's full potential

Integration leaders in buy-side organizations play a central role in overcoming numerous challenges inherent to these transactions—and three in particular.

Structuring IMO and integration teams

Integration leaders can begin by fostering alignment between the buyer's and seller's teams:

— *Establish a healthy and collaborative working relationship with the SMO.* Having a good working relationship with the SMO is both the primary challenge and main value driver of a successful integration. Best practice is to develop joint planning principles and guardrails directly in the purchase agreement, prior to deal signing. From that point, the IMO and SMO can align on roles, responsibilities, and a collaboration model for the pre-deal-close-planning phase. For example, a pharmaceutical company and SMO established a close collaboration model, including shared locations, daily touchpoints, and full-day workshops. All parties involved took the time to carefully detail how the TSA would play out, provide input to decisions, deliver cross-organizational training, and build plan B's to avoid any business disruption.

— *Build a joint plan of milestones with the SMO.* Trying to manage plans in isolation is fraught with risk. The IMO can partner with the SMO to define a single source of truth with critical milestones for both sides, including key deliverables and joint planning workshops.

— *Define which teams require a three-in-a-box setup.* Certain functional areas, especially those with many entanglements, need to include a seller representative as a colead or input provider. Having three-in-a-box teams—composed of buyer, seller, and target representatives—that collaborate openly can facilitate alignment ahead of day one.

Scoping and providing resources for work streams

Integration leaders should focus on actions that reflect the deal's structure and strategy:

— *Identify the need for dedicated resources.* Analyzing deal requirements and strategy indicates what additional resources or teams should be in place. For example, the buyer may need someone in charge of tracking changes to the deal perimeter, someone as the point person with the seller on all TSA matters, and someone orchestrating data and system disposition across teams or working closely with the deal team to translate the implications of closing scenarios into integration plans. Managing the deal perimeter tends to be critical, especially when resources within the assets being carved out are shared across other business units of a seller. Which and how many of these resources should be part of the deal perimeter? Someone in the IMO can be tasked with keeping track and working with business leaders to define who should and shouldn't be transferred.

— *Understand brand and use-of-name restrictions and implications.* If rebranding is a requirement for day one, it makes sense to approach it as a cross-functional effort coordinated by the IMO. For example, one acquirer forgot to stockpile product before the deal closed and ran out of stock while the regulatory team was still waiting to obtain a license to manufacture under the new entity. This led to disruption in order fulfillment and avoidable revenue loss. The checklist is extensive and includes digital platforms, physical signage, and products. Some elements may depend on legal-entity changes (such as

Integration leaders can begin by fostering alignment between the buyer's and seller's teams.

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invoices), and many will have IT dependencies (such as using an email domain). When it comes to physical labels, for example, if the seller requires immediate cessation of name use, the buyer and seller may need to start the manufacturing process for relabeling even before the deal closes.

Creating day one readiness and preparing for post-deal-close integration

Finally, integration leaders will need to prepare for day one readiness and post-deal-close integration:

— *Determine prioritization.* Unlike more straightforward integrations, buy-side carve-outs demand extra focus on identifying entanglements and day one separations and cut overs. In these situations, the final design of the organization and other complex initiatives may need to be temporarily deprioritized, depending on the team's capacity.

— *Run a joint day-one-readiness workshop.* As a deal's close approaches, it's beneficial to run a day-one-readiness workshop with all parties. This group can focus on a detailed sequencing of activities that will occur before, during, and after the deal's close. Exploring what-if scenarios in a cross-functional group setting is helpful to align responsibilities for each required step and ensure that all needs are covered and risks mitigated.

— *Prepare for the unexpected.* The complexity of a target's simultaneous separation and integration may lead to unforeseen issues, regardless of preparation. Setting up a robust day one hypercare effort with rapid escalation processes can be critical to minimizing disruptions.

Despite the additional challenges associated with integrating carve-outs, integration leaders on the buyer's side can view overcoming the hurdles as an opportunity to further build their M&A and integration capabilities. This valuable experience can only make an organization—and its leaders—stronger and more prepared for the next wave of deals.

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How CHROs can win hearts and minds in a buy-side carve-out

Culture, organization, and talent risks often arise when assets are carved out. Here's how people leaders can address them.

by Anna Mattsson, Kameron Kordestani, and Rui Silva with Julia Berbel

Whether buy-side carve-outs encompass entire subsidiaries or specific divisions, locations, or teams, they can be jarring for all employees. It is critical for chief human resources officers (CHROs) on the buyer's side to help manage employees' reactions throughout deal phases, because even the best integration planning can be no match for a demotivated workforce.

With these dynamics in mind, CHROs must work proactively to address fears and to create ownership and enthusiasm among the carve-out's employees. They can do so by establishing reporting structures that connect the new unit to the organization on day one and by communicating early and often with their new employees about what the future holds.

Buy-side carve-outs can be disruptive and challenging, but they also present an inflection point offering new beginnings, opportunities, and professional purpose. With the right CHRO leadership, a carved-out team doesn't just join a new company; it joins a new vision.

Understanding how buy-side carve-outs can make employees feel

Change can be difficult in the best of times. For employees of a company that has been carved out and acquired, the disruption can feel acute and beyond their control. Based on our conversations with employees in dozens of buy-side carve-outs, two emotions are the most powerful and pervasive:

— *Feeling abandoned.* Unlike a regular acquisition in which a whole company moves under new ownership, the seller continues to exist in buy-side carve-outs. That can leave a select number of employees feeling they have been "sent away." Employees often describe feeling hit with the surprise that they are no longer welcome in the seller organization.

— *Feeling uncertain.* In many cases, sellers carve out parts of their business that haven't been the center of attention or have lacked investment. Some employees may be cautiously optimistic that a new buyer can reinvigorate the carved-out entity. Others may not want to go, and still others may be stressed by not knowing their exact fate. Retaining or regaining employees' trust and building their excitement takes work.

Both emotions may increase the risk of attrition, particularly among the highest-performing employees, who often have the most options. They can also lead to the development of a low-performing culture. And while it's critical to provide assurances to the employees of the carved-out entity, these can be hard to deliver because buyers often have little ability to communicate with their new employees before a deal closes. In fact, the buyer may not even have a final view of who exactly will move over with the asset until near the close of the transaction. This makes it difficult to plan a proper onboarding process and to assign employees to the buyer's organization structure, though both steps are vital to a positive transition experience.

We learned about how anxious an R&D team was while the unit was being carved out as part of a patent purchase. These employees were concerned that they would no longer be able to explore diverse research areas and that projects that mattered to them would falter. Many of these employees were offered jobs at other organizations that assured them they could complete their research. To counteract the risk of attrition, the buyer focused on finding ways to communicate what was changing, what would stay the same, and on building confidence that important research projects were safe.

The CHRO's tool kit: Precise talent integration and thoughtful communication

To successfully integrate employees from the carved-out asset and generate the intended value from the deal, people leaders need a strategy to address employee concerns. This requires a seamless transition process and the CHRO's and other leaders' clear and optimistic communications to the new team.

Executing talent integration with precision

CHROs play a central role in ensuring that the transition of talent in a buy-side carve-out is smooth, compliant, and minimally disruptive. A primary goal is to retain the highest-performing employees, who are also the ones who often have the greatest opportunity to leave if they find the integration process overly disruptive.

The buyer can benefit from establishing early alignment with the seller's human resources team on which employees will transfer, which will remain behind, and the expected communication timeline. This clarity enables both simple tasks—such as issuing new email addresses and badges—and more complex activities, like migrating payroll, benefits, and employee data, to move forward efficiently.

Buy-side people leaders can designate a dedicated human-resources-integration lead to coordinate the transition and serve as a single point of contact across functions. They can also map onboarding requirements by geography—covering items such as background checks, employment agreements, regulatory filings, and local labor law compliance, particularly in cross-border contexts.

Even when the carve-out is initially set up as a stand-alone entity by the seller, the buyer can benefit from defining a clear, temporary reporting structure for day one. This includes clarifying where each employee will sit, who they will report to, and who will oversee their onboarding. These decisions also shape critical operational elements, including payroll processing, approval rights, and potential location changes.

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Finally, CHROs can reinforce stability and engagement by sharing a clear people transition road map with affected employees. Transparent communication from the outset can ease uncertainty and help new team members feel anchored in the acquiring organization.

Communicating early, clearly, and intentionally

Strict antitrust and legal restrictions aimed at preventing "gun-jumping" often limit or prohibit buyers from directly engaging with carve-out employees prior to deal close. However, sellers can allow limited, supervised communication between buyers and affected employees. This enables buyers to convey key information—such as planned retention initiatives (both financial and nonfinancial)—as well as broader messaging, including the vision for the new organization.

In one case, an acquirer published a microsite with a welcome message, an overview of the company's values, why it was excited to welcome its new employees, and "what to expect," which offered details about tech enablement and orientation. As part of its onboarding process, the company also paired new employees with peers from similar backgrounds (including those with similar functional expertise or from the same alma mater). These "buddies" and mentors were available to answer questions and help the employees from the carved-out entity navigate the new organization. On day one, this same acquirer hosted both in-person and virtual welcome celebrations.

In situations where the carved-out entity has been underfunded and under-resourced for some time, CHROs and other leaders in the acquiring company may want to focus their communications on actively recognizing new employees and prioritizing their development and well-being. One company, for instance, sent new office-entry badges to employees' homes and created an app that let them book rooms in the new office. These small gestures helped create a welcoming environment and a sense of belonging to the new organization. Both this company and the one mentioned above were rewarded for their efforts by low attrition, positive onboarding experiences, and smooth integrations of the new teams.

While the integration process for buy-side carve-outs isn't easy, its challenges are addressable. Great people leadership starts with understanding affected employees' emotions—and the effect those emotions can have on performance. CHROs can then work on a dual track of excellent people transition processes and early, clear, and intentional communication. When done well, this approach can foster cultural alignment, build trust, and set the stage for long-term value creation.

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The cost of (un)doing business

In a divestiture, companies must overcome the complexities of disentanglement.

by Anna Mattsson, Jamie Koenig, and Tim Koller

Divesting a business unit creates value when other owners can extract more value from it than the current owners can. This is known as the "better owner" principle. Often, new owners change the operating model of both the divested business and the parent company because large companies frequently impose mismatched operational requirements on diverse business units. For example, high-growth, high-margin businesses may require operating models that are different from those of low-margin, mature businesses.[1] Breaking up the business units can help both entities develop a fit-for-purpose operating model.

Moreover, divesting noncore business units can help free up management attention and allow for better resource allocation decisions within the core businesses. Finally, divestments can improve capital allocation decisions while making it easier for the divested entity to raise capital as a pure-play company, versus competing for funding with all other lines of business.

The value *created* in a divestment for a parent company is the price received minus the value forgone minus separation costs incurred by the parent. The value *forgone* is the value of the divested business, as operated by the current management team, plus any synergies it has with the rest of the parent's businesses. This forgone value represents the cash flow that the parent company has given up by selling the business. The costs of separation include the costs the parent incurs to disentangle the business from its other businesses, plus the so-called stranded costs of any assets or activities that have become redundant after the divestment—costs that, as we will see, can often be substantially mitigated by restructuring central and shared services in the parent company.

This article, an excerpt from the eighth edition of our book *Valuation: Measuring and Managing the Value of Companies* (Wiley, May 2025),[2] discusses these synergies and costs. It also examines practical challenges relating to legal and regulatory issues, as well as pricing and liquidity of the businesses.

[1] Jamie Koenig, Tim Koller, and Anthony Luu, "When bigger isn't always better," *McKinsey Quarterly*, December 17, 2021.

[2] *Valuation* was coauthored by David Wessels, Marc Goedhart, and Tim Koller. Chapter 32, "Divestitures," was coauthored by Anna Mattsson and Jamie Koenig, with contributions from Raghav Kapur and Mariola Ndrio.

Lost synergies and stranded costs

When a company divests a business unit, it may lose with it certain synergy benefits that come from having that business in its portfolio, even if the company isn't the best owner of the business. For example, a business unit may have cross-selling opportunities with other units. Likewise, a corporation may bundle its procurement for various businesses globally so that it enjoys significant discounts. In other cases, the divested business may have to give up access to shared resources like innovation centers and engineering teams that foster knowledge sharing, promote best practices, and drive efficiencies across business units.

Divestments could also lead to the loss of nonoperating synergies related to taxes and financing, although these tend to be relatively small. For example, an integrated electricity player that divests its (regulated) transmission and/or distribution network business and keeps a portfolio of generation and supply units will have a higher risk profile after the divestiture and, consequently, a lower debt capacity and corresponding value from tax shields.

One-time disentanglement costs

Depending on the extent to which a business unit is integrated within an organization and its operations, disentangling it can incur substantial expenses. These are one-time costs such as expenses for legal and advisory fees, information technology (IT) system replacement or reconfiguration costs, relocation costs, and retention bonuses. Disentanglements can be more complex than the integration processes of large M&A deals.

Taxes triggered by the divestment depend on the details of a proposed deal structure, but they too can have real impact on post-deal economics. Differences in fiscal regimes also play a role. In many European countries, gains on the sale of business units are to some extent exempt from corporate income and withholding taxes. In the United States, however, capital gains from divestitures are often subject to taxes unless the unit is spun off and meets certain tax requirements. Depending on the fiscal regime, executives may therefore prefer different types of transactions, including spin-offs, split-offs, carve-outs, and IPOs.

The value created in a divestment for a parent company is the price received minus the value forgone minus separation costs.

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Stranded costs

Stranded costs can be hard to accurately estimate and harder still to fully address. These are (corporate) costs for assets and activities associated with the business unit but ultimately not transferred with it. Stranded costs can relate to shared services, such as procurement, marketing, and investor relations. They can also refer to IT infrastructure and shared production assets—for example, when a single manufacturing facility consists of production lines of products from different business units. And they can relate to general overhead costs that are allocated to businesses, such as costs for the board of directors, legal counsel, and corporate compliance.

In our experience, divestments often bring to light excessive corporate overhead that cannot be transferred to the divested business unit and is subsumed under stranded costs. Large companies tend to have many layers of management and communication. This easily leads to redundancy and unnecessary costs. For example, sizable business units often have managers in human resources, strategic planning, or financial controlling functions whose primary job is to coordinate and communicate with their counterparts in the corporate headquarters. After a divestiture, such intercompany transaction costs can be largely eliminated in both the parent company and the divested businesses. In fact, successful sellers often use divestitures as a catalyst to reduce overhead and improve efficiency in the remaining business.

Real stranded costs from divestitures take considerable time and effort to unwind. Some stranded costs are fixed and difficult to reduce, as in the case of shared IT systems. Others can be more readily managed over time—for example, by head count reductions in shared service centers. McKinsey research has found that it often takes up to three years for the parent company to recover from stranded costs, leaving it with substantially lower profit margins during this period.[3]

Legal and regulatory barriers

The divestment process may be complicated by legal or regulatory issues. These are typically not large enough to distort the value creation potential, but they can seriously slow down the process and add to the amount of work to be done, thereby increasing the time and resources required to come to closure. For example, pharmaceutical companies are required to have a so-called marketing authorization to sell an individual product in a specific market, typically a single country. If a pharmaceutical company decides to sell a particular product portfolio (for example, oncology, respiratory, or vaccines) to another pharmaceutical company, it needs to apply for a transfer of the marketing authorization for each individual product in each specific market. The process is time-consuming and requires additional expenses. Asset transactions can be especially complex, because they require extensive documentation and contracts with respect to all the different categories of assets involved.

[3] David Fubini, Michael Park, and Kim Thomas, “Profitably parting ways: Getting more value from divestitures,” McKinsey, February 1, 2013.

Contractual issues often come as unpleasant surprises that typically surface after companies have started the divestiture process. Procurement contracts, long-term contracts with customers, and loan agreements, for example, often require the creation of transitional service agreements between buyer and seller to guarantee continuity of the business unit. Or they may include change-of-ownership clauses activated upon divestiture that render the existing contract or agreement invalid when ownership in the business transfers.

Pricing and liquidity

Market valuation levels are generally in line with intrinsic value potential in the long term but can deviate in the short term. A near-term divestiture would seem to be a good idea if the market would price a business above management's estimate of its intrinsic value. The reverse holds as well: Siemens, for example, delayed the spin-off of its lighting business OSRAM for several years because of adverse market conditions, eventually completing the transaction in 2013.

Although external market factors may lower potential proceeds from a divestiture, management should balance this against the (hidden) costs of continuing with the status quo. Alternatively, management could look into transaction types that do not generate cash proceeds and thereby do not lock in an exit price for the company's shareholders. For example, as the credit crunch unfolded in 2008, Cadbury decided against a planned trade sale (in cash) of its American beverages business. Instead, it opted to spin off the business to its shareholders. This left Cadbury shareholders with the option to hold the shares of the American beverage business and sell at some later stage when prices might be higher.

There is no guarantee that divestitures will create value. The best divestitures indeed outperform the market, but those at the bottom fall even further behind. To increase the chances of a successful divestiture, executives should thoroughly identify the implications for the economics of the remaining businesses and consider these implications when structuring the divestiture agreement. Executives should also take care not to underestimate the time and effort required to complete a divestiture.

This article is excerpted from Valuation: Measuring and Managing the Value of Companies, 8th Edition*, by Tim Koller, Marc Goedhart, David Wessels, and McKinsey & Company, in agreement with Wiley.*

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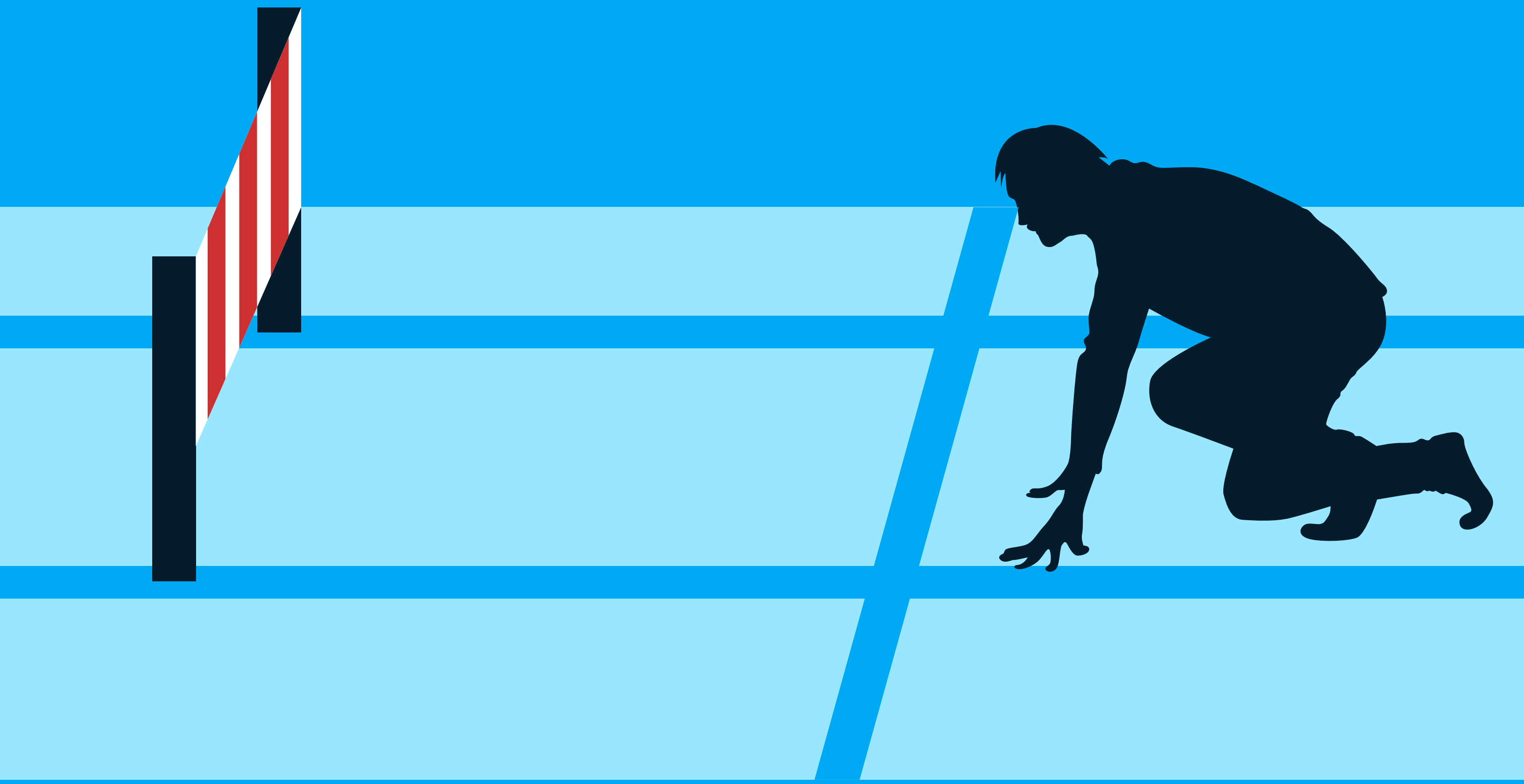
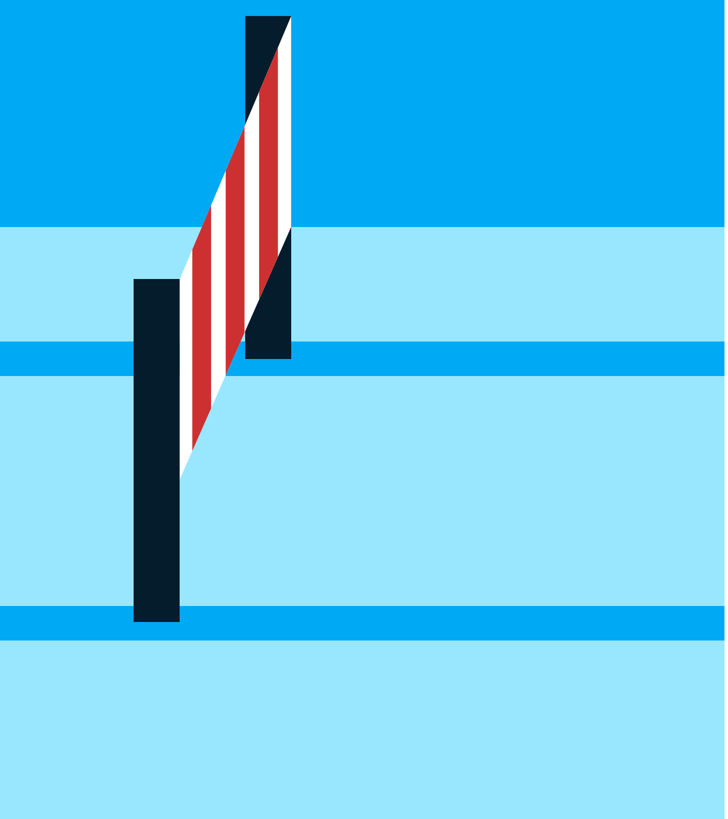


Here's how budgets can keep up with accelerating uncertainty

As CFOs reflect on budget seasons that come and go too quickly, it's time to recognize the advantages of a more agile, proactive, and sophisticated budgeting process.

by Andy West, Christian Grube, Cristina Catania, and Matthew Maloney



After several turbulent budgeting cycles over the past few years, boards, investors, and senior managers are wondering when (if ever) the fire drills will end. From COVID-19 to hyperinflation, from technological disruption to geopolitical tensions (including, most recently, severe shifts in tariff regimes), the uncertainty has been unrelenting. Traditional approaches to budgeting aren't keeping up. What was once a straightforward process based on relatively stable EBIT lines and historically predictable consolidating items now sometimes calls to mind Peter Drucker's corollary to Murphy's law: "If one thing goes wrong, everything else will, and at the same time."[1]

It's time to reflect on how companies can adapt their budgeting processes quickly (and ideally, preemptively) to navigate tremendous uncertainty. Clearly the world won't become more predictable. In fact, the changes are likely to come twice as fast. How can next year's budget—and budgeting processes in the following years—meet the challenge?

The answer lies in continually clarifying the links between budgets and strategy, using detailed data (avoiding blanket approaches to budgeting), and matching the cadence of the budgeting process with real-time business needs. Underlying all three focus areas should be CFOs' clear commitment to the strategic use of technology to enable and enhance the budgeting process. By paying close attention to these three factors, leaders may gain not only some measure of organizational agility and resilience but also a much better understanding of their budgets and what truly drives business performance.

Budgets should equal strategy

Budgets exist to enable strategy. When conditions change, CFOs need budget processes in place to ensure that value-creating initiatives receive ample resources and that their companies' strategies remain sufficiently robust. But given the pace at which conditions are changing these days, it can be difficult for CFOs to keep budgets and strategy aligned. CFOs' initial instincts in times of uncertainty are usually to shelter in place and keep resource allocation essentially the same or to issue incremental cuts across the board to create some short-

[1] Peter F. Drucker, *Management: Tasks, Responsibilities, Practices*, Harper Colophon, 1985.

term buffer on earnings. Over time, such approaches can create a situation in which the next year's budget fails to fund even the first year of a company's strategic plan.

Instead, finance leaders must establish a process for continually revisiting and clarifying the links between budgets and strategy, setting aside dedicated time (monthly, at least, and sometimes more frequently) and going back again and again to the probability-weighted scenarios built into the company's enterprise valuation model. Especially when conditions are in flux, it's important to step back and scrutinize how a company's previously forecasted scenarios are playing out across different geographies and sectors. At that point, it becomes easier to engage key stakeholders in active debate about where resources should go: If performance against budget is going well, the company may elect to double or triple down on initiatives. Conversely, if expectations aren't met, the company can scale back rapidly, with a plan for reallocating resources and capital toward either product lines, dividends, and share repurchases or company reserves.

Data and details matter—now more than ever

Granularity is essential in a challenging business environment. It's no less essential to an effective budgeting process. The consequences of not being granular in budgeting are becoming more pronounced, as once-stable levels of revenues and costs become more prone to spikes, inflation fluctuates beyond a narrow band, and supply chains are exposed.

Now more than ever, finance leaders need a finely detailed perspective on the impact of risk on their budgets because not all businesses or products have the same risk factors or levels of exposure. As tariffs, geopolitics, inflation, and other macro trends affect businesses more often (and more severely), finance leaders will need a clear understanding of which variables are most affecting their businesses and why. For example, a temporary supply chain challenge may make it seem as though a company's top line is tanking when the reality is that supply-side constraints are driving down sales. A granular view of performance metrics can help the business identify and explain anomalies like this.

In general, most of a business's impact and upside come down to a few important initiatives. For pharmaceutical companies, this may be the introduction of a few critical new medicines. For software-as-a-service companies, for which subscription fees are the backbone of revenue, user growth, customer retention, and the upselling of additional features or premium services will be important drivers.

Now more than ever, finance leaders need a finely detailed perspective on the impact of risk on their budgets.

In every instance, however, companies should gather evidence to understand the base-case trajectory of their businesses and the three to five most important actions and projects that will change and accelerate that trajectory. One useful way to gather that evidence is for CFOs and their teams to decouple price data from volume data and expense dynamics from operating challenges.

Rather than defaulting to broad actions such as “cutting administrative expenses 25 percent in all areas” or asking every business unit to “make do with 10 percent less,” the most effective CFOs welcome some exceptions in their budgets—precisely because they know how their business models work. They regularly conduct detailed breakdowns of the ten or 15 highest-value business units, geographies, or strategic initiatives. And they often implement dynamic forecasting, in which performance data are updated and analyzed in real time. Most are exploring the use of various digital platforms and tools, including generative and agentic AI, to ensure that they’re using the most updated business information to build forecasts and plans, stress-test scenarios, and even generate investor communications about budgets.

Budgeting cadence must match real-time business needs

In previous eras of management, companies didn’t need to move as quickly as they do today. When performance is stable, budgeting, too, can take its time, working at a traditional cadence of long-term strategic plans, yearly refreshes, and moderate adaptations, with some scurrying around the time of quarterly investor presentations. But today, traditional budgeting timing is simply too long and slow. Conditions are volatile, and competitive dynamics almost never move in lockstep with quarterly and annual reports.

There are practical ways to avoid being locked into the rigidity of traditional budgeting cycles while still retaining guardrails. As a first step, CFOs and finance teams should take another look at their budgeting cadence against current conditions and determine whether the frequency of budgeting conversations is still appropriate. They should think about whether certain categories of products or projects are on a fast track or a slow track and conduct reviews accordingly.

For example, the finance team in one technology company breaks out its products into two groups for the purposes of budget conversations: a long-cycle group and a high-risk group.

Precisely because conditions are changing, companies can’t wait until it’s too late to change what isn’t working.

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Budgets for long-cycle products and projects are reviewed annually, as per traditional processes. But the budgets for high-risk products and projects are reviewed monthly, with decisions about whether to accelerate or stop funding being made in near real time.

Other CFOs and finance teams should similarly think about implementing contingent resourcing—for instance, requiring projects to meet certain sales, revenue, or other targets before more resources kick in and pulling capital from projects that are underperforming or for which managers need to make a more compelling case for proceeding. The CFO at one dental-services organization set aside funding for office renovations and renewed marketing to consumers in the wake of the COVID-19 pandemic. These discretionary dollars were held centrally and allocated based on which regions opened first and each one's level of customer demand for dental hygiene after quarantine. The organization planned to make this a permanent approach to allocating discretionary funds.

Some companies rely on zero-based-budgeting principles in times of uncertainty to fully rethink which costs are actually needed and where they're needed to create the most impact. Another solution that we've found to be helpful, even if it appears to be radical, is to intentionally make each year's default resource allocation different from the prior year's. That is, if a product line were allocated 5 percent of enterprise capital, CFOs should automatically reject that allocation—the way, say, a user prompt would automatically reject an old password. If there are to be exceptions (and of course, there sometimes should be), line managers should argue the case before the investment committee and bear the burden of proof. In the case of a tie, a new allocation amount would be determined. Precisely because conditions are changing, companies can't wait until it's too late to change what isn't working.

Today's uncertainty makes budgeting more difficult by orders of magnitude. In many organizations, CFOs have just emerged from multiple budgeting cycles in which the resource needs of their businesses quickly fell behind the rapidly changing dynamics in their industries. These changes won't only continue; now they will come even faster.

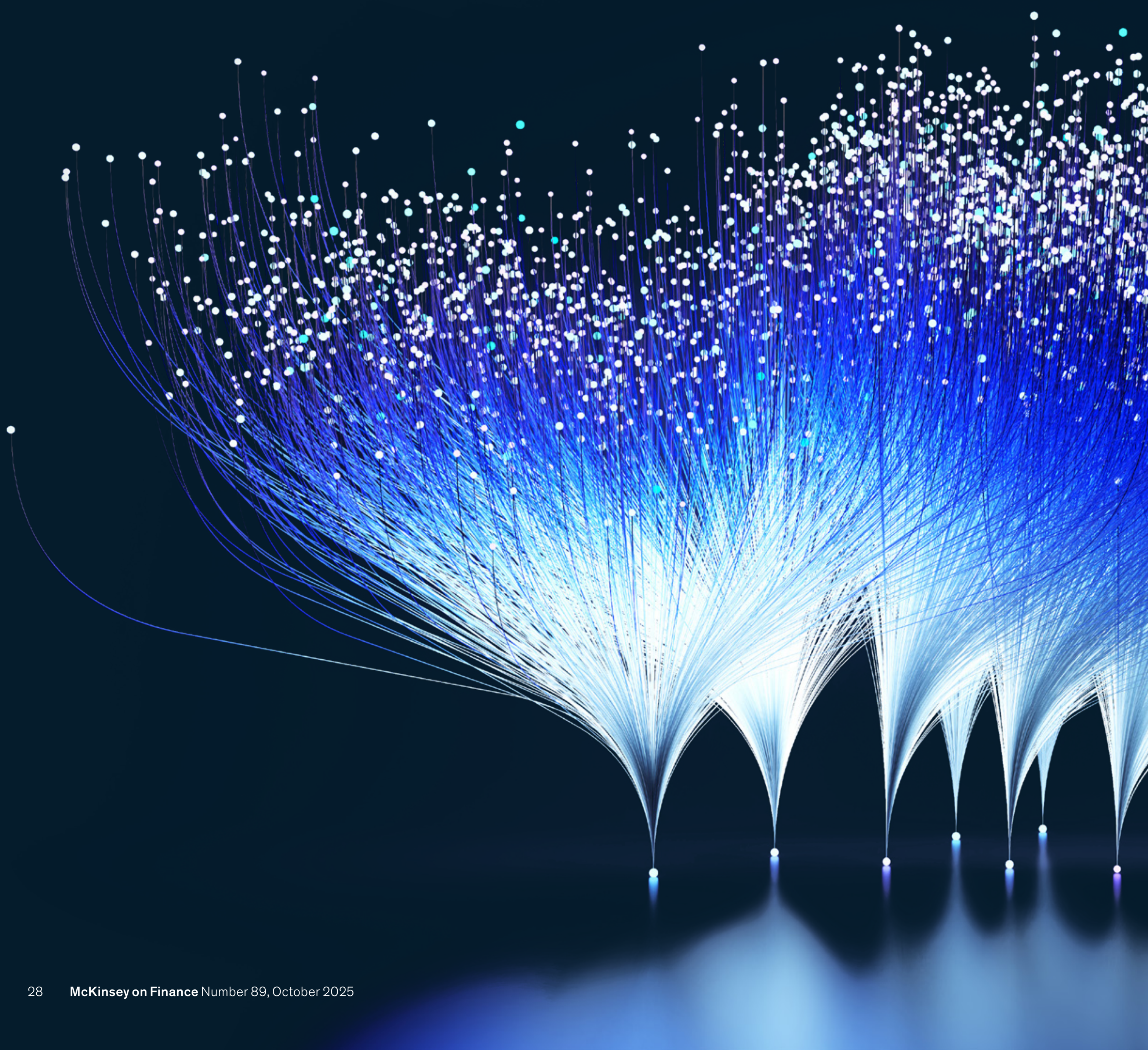
To move budgeting from an exercise in reactive scrambling to a means for value creation, CFOs should put fundamentals first: Make budgeting an enabler of strategy, get granular on growth drivers, and amp up the cadence. In support of those actions, they should push for the use of the most appropriate technologies to accelerate decisions, improve the accuracy of forecasts, and improve collaboration across functions. Indeed, CFOs can work with IT leaders to ensure that everyone has access to a single source of truth—a standard, simple, centralized reporting of financials that can be easily linked to core KPIs. In this way, colleagues across functions can work from the same metrics and can obtain them instantly or in near real time.

Without clear, consistent, accessible numbers, it's impossible to conduct meaningful budgeting. The world isn't going to get any simpler, and it isn't going to wait for a budgeting process to keep pace.

Andy West is a senior partner in McKinsey's Boston office, **Christian Grube** is a partner in the Munich office, **Cristina Catania** is a senior partner in the Milan office, and **Matthew Maloney** is a partner in the New York office.

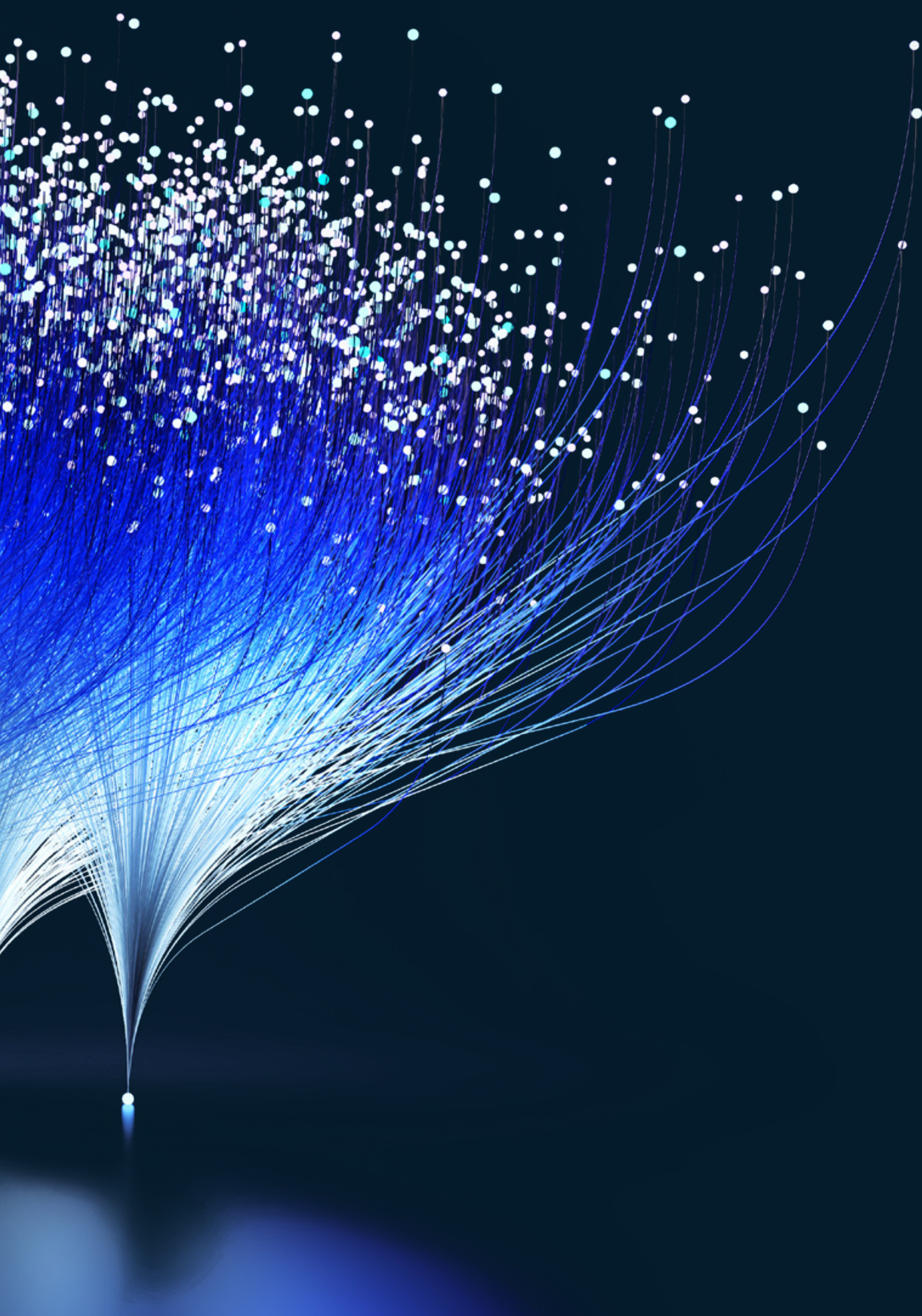
Investing in innovation

Three ways to do more with less



In times of disruption, many organizations freeze their innovation spending despite its critical importance for long-term growth. Here's how to avoid that trap.

by Matt Banholzer and Tim Koller
with Enes Gokkus and Laura LaBerge



Executives view innovation as their companies' primary source of competitive advantage for delivering growth. However, in many sectors, that belief doesn't align with companies' spending on innovation or the returns they get on those investments, the latest McKinsey Global Survey on innovation finds.[1]

During times of economic volatility, business leaders tend to focus on short-term profitability, often putting longer-term projects designed to spur growth on the back burner. Yet as our long-standing research shows, companies that take a through-cycle approach to investing in growth and innovation consistently outperform their peers.[2]

In fact, innovation can be a solution to weathering uncertainty. When it's unclear, as it is today, what the "next normal" will look like, organizations that seek ways to adapt their business models or processes and develop pathways for future growth can gain a competitive edge that often lasts through the recovery. In short, companies can't afford to wait until the world is calmer before investing in growth—especially since the duration of current volatility is impossible to predict. Instead, they should adapt their short-term decisions to the shifting conditions while striving to maintain a portfolio of investments that will fuel their long-term success.

[1] The online survey was in the field from October 15 to 31, 2024, and garnered responses from 1,017 C-level executives and senior managers in 99 nations representing the full range of regions, industries, company sizes, and functional specialties.
[2] Rebecca Doherty and Anna Koivuniemi, "Rev up your growth engine: Lessons from through-cycle outperformers," McKinsey, May 27, 2020.

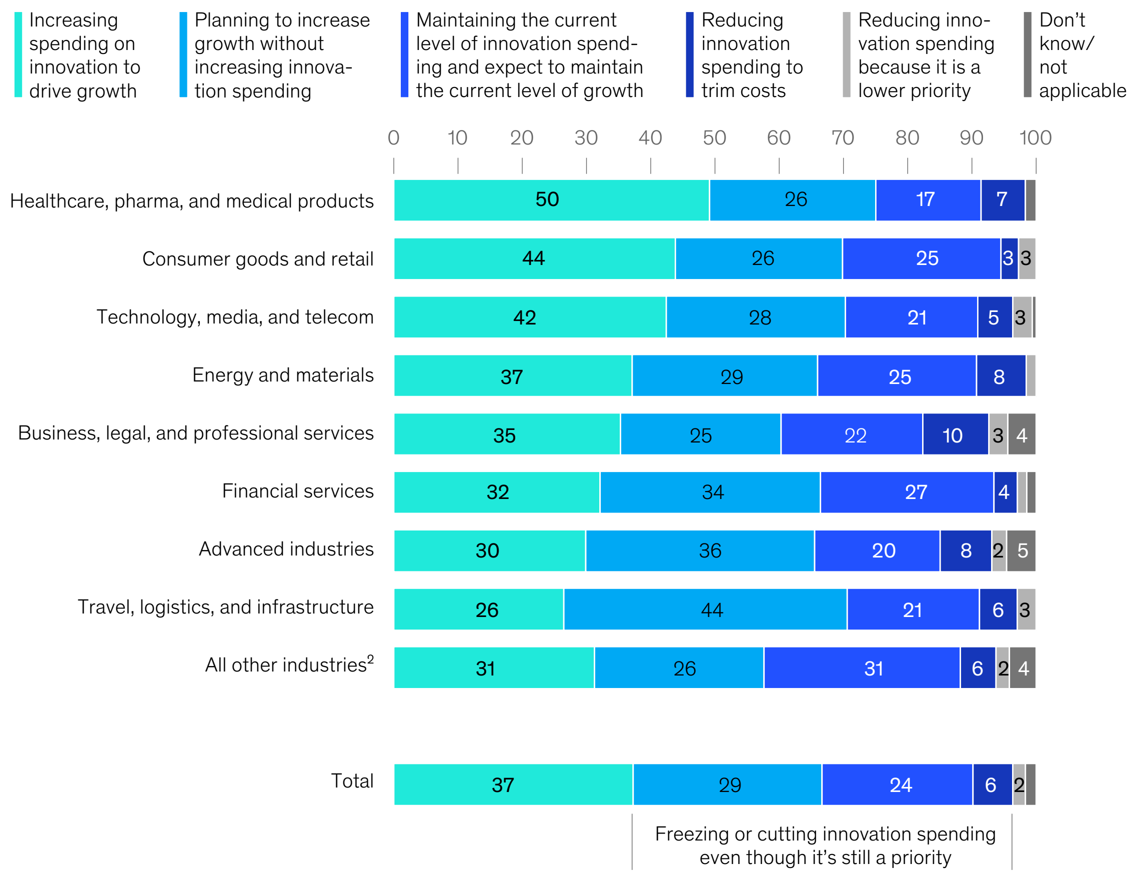
Rising expectations for getting more from less

In late 2024, we surveyed 1,017 executives across industries and regions to understand how they are approaching their innovation investments. The responses clearly indicate that companies are looking to generate higher returns on innovation spending without increasing budgets. Nearly 60 percent of respondents say they are either freezing or cutting their spending on innovation. Another 30 percent are holding funding for innovation flat (Exhibit 1).

Exhibit 1

Most companies are freezing or cutting innovation investments despite considering innovation essential to growth.

Changes in organizations' innovation investments over the coming 12 months,[1] % of respondents



Note: Figures may not sum to 100%, because of rounding.
[1]In healthcare, pharma, and medical products, n = 115; in consumer goods and retail, n = 73; in technology, media, and telecom, n = 165; in energy and materials, n = 194; in business, legal, and professional services, n = 68; in financial services, n = 137; in advanced industries, n = 87; in travel, logistics, and infrastructure, n = 34; in all other industries, n = 144.
[2]Other industries include public sector, real estate, and social sector (including not for profits), among others.
Source: McKinsey Innovation Survey, 2024–25, n = 1,017

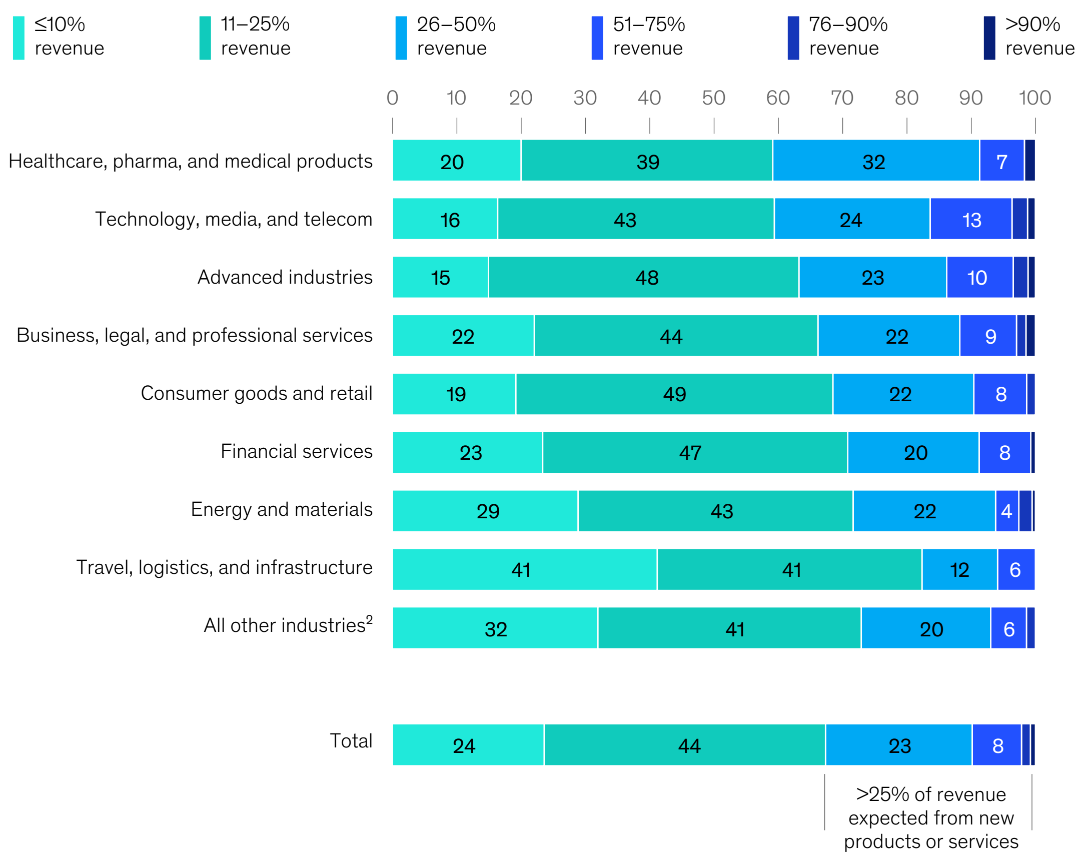
Notably, top economic performers[3] are 61 percent more likely than others to increase their innovation investments. Additionally, some industries—including healthcare and pharmaceuticals, consumer goods, and technology—show higher willingness to invest in innovation.

Even as they curtail innovation spending, however, many companies view innovation as essential to growth. A third of surveyed executives expect more than a quarter of their companies' revenue in the next three years to come from offerings not yet on the market (Exhibit 2). This expectation of innovation-fueled growth is highest in healthcare and pharmaceuticals, technology, and advanced industries.

Exhibit 2

A third of companies expect more than a quarter of their future revenues to come from new offerings.

Revenues in 3 years' time that respondents expect to come from new products or services not yet on the market,[1] % of respondents



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[1]In healthcare, pharma, and medical products, n = 115; in consumer goods and retail, n = 73; in technology, media, and telecom, n = 165; in energy and materials, n = 194; in business, legal, and professional services, n = 68; in financial services, n = 137; in advanced industries, n = 87; in travel, logistics, and infrastructure, n = 34; in all other industries, n = 144.
[2]Other industries include public sector, real estate, and social sector (including not for profits), among others.
Source: McKinsey Innovation Survey, 2024–25, n = 1,017

[3] Companies whose executives report increases of at least 15 percent revenue and EBIT over the previous three years.

Additionally, approximately 60 percent of respondents state that their companies would significantly underperform market expectations if they stopped investing in innovation. Nearly half also report that they will need to significantly innovate their current business models to remain financially viable over the next three years.

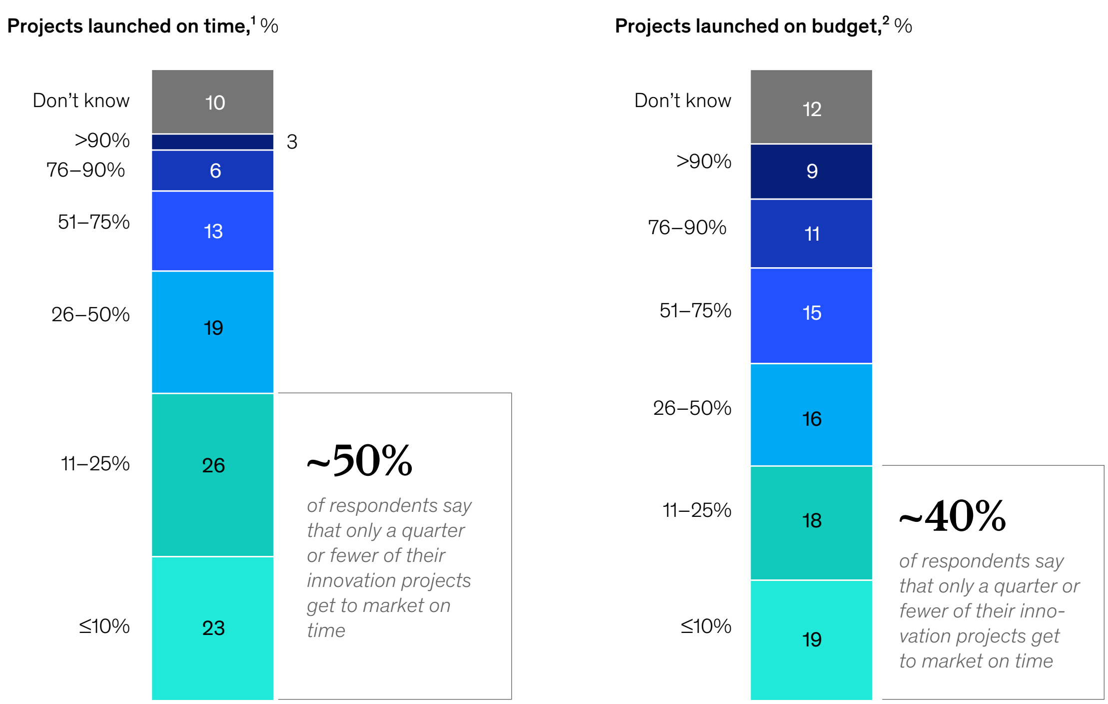
Growth ambitions undercut by missing innovation basics

The feasibility of executives' aspirations to generate higher growth at current spending levels is doubtful given the success rate of their existing innovation portfolios. For example, nearly half of respondents say that only a quarter or fewer of their innovation projects get to market on time, and about a third say they see a similar low rate launch within budget (Exhibit 3). This is true even for incremental innovations, which are typically more predictable than investments in breakout moves. What's more, many executives are unable to estimate how much additional value innovation initiatives would deliver over the offerings they would replace. This lackluster track record, combined with plans to lower innovation spending, could produce a significant gap between companies' expected and actual growth.

Exhibit 3

Companies struggle to get innovations to market on schedule and within budget.

Share of projects that get to market on time and within budget



[1]Meets projections for first customer delivery for all projects launched within the past 24 months.
[2]Meets budget projections for all projects launched within the past 24 months.
Source: McKinsey Innovation Survey, 2024–25, n = 1,017

When asked how their organizations' innovation practices align with our long-established eight essentials of successful innovation,[4] the surveyed executives' responses highlight four areas in which the majority of organizations consistently struggle (Exhibit 4). In each area, fewer than 10 percent of respondents say that their companies perform strongly on the criteria for mastery of the corresponding essentials, and more than half identify them as capabilities in which their organizations are deficient.

When we looked deeper at companies whose executives report strong performance on these four practices, we found that they are more than twice as likely as those with the lowest-decile performance on these factors to find white space ahead of their peers and have more than half of their innovations launch within budget. They also report being up to three times better at scaling new businesses or offerings, attracting and retaining key innovation talent, and launching innovations on time.

The biggest disparity, however, is in respondents' understanding of how their innovation projects perform. When asked whether incremental innovations tended to deliver more value than the offerings they replaced, more than a third of executives whose companies perform poorly on the four factors report that they do not know, compared with fewer than 10 percent of respondents from companies that perform well.

Exhibit 4

Four elements of the innovation process are the biggest hurdles to delivering growth.

The 8 essentials of innovation and the specific practices survey respondents struggle with the most

Aspire → Choose: We don't have an accurate way to compare the expected future value of initiatives that have different levels of associated risk or different times to payout.

Discover → Evolve: We don't sufficiently prune investments that have low ROI and high investment requirements prior to piloting.

Accelerate → Scale: We haven't connected our M&A function with our innovation process to accelerate strategically important initiatives where we have low existing capabilities.

Extend → Mobilize: We have too many exceptions to our resourcing processes to ensure we maximize our innovation spending at the portfolio level.

[4] Marc de Jong, Nathan Marston, and Erik Roth, "The eight essentials of innovation," *McKinsey Quarterly*, April 1, 2015.

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A similar pattern exists in executives' understanding of the time and total investment that new innovations require: Up to a third of respondents whose companies do not follow these four innovation practices say their organizations have no visibility into whether their offerings launched on schedule or within budget. When organizations are flying blind on their innovation investments, maximizing value from them is nearly impossible.

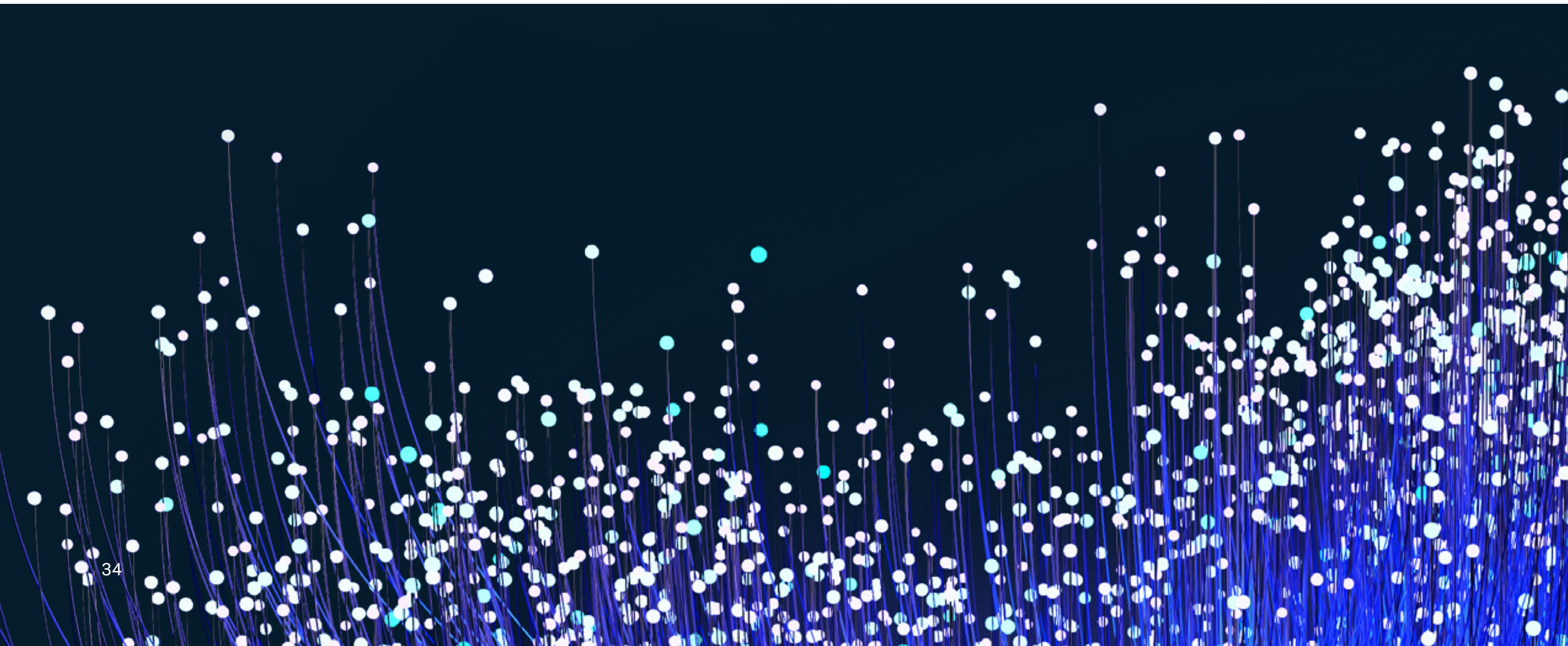
Three steps to getting more growth at no extra cost

Whether business leaders are seeking to get more growth from their existing innovation investments or planning to increase their spending, transparency and accountability are imperative. One of the most critical (and most common) bottlenecks in the innovation process stems from ineffective allocation of resources—not because of insufficient funding but rather because of unclear or inaccurate definitions of how resources will be deployed and what kinds of returns they are expected to generate. This can result in low-performing initiatives being funded at the expense of higher-performing ones or critical initiatives failing because some teams deliver on their work while others don't.

Companies can take three immediate actions to improve the performance of their innovation investments without additional cost: conduct a detailed assessment, or "teardown," of the current innovation portfolio; encourage risk-taking while managing risk; and restrict who can freeze projects.

Perform an innovation portfolio teardown

Innovation portfolios are where business leaders' commitment to their growth strategy is put to the test: If organizations aren't funding a portfolio of initiatives, their leaders' aspirations mean little. As our survey results demonstrate, most organizations struggle to make trade-offs between short- and longer-term initiatives, as well as among projects with different risk profiles. This inhibits their ability to align resources with business goals, particularly across multiple growth horizons. To better understand what their innovation dollars are funding and the returns these projects are expected to bring, business leaders can do a portfolio analysis, or teardown. The process involves applying an analytical methodology, as outlined below, to make better-informed decisions on innovation spending and improve ROI.

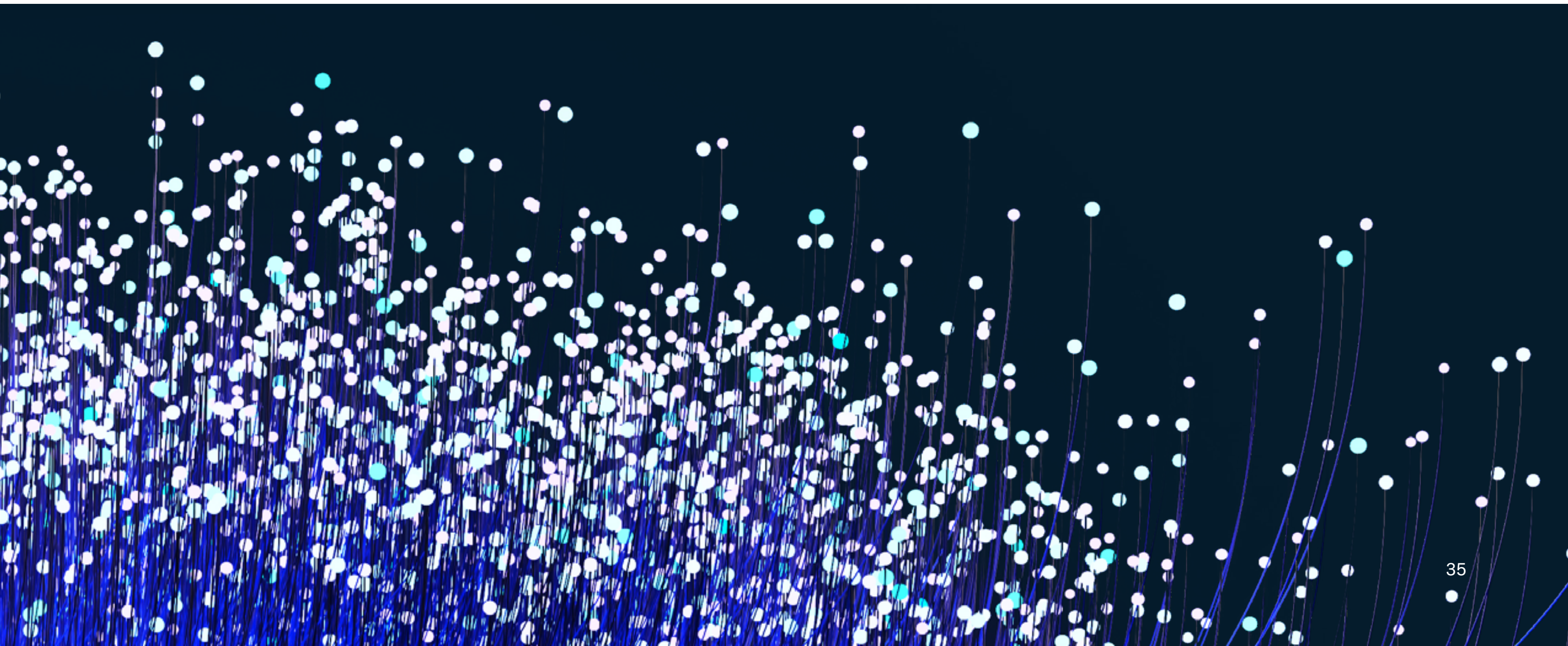


Is innovation spending aligned with strategic objectives? This analysis assesses the degree to which innovation spending aligns with expected growth areas, strategic priorities, and shifts in competitive advantage. Companies often continue to fund innovations for markets they had earlier decided to exit. This happens especially often during times of economic disruption when relative market attractiveness might change quickly, leaving the pipeline out of sync with new priorities.

It is also critical to align the portfolio with the company's risk appetite. For example, organizations that aspire to be first movers or market leaders need to have a higher share of bold innovation projects than more conservative organizations that focus on incremental improvements have. Without this alignment of risk profile and growth demands, business leaders may end up disproportionately cutting high-risk, high-reward projects, leading to a portfolio dominated by relatively low-growth projects. Alternately, overprioritizing higher-risk innovation initiatives can leave companies exposed if their riskier bets fail. When the business environment is changing rapidly and risk assessments lag behind reality, companies are particularly prone to overestimating the stability of past trends.

Can the innovation portfolio meet growth expectations? Organizations with several business units sometimes lack a clear understanding of how one unit's high-potential initiatives stack up against another's low-potential initiatives. After all, one business's low-hanging fruit can deliver higher growth for the overall organization than another's highest-potential bet. Without this enterprise-level view, business leaders may defund initiatives with high growth potential in the service of equally allocating resources across business arenas rather than optimizing funding for the overall portfolio's returns. Similarly, a lack of visibility into how business unit leaders make trade-offs between near-term and longer-term priorities can cause the enterprise to overweight short-term ROI versus long-term growth.

Before conducting a portfolio teardown, business leaders should consult their finance colleagues on how to weigh different risk levels or payout times. A single business unit or function, such as corporate R&D, can serve as a test case to ensure the math works. Shortfalls in the portfolio's ability to meet growth expectations can then be filled organically by launching new businesses or offerings or through acquisitions.



If organizations aren't funding a portfolio of initiatives, their leaders' aspirations mean little.

Have underperforming initiatives been sufficiently pruned? Once business leaders have instituted a rigorous way of evaluating and comparing the likely performance of different types of initiatives, they can compare the projects' net present value to the resources needed to deliver it. This analysis generally reveals a long tail of low-ROI initiatives that are soaking up resources that higher-performing projects could better employ. Establishing stage gates can allow decision-makers to cut underperforming initiatives early in the development funnel.

Consider the experience of a global producer of baking ingredients that found its R&D portfolio crowded with initiatives but delivering disappointing returns. The company appointed a "project killer"—an individual with deep knowledge of both food technology and the business aspects of the industry—to rein in project creep. This person maintained a database of all active projects, noting areas of repeated inefficiency, lack of success, or lack of market opportunity, and based on these criteria, built a dispassionate case for why a project should or should not continue.

Do gaps exist in the resource allocation process? Many organizations have performance expectations that are out of sync with past reality, leading to inflated growth projections that leave the companies exposed to missed growth targets and budget overruns. A methodical review of the reasons why recent innovation projects succeeded or failed can enable leaders to better vet the assumptions behind revenue projections and time to launch for initiatives in the pipeline. A postmortem can also flag breaks in the innovation process, such as high rates of exceptions being made for pet projects or "shadow spending" that doesn't go through the standard approval process.

A portfolio teardown can identify significant opportunities for better resource allocation. One consumer electronics company ended up rebalancing its innovation portfolio, which freed up 20 percent of the budget, and identified opportunities for a 10 percent ROI increase at the portfolio level. Consumer-packaged-goods and chemical companies that followed a similar process freed up 20 percent and 12 percent of their R&D budgets, respectively, to deploy in higher-performing projects.

Encourage risk-taking while managing downside risk

Fear is an innovation killer. Corporate cultures and policies that are too risk averse can stifle innovation and lead to portfolios that deliver only incremental gains. Business leaders should dedicate explicit time and resources for teams to innovate, provided the projects meet the organization's risk appetite. Setting targets that build in an allowance for failure and establishing processes for learning from those failures helps foster more innovation.

A corollary to allowing more risk-taking, however, is the need for visibility into a project's progress. Companies that quickly halt unproductive initiatives can take more risks up front because they manage the downside. Failure to do so often leaves organizations with bloated pipelines of underperforming initiatives that deliver no growth.

Eliminate exceptions and restrict who can curb funding

A project isn't a real priority if it isn't funded. If the CEO or CFO considers an innovation initiative strategically important, they should ensure that the budget reflects it. Many organizations cite frequent exceptions to the resourcing process as an obstacle to their ability to deliver strong performance from their innovation portfolios. These exceptions stem largely from influential leaders promoting pet projects and shifts in business context that outpace the existing planning processes. Raising the company's metabolic rate by increasing the frequency of updates to annual and quarterly plans might be required, but companies shouldn't rely on frequent exceptions as a correction mechanism, as it can lead to inefficiencies and underperformance of the portfolio.

Companies that frequently pull funding from high-performing, longer-term initiatives to hit short-term targets sacrifice future growth and overall performance. It's a tough choice that every management team needs to make at times, but it's a call that the CEO should fully own. Things change—the past few months have clearly shown that. Exceptions to funding rules can multiply in times of uncertainty, especially if the resourcing process doesn't include scenario planning. If such decisions are made on an ad hoc basis or, worse, through internal politics, the result could be a rapid erosion of the performance of the company's innovation portfolio. It's therefore important to categorize which projects will be funded (or defunded) as resource availability changes, existing initiatives fail to perform, or the business context shifts. Tying decisions to scenarios or contingency plans enables organizations to pivot faster when disruption happens.

In times of volatility, innovation can provide companies with options for growth in different future circumstances. While it may be tempting to freeze innovation spending during such periods, companies that do so risk sacrificing their future for the present. A better path is to maximize returns on innovation investments while minimizing risk by conducting portfolio teardowns, encouraging risk-taking, and applying rigor to how projects are funded.

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The authors wish to thank Noah Bereketab and Talia Shakhnovsky for their contributions to this article.

McKinsey survey shows investors seek fundamentals and . . .

FEATURE

long-term vision

by Joseph Cyriac
with Filip Abrahamsson Kwetczer
and John Evers

The latest investor survey underscores the importance of the right metrics and cohesive communications.

The search for stability through a focus on value-creation fundamentals remains a constant for investors—even as they navigate inflation, geopolitical uncertainty, and the rise of AI. Our most recent survey of investor priorities reinforces this enduring theme, showing strong similarities to our 2023 findings, while also revealing a few noteworthy shifts.[1]

Overall, investors continue to ask for hard data on the fundamentals that signal a company's long-term resilience. The previous survey highlighted cost efficiency, capital productivity, and product innovation as the key engines of future value. In the latest poll, respondents leaned slightly more toward headline profitability metrics—especially return on capital. The direction of travel is, therefore, less a wholesale change than a subtle reweighting: As always, investors care about the underlying levers, but in today's market, they want to see those levers translated into tangible financial outcomes.

Likewise, whereas respondents in the earlier survey focused on sustainable competitive advantage, superior margins, and disciplined capital allocation, the latest survey shows more concern with a broader rubric of overall financial performance and health. This marginal shift likely reflects the prevailing macro backdrop—swings between risk on and risk off sentiment, shifting interest rate expectations, and concerns over inflation—rather than a fundamental change in what long-term-oriented investors deem important.

Our methodology

The survey was conducted between December 9 and 17, 2024, across Canada, Europe, and the United States, encompassing 81 investors across several industries, including technology, media, and communications; industrials; consumer; financials and insurance; pharmaceuticals; energy; materials; and travel and infrastructure. Roughly 75 percent of respondents manage portfolios exceeding $1 billion, and roughly 85 percent operate with a time horizon of at least four years.

The prior survey, conducted in the third quarter of 2022, was of 19 chief investment officers of leading investment funds around the world. Because of differences between the two surveys—including differences in questions asked and how they were phrased—results cannot be directly compared but do point to some directional differences.

Perhaps the most notable difference since our last survey (see sidebar, "Our methodology") is the new importance of AI. In the most recent survey, 31 percent of respondents cite "AI and technology utilization" as a characteristic of a winning company in 2025. In our 2023 findings, AI never came up as an important feature to which investors were paying attention, reflecting a rapid sea change in how investors view the role of technology. Also of note is a downtick in concern with environmental, social, and governance (ESG): In our prior survey, 20 percent of respondents said they consider ESG a top driver of long-term value creation. In the latest survey, only 18 percent of respondents rate it "very" or "extremely" important.

This article explores the latest survey's findings and examines investor preferences in today's complex financial landscape. We conclude by outlining actions that companies can take to ensure that they foster an optimal dialogue with their investors.

[1] The two surveys worded some similar questions differently and also asked many different questions.

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How investors assess a company: Performance data, long-term metrics, and the equity story

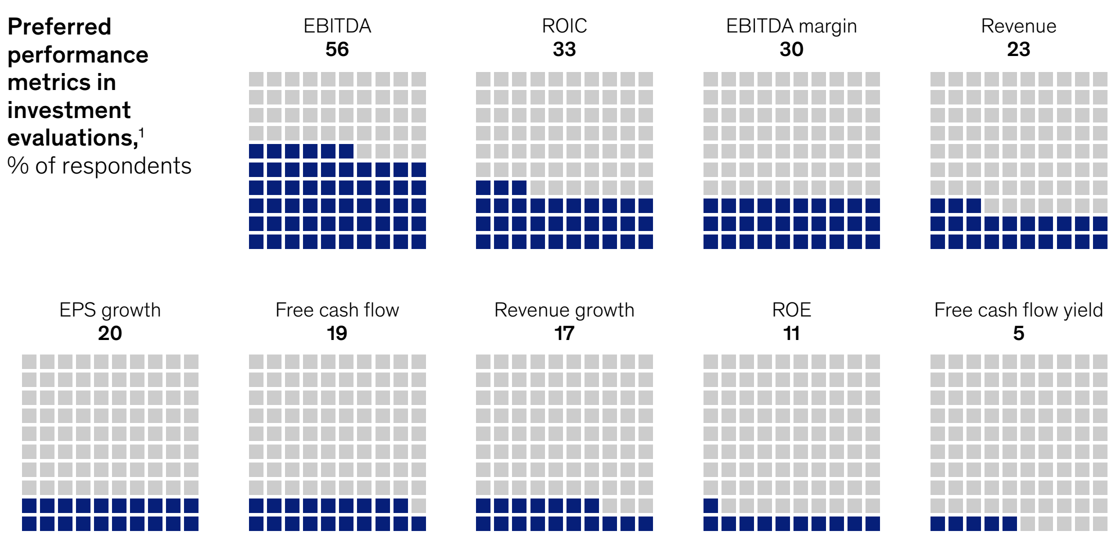
Granular performance data builds credibility, but it's the broader equity story that captures attention and inspires conviction. Respondents made it clear that they value consistency across all investor communication touchpoints and want all information to clearly tie back to the company's equity story. To assess performance, survey results showed—unsurprisingly—that investors rely heavily on EBITDA, followed by ROIC and EBITDA margins (Exhibit 1). To assess an investment's long-term potential, investors lean on metrics that inform them about return, growth, and profitability. The equity story heavily influences their view of an investment, survey results show.

Metrics investors rely on to evaluate a company's long-term strategy

Across industries and company types, respondents prioritize return, growth, and profitability as the foundation for evaluating a company's long-term potential (Exhibit 2). These metrics serve as universal benchmarks for value creation, enabling investors to assess whether a company's strategy is positioned for long-term success.

Exhibit 1

To evaluate company performance, more than half of survey respondents prioritize EBITDA and a third rely on ROIC.



[1]Question: Which performance metric do you prioritize most when assessing a company (eg, ROIC, EBITDA margins, free cash flow yield, EPS growth, etc)? Respondents could provide up to 3 metrics in a free-text field; some count variation may occur, given interpretation of free-text responses.
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

Within specific sectors and company types, there is variation in which metrics are most highly valued. For example, investors in capital-expenditure-heavy industries—such as capital goods, industrials, and physical assets—cite cash metrics as important. Financial-industry investors prize balance sheet metrics, while investors in software and software-as-a-service companies focus on retention and churn statistics.

Exhibit 2

Investors cite return, growth, and profitability as the most crucial long-term strategy metrics.

Metrics preferred by investors for anchoring of companies' long-term strategies,[1] % of respondents

Metric type	% of respondents	Most cited within metric type
Return	62	ROIC, ROE, ROI, IRR, ARR[2]
Growth	43	Revenue growth, EBITDA growth, EPS growth and other margin growth
Profitability	30	EBITDA, EBIT, EBITDA margin, NOPAT[3]
Cash flow	11	Free cash flow, free cash flow margin, cash conversion
Leverage	5	D/E[4] ratio or other leverage ratios, net debt, credit rating
Market	2	Market share
Efficiency	2	Cost efficiency, usage
Customer	2	Client numbers, customer satisfaction score, retention
Valuation	1	EV/EBITDA, MOIC,[5] P/E
Sustainability	1	ESG[6] score and other sustainability metrics
Management	1	Outstanding management
Other	1	Performance vs benchmark, distribution

[1]Question: What are the 3 to 5 key metrics you prefer companies to anchor their long-term strategy to (eg, ROIC, revenue growth, etc)? Respondents could provide up to 5 metrics in a free-text field; some count variation may occur given interpretation of free-text responses. [2]Annual recurring revenue. [3]Net operating profit after tax. [4]Debt to equity. [5]Multiple on invested capital. [6]Environmental, social, and governance.
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

Crafting an equity story that inspires

It's crucial for companies to create a compelling equity story that clearly articulates how they create value today and how they plan to grow profitably over time. A majority of respondents consider an unattractive equity story a highly significant factor in an investment's relative appeal (Exhibit 3).

By tying metrics to the equity story in a transparent and compelling way, companies can build investor confidence and strengthen the case for why they should remain committed for the long term.

What investors want from interactions with companies

Prior McKinsey research has indicated that investors feel that there is room for improvement in how companies communicate about their stories. In this year's survey, over 90 percent of respondents said they believe a company's equity story should align with other investor communications and guide the content of capital markets and investor days.

Companies can work on delivering these consistent messages on these days, on quarterly calls, and at each touchpoint with investors. Elevator pitches, in particular, demand improvement: 21 percent of respondents identified them as the most "insufficiently communicated aspect that is most crucial to address." This feedback reflects a common challenge: Even within the same executive team, members may present differing versions of the company's core narrative. Such inconsistencies can undermine investor confidence, creating the impression of a lack of

Exhibit 3

For 82 percent of investors, a company's equity story strongly influences their decisions.

Perceived level of significance an unattractive equity story has on investment attractiveness,[1]
% of respondents

Note: Figures do not sum to 100%, because of rounding.
[1]Question: How significant do you believe an unattractive equity story is as a risk factor for a potential initial public offering (IPO) or investment into the company?
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

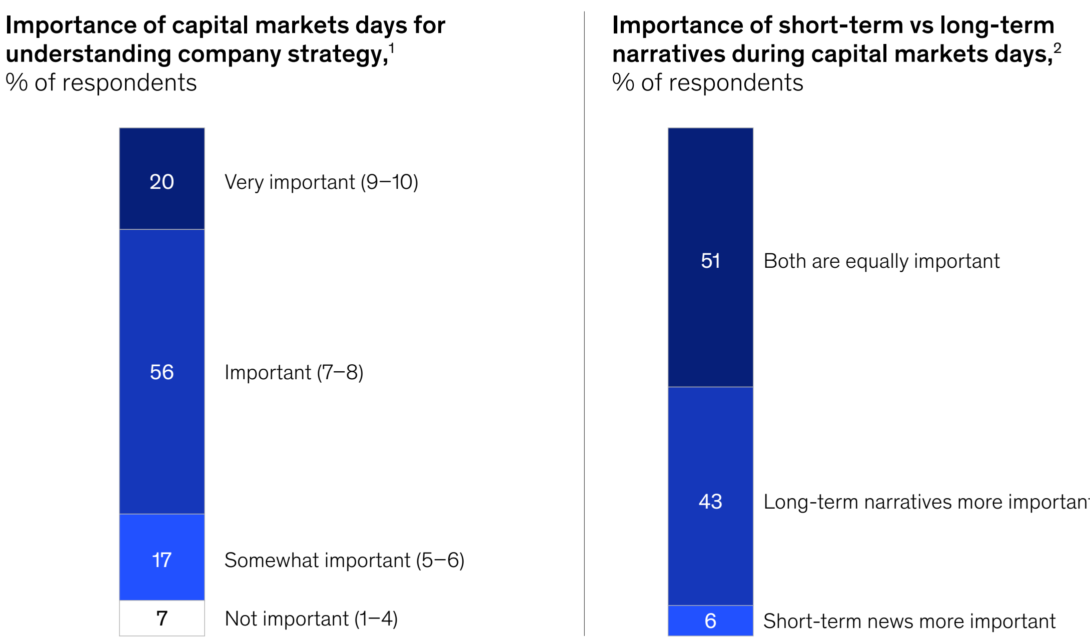
strategic cohesion. To build trust and ensure the market receives a unified message, it's essential for management teams to align on a single, compelling equity story that is consistently communicated at all levels and across all investor touchpoints.

What investors want out of capital markets days

Survey respondents identified capital markets days as a vital point of contact: 56 percent rated them as "important" to understand a potential investment's prospects, and another 20 percent rated them as "very important." More than 90 percent of respondents expressed a preference for a narrative that includes just a long-term perspective or both short- and long-term perspectives (Exhibit 4). This finding aligns with McKinsey's long-standing research that shows that intrinsic investors are most focused on the long-term drivers of value creation.

Exhibit 4

Investors highly value capital markets days and want them to include long-term narratives.



[1]Question: On a scale of 1 to 10 (where 1 = not at all important and 10 = extremely important), how important are capital market days for understanding a company's strategy and prospects?
[2]Question: Which perspective is most important during capital markets days: emphasis on short-term versus long-term narratives?
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

The characteristics of best-in-class quarterly calls

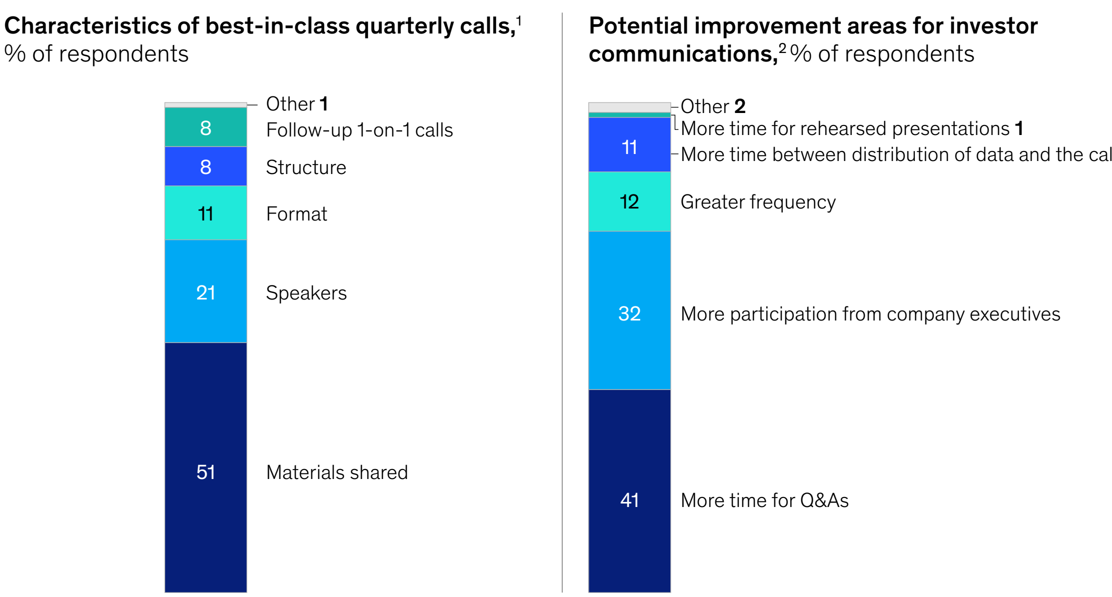
Over half of survey respondents consider the "materials shared" to be the most important factor in a quarterly call. More than a fifth cited "speakers" as the most important. By contrast, format and structure were rated as only moderately important, cited by 11 and 8 percent of respondents, respectively.

Interestingly, one-on-one follow-ups after quarterly calls were of limited interest to investors. This may reflect that investors (not to be confused with equity analysts) may simply not need much explanation from investor relations executives after a quarterly call. However, additional responses show that investors highly value unscripted time with company decision-makers and more participation from company executives (Exhibit 5).

These are messages we've heard before: In our 2023 findings, respondents cited more time for Q&As and participation from a broader array of executives as top areas for improvement.

Exhibit 5

Investors rate detailed materials and quality speakers highly on quarterly calls, but say there could be more Q&A and executive input.



Note: Figures may not sum to 100%, because of rounding.
[1]Question: Among the quarterly results calls you listen to or participate in most often, what distinguishes the best examples of such events from others? Please rank 3 things that distinguish these, where 1 = top factor.
[2]Question: What would you like to improve in how companies do investor communications? Please rank 3 improvements, where 1 = top improvement.
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

What mattered most to investors at the time of the survey—and what always matters

Large numbers of respondents cited geopolitical risks, inflation and interest rates, and government regulations and political risks as their top concerns for the 2025 investment climate. It's interesting that these concerns were top of mind in December, even before tariffs became a common preoccupation (Exhibit 6).

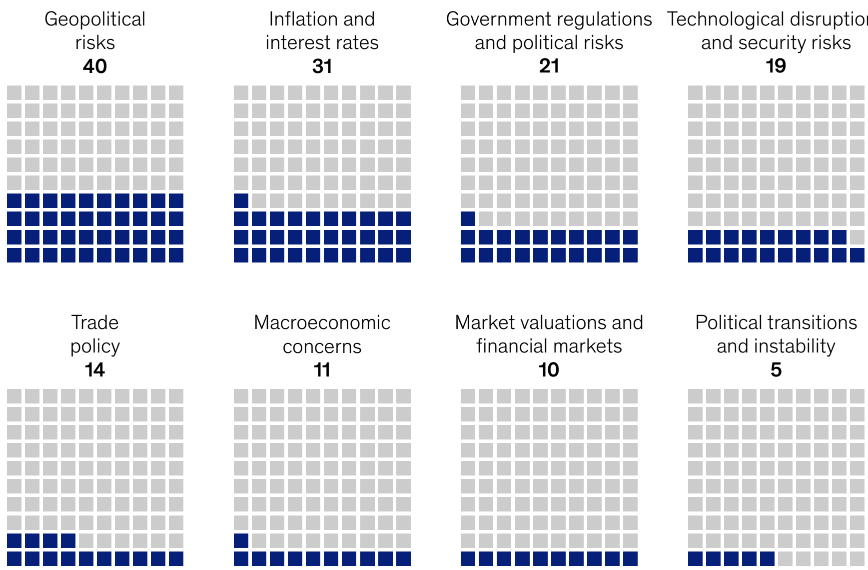
Additional responses showed that investors predicted that AI would be a key investment theme this year and that they perceive companies with a clear tech angle as more successful (Exhibit 7). By contrast, 82 percent of respondents indicated that they do not consider ESG factors to be a "very" or "extremely" important factor in an investment's attractiveness.

Investor communication groups can keep the list of what worries and excites investors in 2025 in mind as they communicate about the areas investors use to gauge company attractiveness (Exhibit 8). Investors scrutinize six main areas, of which the top five are addressable by companies themselves.

Exhibit 6

Investors' top concerns for 2025 included geopolitical risks, inflation and interest rates, and government regulations.

Top concerns for investment climate,[1] % of respondents

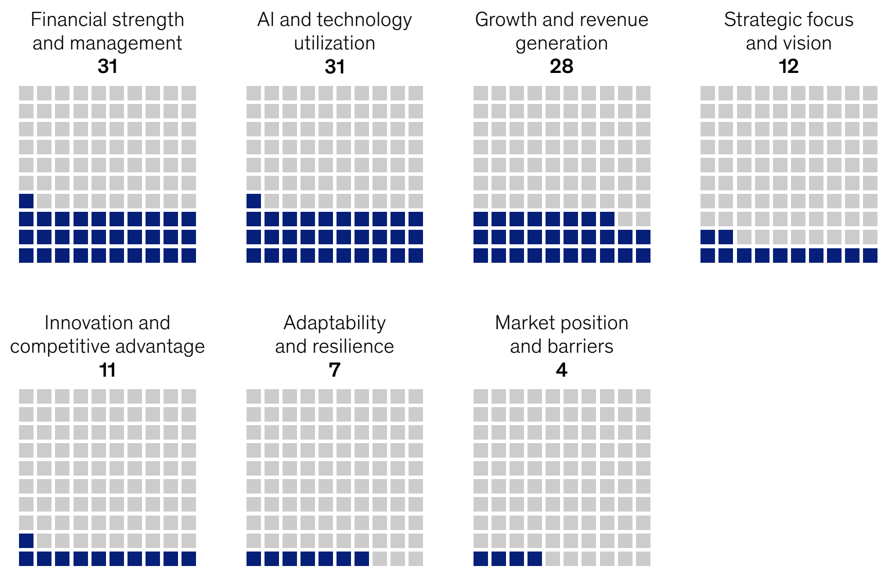


[1]Question: What are the top concerns you see for the investment climate in 2025? Respondents could enter more than 1 concern. Some count variations may occur, given interpretation of free-text responses and due to overlaps in responses across areas.
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

Exhibit 7

Investors predicted that companies with strong financial profiles and high AI and tech utilization would be winners in 2025.

Characteristics of top-performing companies,[1] % of respondents



[1]Question: What are the key company characteristics you see winning in 2025? Respondents could enter more than 1 concern. Some count variations may occur, given interpretation of free-text responses and due to overlaps in responses across areas.
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

Key actions for companies

To effectively highlight value creation and position themselves as attractive investment opportunities, companies can ensure their narratives are firmly anchored in the right financial metrics. This includes focusing on fundamentals, such as ROIC to demonstrate returns and EBITDA to showcase growth. At the same time, companies can tailor their metrics to align with their specific sector or business model. For instance, retention rates are particularly relevant for software companies, while customer acquisition costs may be more critical for consumer-facing businesses.

Companies can also supply the metrics investors rely on to anchor on a long-term vision. Equity stories should be clear, supported by these metrics, and consistently communicated across investor interactions.

In addition to robust reporting, meaningful and unscripted interactions with investors are essential. Open Q&A sessions provide a valuable forum for transparent exchange, fostering trust and understanding. Investor relations activities become even more critical during periods of

Exhibit 8

When assessing company attractiveness, investors focus on six areas.

Most important areas when assessing a company's attractiveness,[1]
% of respondents

[1]Question: What are the most important areas you look for to assess a company's attractiveness? Respondents could enter a single response in a free-text field, and responses were synthesized into 6 areas. Some count variations may occur, given interpretation of free-text responses.
Source: McKinsey Investor Survey, Dec 9–17, 2024 (n = 81)

transformation, as they help investors navigate uncertainties and maintain confidence in the company's direction. Companies can respond to investors' preferences by using capital markets days to clearly articulate long-term strategies, ensuring investors have a clear understanding of the company's trajectory and potential for sustainable growth.

Finally, companies can find ways to communicate the issues that are currently of greatest concern while addressing the six areas investors assess to gauge an investment's appeal.

The survey results are a reminder of how important it is for companies to anchor their narrative in the right metrics, articulate a clear strategy, and foster open dialogue. By combining these actions, companies can effectively engage investors, build trust, and position themselves as compelling investment opportunities.

Joseph Cyriac is a partner in McKinsey's New York office, **Filip Abrahamsson Kwetczer** is an associate partner in the Stockholm office, and **John Evers** is a knowledge expert in the Toronto office.

Don't delegate the AI revolution

A conversation with Sanofi CEO Paul Hudson

The global biopharmaceutical company is using AI and agentic AI to improve financial and operational outcomes.

At Sanofi, AI has become central to reshaping operations and making strategic choices. In this interview, CEO Paul Hudson describes how the organization used AI to redeploy nearly a billion euros last year, reduce out-of-stocks by 80 percent, and improve asset utilization by more than ten percentage points. He notes that the company designed its AI systems to cut across functions rather than remain in isolated pockets, enabling capital and resources to flow to the areas of greatest impact.

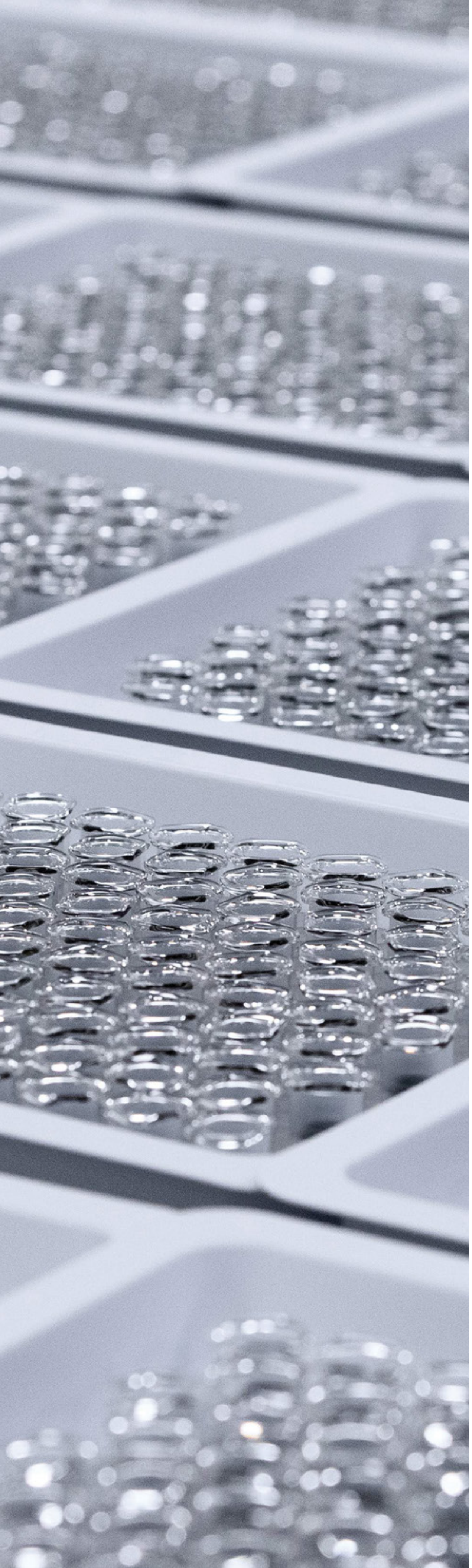
For CFOs and finance teams, Hudson's account highlights the enabling role of finance in AI adoption. Finance leaders are tasked with identifying inefficiencies, freeing up capital, and ensuring that resources are redeployed to their best use. In the context of AI, this means capturing the savings it generates, rapidly reallocating funds to scale successful use cases, and directing investment toward the AI initiatives with the greatest potential impact. In this edited version of their conversation, McKinsey Senior Partners Hemant Ahlawat and Lareina Yee speak with Hudson about his and other leaders' roles in Sanofi's AI transformation.

Lareina Yee: Paul, there has been a lot of change in the world since you became CEO of Sanofi in 2019. In technology, we have seen remarkable shifts, most recently with AI and agentic AI. As CEO, you are all in on the details of this transformation. You have told me that you won't delegate this to the technologists.

Paul Hudson: CEOs in my generation delegate. We're masters at it, and we build teams we can delegate to. But with the new breakthrough technologies, you're instantly obsolete—even if you have an amazing CDO [chief data officer], as I do.

If you delegate, here's how it goes: You'll be in a meeting and hear about some AI breakthrough the company could use. At the next meeting, you ask, "What happened?" They say, "We delegated it to our CDO. We can build it ourselves. We'd rather keep it in our protected environment." And then they hope that you will forget you ever asked. It's corporate lingo, shorthand for "We have no idea. We're a little embarrassed that we have nothing to show you, boss."

'Using AI, we reduced out-of-stocks by 80 percent, which is close to a billion euros, and we improved asset utilization by more than ten percentage points.'



The way we do it at Sanofi is a competitive advantage. Last year, I redeployed close to a billion euros in real time. We didn't wait for a budget cycle; we had real-time business intelligence. Using AI, we reduced out-of-stocks by 80 percent, which is close to a billion euros, and we improved asset utilization by more than ten percentage points.

We look at everything end to end. Can we go cheaper? Can we go more robust in certain areas?

Can we introduce a shop floor agent to improve asset utilization? Can an agent help with drug design and discovery? We've made some good decisions along the way. For instance, most companies have built AI in silos or verticals. Our leadership team decided four years ago to build it transversally so that we would be one of the few companies with a transversal data set that allowed us to go entirely along the value chain. We thought we might be crazy at the time, but it was a good call.

All of this is fabulous. It creates opportunities to simplify so much, to remove bureaucracy, to make workflows more efficient. It's great for me because I get to redeploy all these resources elsewhere in the business, principally to chase miracles for patients who need help.

Hemant Ahlawat: I remember you saying that you want Sanofi to be the first biopharma company powered by AI at scale. If you look out five years, what would this look like for patients, doctors, and caregivers?

Paul Hudson: We know it will be a while before AI designs, develops, and delivers a medicine on its own.

When we are in a Phase I critical trial, we're eight to ten years from launch, and we have a 90 percent probability of failure. In the medium term, we think that we might be able to use AI and generative AI to reduce the chance of failure to 70 percent. You're still bringing forward a medicine that may not make it, but you're much more efficient. You could, of course, drop those efficiency gains to the bottom line. But we're an R&D-led business. Using AI in early discovery and development stacks the cards in your favor. So, you can now deploy the capital that was not at risk into more programs that reach for the miracles.

Vaccines in prefilled, single-use vials.
Photo by Joel Saget/AFP via Getty Images.

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The trend is also true in Phase III trials, where you might spend $500 million despite having a chance of failure at something like 30 to 35 percent. The cost of a miss is massive. People don't understand how much pharmas spend every year in pursuit of breakthroughs. Raising our chance of success to 80 percent, from 70 percent, would be incredible.

There's so much opportunity to support patients on their journey. The holy grail, of course, is developing breakthrough medicines. But we can help reduce friction during their journey. We can help make sure that they have the right insurance coverage. We can improve our support of people in patient access programs. There are strict rules on how we communicate to consumers, but we can improve that. For instance, Hemant, you might read that package insert with tiny print in every box of medicine, but you'd be the exception. We'd rather use a QR code to direct people to a YouTube video, or to TikTok and Instagram. We're trying to meet them where they are.

Lareina Yee: Have you encountered internal resistance to using AI agents?

Paul Hudson: We did at the beginning. Most people fear this revolution because they worry about their jobs. But the only job that gets replaced is the human who refuses to use AI,

Inside an R&D oncology laboratory at Sanofi. Photo by Thomas Samson/ AFP via Getty Images.

‘The AI agent is the great leveler. We don’t get the biases in resource deployment that we used to get.’

because human plus AI beats AI alone every time. The only human it replaces is the one who refuses to use it.

An epiphany for me was taking to heart the fact that the algorithm or the agent doesn’t have a career at stake. So, when we are doing a Phase III trial, with hundreds of millions of dollars at stake, we can ask the agent whether we should go forward or not, and the agent gives us a pure yes or no. It can be truly sobering to have an agent tell you yes or no. It has not been wedded to the project for 11 years, so its candor is exponentially different.

But our people rise to that. Whether you follow the agent’s recommendation is up to you. You need to make a conscious decision to reflect on its insight, but the decision to follow it or not is entirely yours. We’re never going to tell people to execute everything the agent says.

It’s kind of like Waze telling you the best route to somewhere you want to go. You decide whether to go that way or not.

Hemant Ahlawat: How has AI improved your life as a manager?

Paul Hudson: I’ll give you an example. Like many CEOs, I’ve been in budget meetings where people say, “You know, the end of the year could be quite tough. So, I’m not sure that this growth we’re seeing now can be maintained.” They want to get to the end of the year with a budget that’s reasonable so they can accelerate the following year. Everybody’s hedging a little here, there, and everywhere. So, you may not deploy $500 million, $600 million, $800 million because it’s hedged. That’s a waste, because that money could be working for you.

I was with our brilliant team in Germany recently, and they wanted to show me their resource deployment agent. They had asked the agent to tell them where they were not optimally deployed. And the agent came through. It looked at everything and quickly came back, saying, “You’re a few hundred grand over here, a few hundred grand under here.” And it made a recommendation that the team already had plans to deploy.

The agent is the great leveler. We don’t get the biases in resource deployment that we used to get. For me, it’s incredible. I now have the privilege of being able to look across all our major markets and consider whether the agent supports the fact that we have deployed as optimally as possible. That is a huge weight off my mind.

Lareina Yee: For CEOs who are just starting to dive into agentic AI, what are the one or two things you'd tell them to do to accelerate the effort?

Paul Hudson: For starters, you must make sure that you have a basic level of understanding of AI and agents.

Second, here's a key idea that worked for us. Back in 2021, we decided to put together a sort of AI club, consisting of 12 people from different functions such as procurement, clinical operations, and so on. These were respected change agents with no AI expertise. We told them to work with one of our partners and disrupt their functions. We meet once a year, and I don't ask them questions in between. When we do gather, they tell their peers how their group has evolved its agent and AI approach over the previous 12 months. This is a great way to involve your newer generation of talent, who do not want cascaded innovation. They want to participate, they want to shape, they want to do things in a very different way, and we really give them a chance to do that.

Finally, CEOs should not underestimate the personal energy required. As people have said, AI may be the greatest revolution since the printing press. If you're planning to delegate the AI revolution, then good luck to you.

Paul Hudson is CEO of Sanofi. **Hemant Ahlawat** is a senior partner in McKinsey's Zurich office, and **Lareina Yee** is a McKinsey Global Institute director and a senior partner in the Bay Area office.

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.

Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision-making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

When the question—not the answer—is the mistake

How you frame a problem can lead to solving the wrong one.

by Aaron De Smet and Tim Koller

The dilemma

Marketing executives at an international e-commerce retailer noticed a decline in average order value (AOV) and decided to take action. They met with the analytics team and asked, "Which promotions will increase AOV the fastest?" The team's answers led to experiments with advertising, bundled discounts, price cuts, and upsell offers.

The promotions generated significant short-term spikes in AOV. However, over the long term, customer engagement and profit margins continued to slide. Six months later, customer surveys revealed that the real problem was declining trust in product quality and delivery reliability. That's when leaders realized that in their attempts to address the short-term spikes in demand, they had put additional strain on the company's manufacturing and supply chain and had, in fact, exacerbated their product quality and delivery issues.

The executives' original question had framed the issue as a pricing and promotion problem, which not only didn't solve the company's underlying problems but also made them worse. The experience demonstrated that a good answer to the wrong question can be just as devastating as a bad one.

The research

The framing effect is a well-documented cognitive bias in which people with identical information make different decisions based on how the information is presented. Research by Amos Tversky and Daniel Kahneman showed that the way a problem is presented can heavily influence the options people consider and the decisions they make.[1] Additional studies have shown that groups are just as susceptible to the framing effect as individuals, particularly in high-stakes or uncertain situations.

A frequent consequence of the framing effect is asking misguided questions. In business settings, framing an issue too narrowly or embedding unchallenged assumptions often leads teams to ask the wrong question. The right questions are crucial as generative AI and agentic AI assume central roles in the workplace, because these tools will confidently generate or act on whatever they're given, even if the original framing is flawed.

Framing an issue too narrowly or embedding unchallenged assumptions often leads teams to ask the wrong question.

[1] Amos Tversky and Daniel Kahneman, "The framing of decisions and the psychology of choice," *Science*, January 1981, Volume 211, Number 4481.

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One of the most haunting examples of the framing effect occurred during the lead-up to the *Challenger* space shuttle disaster. Engineers for the contractor had warned that cold temperatures could affect the O-ring seals in the rocket boosters and recommended postponing launch at temperatures below 53°F—the coldest temperature at which the O-rings had been tested. Concerned about long delays, NASA held an emergency conference call the night before launch to ask the contractors for proof that it was unsafe to launch—proof that they did not have.[2]

The tragedy the next morning revealed the flaw in the framing. Some parts of the space shuttle were sitting in an ambient temperature of only 28°F.[3] The team needed to have asked, "Do we have any evidence the seals will hold below freezing?" The answer would have been, "No, we've never tested the O-rings in such conditions."

By framing the discussion abstractly, rather than anchoring a specific question to the actual temperature forecast, NASA missed a critical warning—and the mission ended in disaster.

The remedy

One way to compensate for the framing effect is to "follow the thread"—that is, reverse engineer decisions by starting with the desired outcome, tracing back through the actions and decisions that led to it, and identifying the right question to ask.

When customer surveys revealed issues with quality and reliability, leaders at the e-commerce retailer followed the thread to clarify their goal—profitable growth through customer loyalty—and landed on the question they should have asked earlier: "What do we need to do to rebuild trust?" This led to greater investment in product quality and a company-wide focus on on-time delivery.

Counteracting the framing effect begins by challenging the problem's definition. Rather than accepting the frame as given, teams benefit from broadening their inquiry. One proven debiasing method is to invite constructive dissent—devil's advocates, challengers, or red team–blue team exercises—not just to question answers, but to question the questions.

Leaders can foster better decisions by supporting this kind of reframing. It may seem costly to slow down and reflect, especially under pressure. But patience can pay off—because a brilliant answer to the wrong question is still the wrong answer.

Aaron De Smet is a senior partner in McKinsey's New Jersey office, and **Tim Koller** is a partner in the Denver office.

[2] William P. Rogers et al., "The contributing cause of the accident," chapter 5 in *Report of the Presidential Commission on the Space Shuttle Challenger Accident, Volume 1*, NASA, June 6, 1986.
[3] Paul Dorian, "Weather and the Space Shuttle Challenger disaster on January 28, 1986," Iowa Climate Change, January 28, 2021.

Looking back

National productivity rests on a handful of value-creating firms

The traditional view of productivity growth is that it emerges gradually through the incremental improvements of many firms, trickling down as best practices diffuse from leaders to the rest.

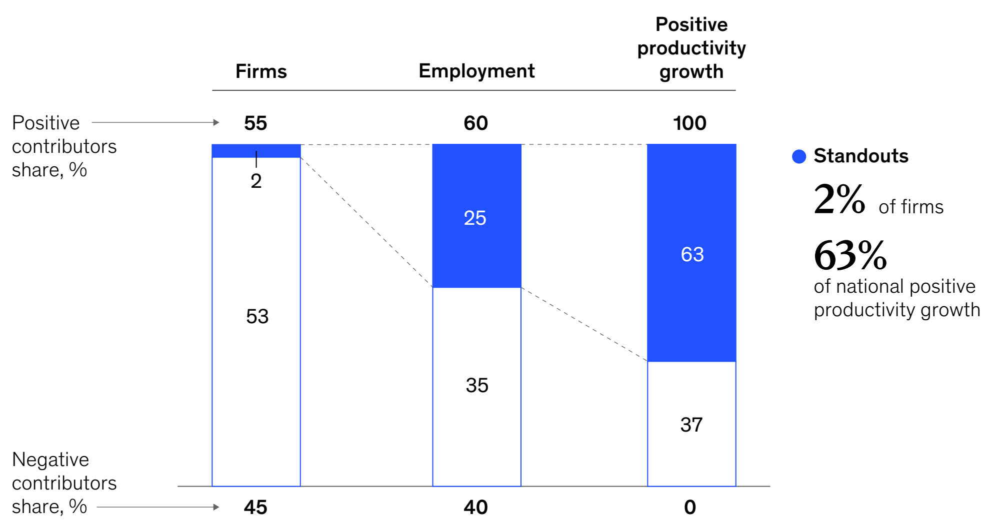
But new research from the McKinsey Global Institute (MGI) reveals that a small number of value-creating firms create most productivity gains. These are dubbed “standouts” in MGI’s report, *The power of one: How standout firms grow national productivity*. They do this with bold strategic moves—mostly expanding top-line growth—and with rapid scaling rather than efficiency improvements. In a sample of 8,300 large firms across Germany, the United Kingdom, and the United States, fewer than 100 firms generated two-thirds of all positive productivity growth. These firms created powerful bursts of productivity that lifted entire sectors and economies. The most dramatic results occurred in the United States, where standouts not only made significant productivity improvements but also benefited from dynamic reallocation of labor and capital from less productive firms.

This fresh view of productivity growth calls for a new CFO playbook: Support radical resource allocation, including zero-based budgeting. Prioritize growth momentum. Continue to look at head count budgets and efficiency, but in conjunction with return on labor invested and value created. Finally, when addressing societal contributions in annual reports, consider including how much your company adds to sector and national productivity.

Exhibit

A few ‘standout’ firms shape the majority of productivity growth.

Share of national sample’s productivity growth, %



Note: Simple average figures of the 3 countries studied (Germany, UK, and US).
Source: 2025 Moody’s Investors Service, Inc. and/or its affiliates and licensors; Capital IQ; EU KLEMS; US Bureau of Labor Statistics; McKinsey Global Institute analysis

For more about firm-level productivity and how it affects economies, see The power of one: How standout firms grow national productivity, *McKinsey Global Institute, May 6, 2025.*

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