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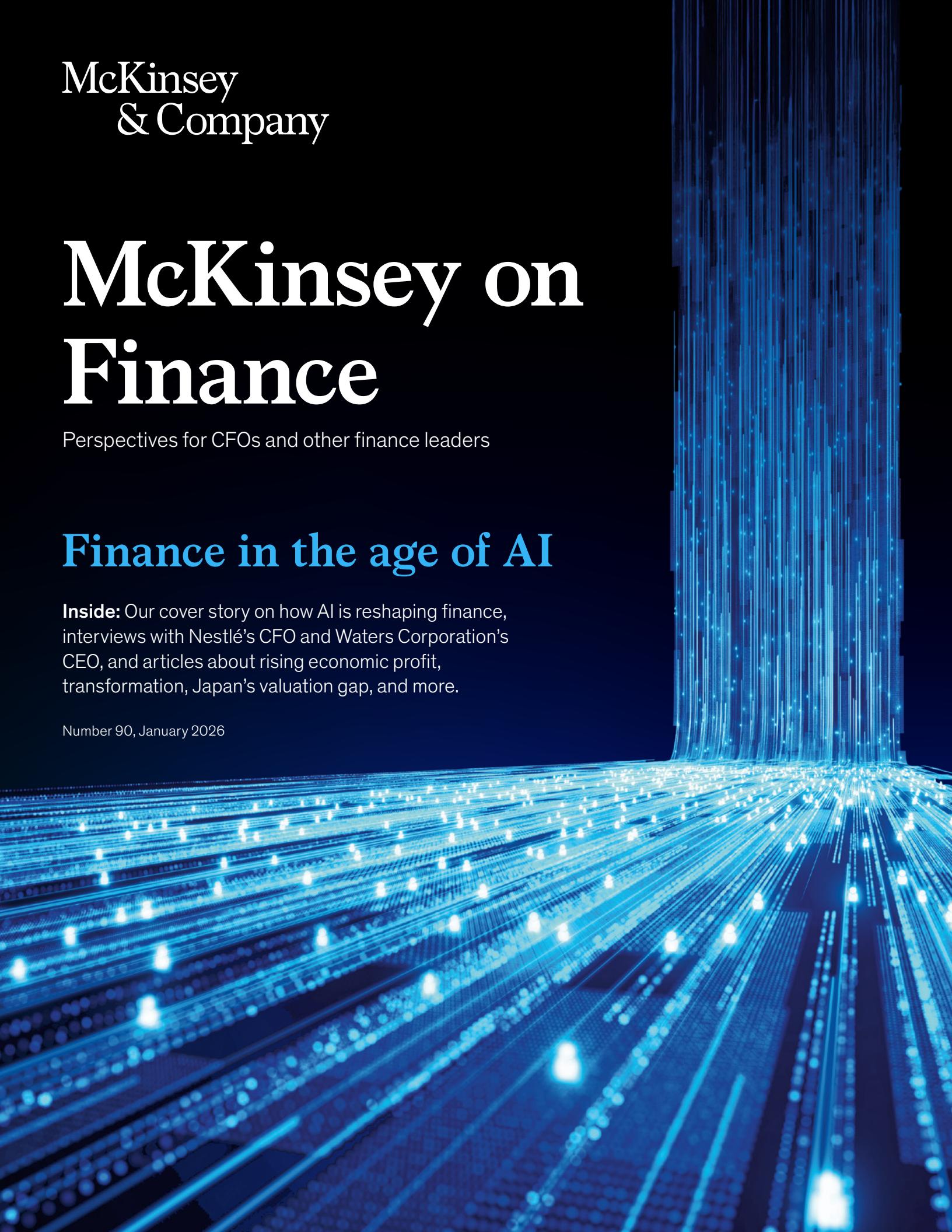
McKinsey on Finance

Perspectives for CFOs and other finance leaders

Finance in the age of AI

Inside: Our cover story on how AI is reshaping finance, interviews with Nestlé's CFO and Waters Corporation's CEO, and articles about rising economic profit, transformation, Japan's valuation gap, and more.

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

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Finance in the age of AI

AI—especially its generative and agentic tools— is beginning to reshape the finance function. In the cover story of this issue of *McKinsey on Finance*, Senior Partners Alex Sukharevsky, Andy West, and Cristina Catania and their coauthors explore how some finance teams are already revolutionizing the way that they work. A companion piece from our *Bias Busters* series examines how leaders can overcome the behavioral and organizational barriers that can slow AI adoption.

Alongside this exploration of cutting-edge tech and processes, several other articles hew to this publication's traditional focus on creating long-term value. Our excerpt from an interview with Nestlé's CFO Anna Manz highlights the challenges that finance leaders face in choosing where to invest to build winning businesses for the future. In "The power of performance," Tim Koller and Prateek Gakhar explain what long-term intrinsic investors most want to see from companies. Our interview with Sarah Keohane Williamson, CEO of FCLTGlobal, discusses the not-for-profit organization's mission to help companies avoid the trap of "short termism." And "How to value cyclical companies" explains how to assess fundamentals to avoid getting thrown off by temporary noise.

We see no contradiction in this issue's juxtaposition of AI and enduring principles. Today more than ever, CFOs and their teams face high volatility, fast technological change, and rising expectations from investors and boards. Meeting these challenges requires members of finance teams to be innovators who are ready to explore new ways of working while staying grounded in their mission of securing long-term value creation.

Finance leaders' ability to balance innovation with long-term thinking is being tested daily as they navigate fast-changing markets and diverse geographies. In an interview, Udit Batra, CEO of Waters, reflects on leading a large-scale transformation.

"Closing Japan's valuation gap by changing corporate traditions" explores how the country's corporate practices are changing and need to change more to help realize companies' full potential. In "Global economic profit bounces back to an all-time high," Senior Partner Marc de Jong and his collaborator Peter Stumpner trace the value creation resurgence across major markets and illustrate that generating returns above the cost of capital remains essential. "Deal delays are the new normal" explains how to keep deals moving despite long regulatory reviews.

Together, these articles capture the dual challenge facing finance leaders today: making the most of the opportunities that new technologies offer while staying rooted in the timeless mission of creating long-term value.

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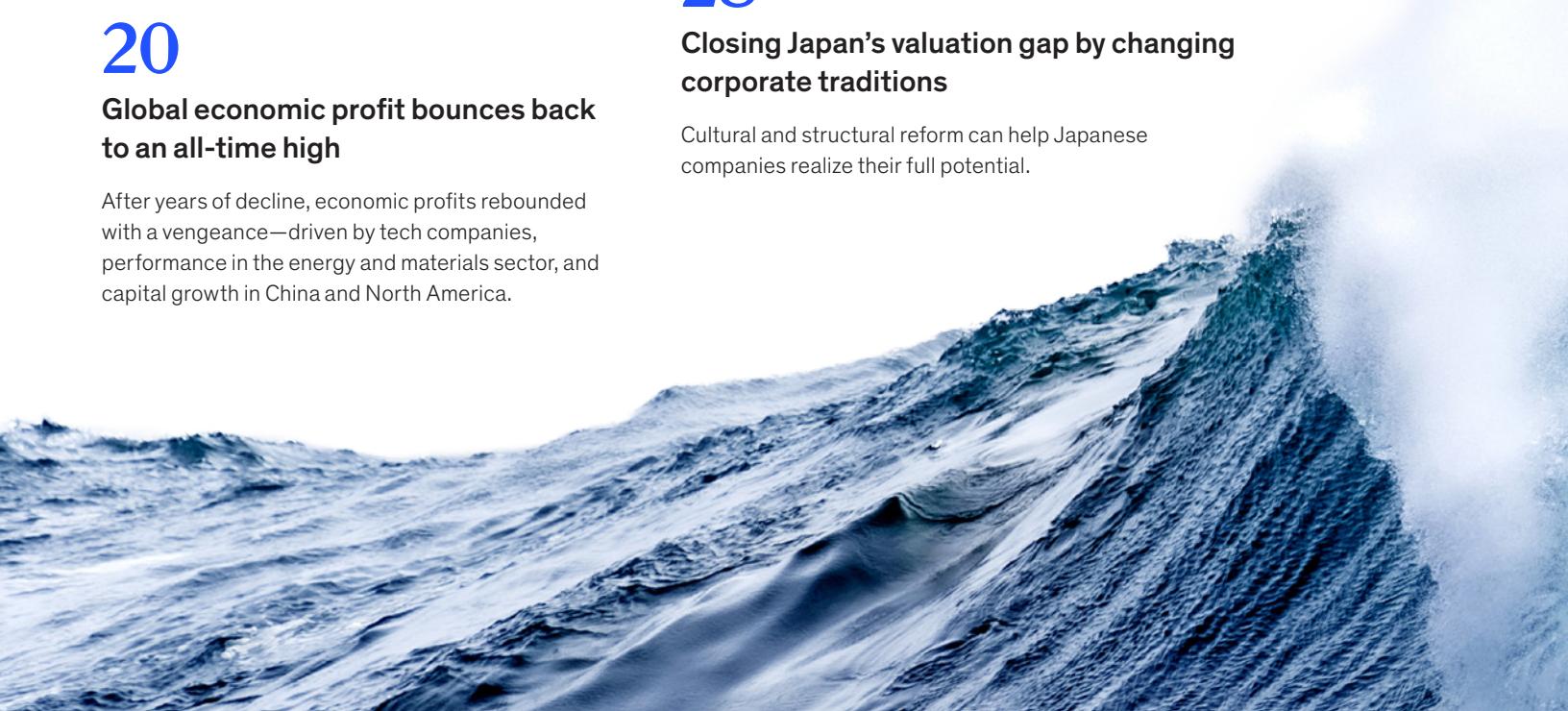
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Real-world examples reveal how finance functions apply AI to deliver faster insights, stronger controls, and measurable results.

This article is a collaborative effort by Alex Sukharevsky, Andy West, Cristina Catania, and Davide Grande, with Andrea Tricoli, representing views from McKinsey's Strategy & Corporate Finance Practice and Quantum Black, AI by McKinsey.

How finance teams are putting **AI** to work today

AI

has dominated business headlines for the past two years, and finance functions are no exception. In a proprietary McKinsey survey of 102 CFOs across industries and global regions, 44 percent of respondents said they used gen AI for over five use cases in 2025, up from 7 percent in the previous year's survey. Investment in AI tools is also growing: 65 percent of respondents said their organizations will increase gen AI investment in 2025; two years ago, only about a quarter of respondents said the same.

Yet the reality across the corporate landscape underscores how elusive tangible value remains: [A recent McKinsey survey](#) found that nearly two-thirds of respondents said their organizations have not yet begun scaling AI across the enterprise. Poor outcomes are largely due to pilots breaking down under real-world conditions, failing to adapt as new data emerges, and remaining poorly integrated into core processes.

Some finance teams, however, are successfully using AI, gen AI—and increasingly, agentic AI—to boost efficiency, improve insights, and offload time-consuming manual tasks (see sidebar, “A guide to automation and AI terms”). Rather than relying on isolated pilots, these organizations [apply AI across foundational finance domains](#). We have observed some CFOs and their teams using AI to forecast more accurately, monitor working capital in real time, speed up reporting cycles, and surface new opportunities for cost savings. These efforts are enabling them to become more agile, forward looking, and aligned with the needs of their organizations.

A guide to automation and AI terms

As automation and AI become more embedded in finance, understanding the nuances among these technologies is increasingly important. Here are some of the major terms shaping the field today:

- *Automation*: Rule-based technology that follows predefined instructions to complete repetitive tasks. Finance functions commonly use automation for processes such as checking and paying invoices, performing accounting reconciliations, and generating basic reports.
- *AI*: A broad category of technologies that augment human intelligence, such as recognizing patterns, making predictions, and learning from data. AI is often used in forecasting, fraud detection, or risk modeling.
- *Gen AI*: A subset of AI that understands unstructured data—audio, code, images, and text—and creates new content using foundational models. In the finance function, gen AI can handle tasks such as drafting commentary, summarizing performance, and supporting scenario modeling.
- *Agentic AI*: An emerging class of AI that can independently pursue goals, make decisions, and take actions with limited human input. In the finance function, agentic AI can orchestrate time-consuming workflows, like the closing process in accounting and the drafting of complex reports.

Decision support tools make it faster and easier to access company data, generate reports, and run forecasts.

This article examines three areas where, based on our experience, finance teams are [delivering the most value with AI](#): strategic planning and control, cash and working-capital management, and cost optimization. Each section includes case studies that illustrate how leading organizations use gen AI and agentic systems to improve how finance functions operate. Finally, we identify five common missteps that can slow things down and what it takes to get past them.

Strategic planning and control: How AI delivers better insights

[Decision support tools](#), powered by a combination of predictive analytics and gen AI, make it faster and easier to access company data, generate reports, and run forecasts or scenarios. These tools support finance leaders and their teams while also making data more accessible to decision-makers across the business. Typically, AI tools combine a few common capabilities: alerts that help finance leaders focus their time and attention, interactive root-cause analysis that helps the user understand what's influencing performance, and alternative scenarios to consider. AI is suited for these tasks because it's particularly good at integrating multiple layers of information—such as from external, financial, and operational sources—into a cohesive view.

For example, at a global consumer goods company, a gen AI assistant helps finance professionals deliver insights on budget variances to business leaders in different divisions and markets. The tool replaces manual number crunching, saving an estimated 30 percent of finance professionals' time.

In another example, at a large North American financial institution, a gen AI tool helps generate first drafts of reports that document internal risk model requirements and updates. The tool also assists in generating market-specific risk models by combining internal data with public sources, streamlining what was once a time-intensive process.

Across multiple industries, companies are developing and deploying decision support agents enabled by gen AI and agentic AI to considerably reduce the time that their finance teams need to make resource allocation decisions. Instead of manually pulling reports and stitching together insights across functions, these teams now generate complex scenarios using natural language during planning sessions. The AI tools integrate data from multiple sources—such as customer-relationship-management systems and financial, operational, and marketing data sets—to surface management alerts (for example, when there is declining ROI). They also



provide root-cause analyses (for example, “The problem stems from cost category A in region Y”). The tools then suggest data-driven action steps (for example, “Based on recent ROIs and forecasts, consider shifting 10 percent of the sales budget to digital marketing to encourage higher growth”).

Specific AI implementation varies by organization, of course. Across a handful of finance functions where it has been adopted robustly, we have observed that finance professionals spend 20 to 30 percent less time crunching data. They devote the saved time to their role as business partners who support strategy execution. By quickly generating customized reports that maintain appropriate security and hierarchical-access controls, AI tools also make it easier for finance departments to provide insights across their organizations.

Cash and working capital management: How AI scrutinizes terms and invoices for greater accuracy

Agentic-AI-powered workflows are enabling the next level of automation in both payable and receivable processes, helping make procurement and other back-office teams more efficient.

For example, a global biotech company introduced invoice-to-contract compliance using an agentic AI system that ingests contracts and invoices throughout the year and checks that all contract terms are correctly applied. This approach helps prevent value leakage when vendors miss or misapply terms such as early payment discounts, tiered pricing, and volume rebates. It runs alongside preexisting automation, extending coverage across the full range of the company’s spend base and reducing the need for manual monitoring of high-value contracts. The system is able to interpret each vendor contract and its terms, track incoming invoices for compliance, and identify issues that emerge only across multiple invoices, such as when cumulative purchase volumes trigger eligibility for a lower-priced tier.

By using this AI system, the company identified contract leakage equal to approximately 4 percent of total spend (a level of leakage that is not uncommon in the industry). This translated into a clear opportunity to recover lost value and improve margin performance. To put this in a hypothetical context, for a company with a nominal spend of \$1 billion, closing that gap could result in a recurring margin improvement of \$40 million.

Cost optimization: How AI finds savings by analyzing granular spending

AI can simplify the time-consuming task of categorizing detailed costs by analyzing complex invoices and purchase orders and organizing them into clear, structured categories. With better visibility, finance teams can apply advanced algorithms to spot anomalies and areas of waste.

To better understand and control its indirect-spend base, a large European financial institution set out to identify hidden inefficiencies across its operations. It began by collecting invoice-level data from thousands of suppliers and organizing it into a detailed cost taxonomy with four levels of increasing detail and approximately 400 subcategories. To efficiently process and classify this data, the organization used a combination of large language models and analytics. With the structured data set in place, it surfaced cost inefficiencies by applying both automated and semiautomated methods (for which an expert reviewed the output) for anomaly and pattern detection. This analysis revealed specific opportunities to reduce costs and cost waste in areas such as energy usage, travel and transport, and facility management. While each category delivered modest savings on its own, together they helped reduce costs by approximately 10 percent of a multibillion-euro spend base.

Another large European company in the packaging industry gained better control over a fragmented supplier base by using gen AI to categorize more than 10,000 suppliers. Management had historically focused on top-spend vendors, while numerous smaller suppliers—many in indirect-spend categories—remained poorly understood. Using gen AI, the company classified all suppliers with greater accuracy, identifying patterns and overlaps that had previously gone unnoticed. This enhanced visibility helped uncover cost-saving opportunities and optimize procurement strategies. The categorization also revealed gaps in supplier diversity, enabling the company to expand sourcing in underserved areas.

To capture AI's potential in finance, teams must rewire core processes, talent, and technology.



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Overcoming barriers to scaling AI in finance

To capture AI's potential in finance, teams will need to do more than add new tools on top of old ways of working. They must [rewire core processes](#), talent, and technology so that adoption takes hold and creates value. Along the way, progress can be slowed or stalled by these common pitfalls:

- *Waiting for perfect data:* Some teams delay rewiring processes until every data set is perfectly accurate, connected, and standardized. In practice, finance teams can create value by delivering use cases that work with today's data while also [strengthening data foundations](#).
- *Trying to transform all at once:* Holding back until the entire function is "AI ready" slows progress. The better path is to transform domain by domain, building momentum and capabilities that deliver sustainable results.
- *Jumping in without a clear road map:* Pilots launched without direction rarely scale. Finance leaders need a road map tied to their business priorities, with clear choices of which use cases to pursue first and which to take on next. Use cases should also be supported by the technical talent that can help them succeed.
- *Neglecting change management:* The biggest barrier is often adoption, not technology. [Equipping teams and building buy-in](#) are essential for capturing and sustaining impact.
- *Automating fragmented processes:* Without simplifying and standardizing core workflows first, AI only adds to the complexity. Removing unnecessary steps and making processes consistent across teams allows technology to scale effectively.

Avoiding these pitfalls requires a clear vision, strong business alignment, and a focus on practical execution. Finance leaders who approach AI with a strategy rooted in business needs are best positioned to achieve enduring impact.

As AI adoption broadens, the difference between pilots that fizzle and those that create lasting value is becoming clear. As the case studies in this article show, the companies achieving results are the ones that tie AI to specific business needs, streamline core processes, and use the technology to free up capacity for higher-value work. For CFOs, the message is unequivocal: The opportunity is real, but capturing it requires moving beyond experimentation to disciplined execution anchored in business priorities.

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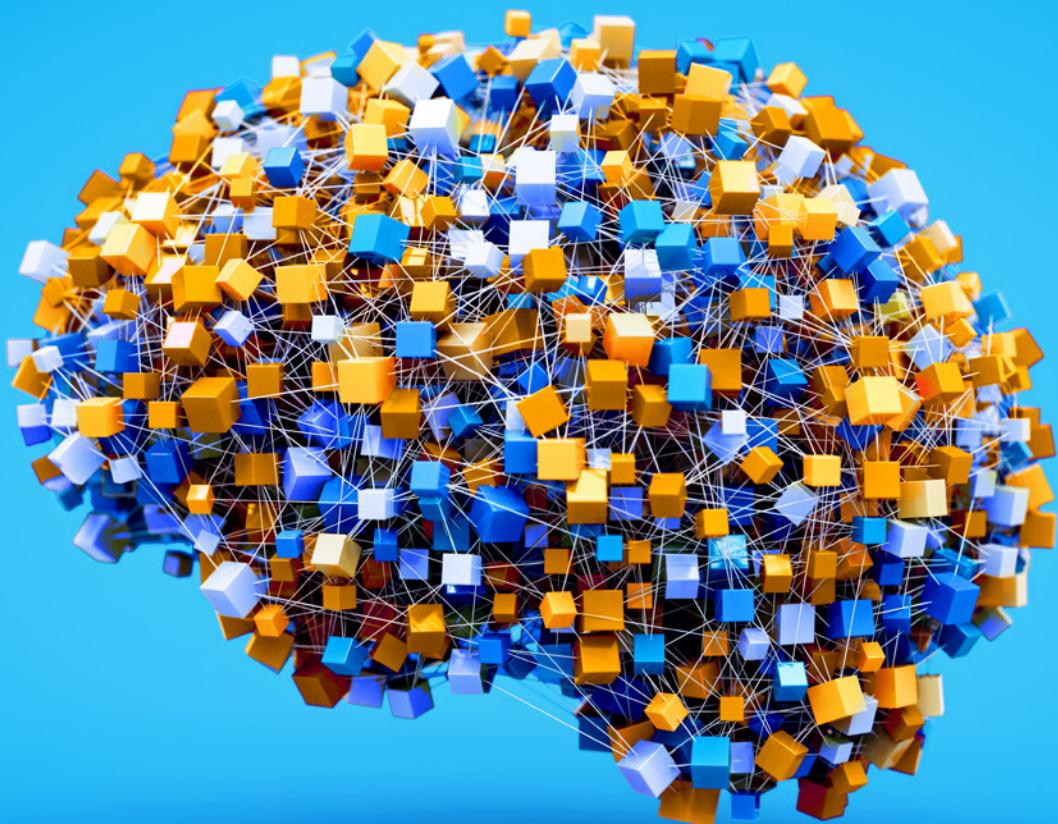
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The cognitive brakes on the gen AI accelerator

Status quo bias and inertia are quiet forces blocking organizations' progress with gen AI. These moves can overcome them.

by *Julia Sperling-Magro and Tim Koller*



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

The dilemma

A healthcare company had a plan to accelerate its employees' use of gen-AI-based tools. It invested substantial time and resources into a company-wide, self-paced, interactive training program for its employees. More than 90 percent of the attendees rated the program highly, making leaders believe that it had been a great success.

However, six weeks later, fewer than 10 percent of the attendees had adopted the gen AI tools in their day-to-day work lives. When questioned about their behavior, employees' replies were surprising: Even in cases where someone's job would have been made easier, faster, and more enjoyable by using the tools, some had failed to even try them.

The research

The cognitive bias that the company's leaders had run up against is known as status quo bias. It's a psychological phenomenon whereby, when faced with a decision, people often take a mental shortcut and default to the current state of affairs. William Samuelson and Richard Zeckhauser's 1988 "Status quo bias in decision-making"¹ is considered the seminal research on this topic. In the study's experiments, participants faced hypothetical decisions about portfolio allocation, retirement plans, and job choices. The researchers found that subjects disproportionately chose whatever was described as the choice currently in effect.

Status quo bias can cause people to overindex on the risks of adopting gen AI tools (as with, "The robots will replace me") and underindex on the risks of inertia.

One method for overcoming this cognitive trap is to reframe the choice as one between standing still to suffer potential losses and [moving forward to reap potential rewards](#). Additional approaches include making new-tool adoption the default position, using leader and peer

Status quo bias can cause people to overindex on the risks of adopting gen AI tools and underindex on the risks of inertia.

¹ William Samuelson and Richard Zeckhauser, "Status quo bias in decision making," *Journal of Risk and Uncertainty*, March 1988, Volume 1.



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models to encourage behavioral change, and raising awareness of how dramatically the status quo is changing in the wider world.

The remedy

The company realized that it needed to work on a more intimate, personal level to inculcate the sense that inertia was risky and that [adopting gen AI tools was the smartest and safest choice](#). This time, facilitators worked with specific teams, analyzing each group's tasks. The focus was on not just recommending the right gen AI tools but helping employees figure out where to fit them into their workflows. The subtext of these small-group trainings was, "This is our default way of working now."

Meanwhile, the CEO, the CFO, and other senior leaders received one-on-one training that showed them how gen AI could help free their time to work on the highest-value tasks. This approach was important because experts may fear losing relevance if they believe that the tools could replace them. By demonstrating how gen AI could actually improve leaders' job performance, the company motivated them to become adoption front-runners.

These knowledgeable leaders were then able to identify "super users" on their teams who were boldly experimenting and [uncovering real gains through gen AI](#). These employees were celebrated, rewarded, and deployed as coaches for the rest of their teams. The goal was to leverage the influence of peer models, who are often the most effective at inspiring others to try new behaviors.

One of the most powerful things that the company did was to take specific teams on "[go and see](#)" [visits to organizations](#) that had integrated gen AI into their operations to surprising effect. People often don't believe that something is possible until they see it themselves, so they fall back on the idea that it can't be done. Seeing how much [some companies have rewired for gen AI adoption](#) can be a powerful way to dislodge the comfortable sense that there's plenty of time for change.

The combined effect of these efforts was to dispel the idea that inertia was the safest option. Instead, employees saw leaders, peers, teams, and other companies establish new ways of working. This helped trigger a mindset shift: Employees recognized that the status quo was becoming obsolete and that embracing gen AI was essential to keeping pace and advance in their careers.

Making these moves increased gen AI adoption drastically at the company and revealed a powerful insight: Employees embrace change when new ways of doing things feel not like a disruption but like the new normal.

Julia Sperling-Magro is an alumna of McKinsey's Frankfurt office, and **Tim Koller** is a partner in the Denver office.

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The building blocks of transformation

A conversation with Waters CEO Udit Batra

The CEO of Waters Corporation describes the core leadership practices that helped the life sciences company deliver greater returns.



In 2020, **Waters Corporation**, a Boston-area life sciences company that has been manufacturing analytical instruments since 1958, found itself losing ground to competitors. That year, the company's newly appointed CEO, **Udit Batra**, engaged employees, the board, and other important stakeholders in a transformation effort aimed at rediscovering what he calls the organization's "indomitable spirit."

"Taking a step back, you never really know" if a transformation is going to succeed, he explains, "but if the brand is good, the gross margin is good, and the overall market has successful players, you can tell there is at least a path to success."

Waters took that path and, five years later, is beginning to see its transformation pay off: The company has outperformed its peers over the past several years, including some that are considerably larger. It ended the first quarter of 2025 with five-year total shareholder returns of 102 percent, exceeding the peer average of about 60 percent.

In March 2025, Udit spoke with McKinsey Partner John Chartier and McKinsey Editorial Director Roberta Fusaro about the importance of having the right people, clear processes, and a simple (and memorable) storyline in place for transformations to take hold. In July, the company announced it was buying Becton Dickinson's biosciences and diagnostic solutions business for about \$17.5 billion.¹ The deal is expected to close in the first quarter of 2026.

The conversation has been edited for clarity and length.

McKinsey: Tell us a little bit about Waters and how your background and experience prepared you for the role of CEO at the company.

Udit Batra: We're one of the largest analytical-instruments companies in the world. We work in high-volume applications to ensure that the food you eat, the water you drink, and the medicines you take are safe to consume. There are roughly 8,000 of us globally, on nearly every continent, and we have about \$3 billion in sales, and a nice margin.

In terms of what prepares you for such a role? Nothing ever totally prepares you, right? But I have been a customer. I have used our products as an undergraduate, as a graduate student, as a researcher, and then as a leader of pharmaceutical and vaccines businesses around the globe. I understand how many of our customers make decisions. I've also had the good fortune to lead large, global organizations in the sector itself—be it a consumer business at Merck, the vaccines business at Novartis, or, most recently, the MilliporeSigma business of Merck. I've also had the good fortune to work with teams transforming different businesses from point A to point B.

McKinsey: How do you know that an organization can be transformed?

Udit Batra: It's tricky to identify prospectively the characteristics that could make a business transformation successful. But number one is the brand. Is the brand still relevant? The brand is a representation of the customer's perceived value of what you do for them. We knew that Waters was still a fantastic brand.

¹Denny Jacob, "Becton Dickinson biosciences & diagnostics unit to merge with Waters Corp. in \$17.5 billion deal: Executives from both companies touted the deal's merits," *Wall Street Journal*, July 14, 2025.

‘We said, “We cannot succeed in 40 countries.” We narrowed it down to eight.’

Second is the financial picture, which also starts with the value of the brand. You can measure that just by looking at a company’s gross margin. Waters’ gross margin has hovered between 58 percent and 60 percent, which means customers are willing to pay for the brand, regardless of any challenges the company has had or the broader dynamics of the industry.

Third is the industry itself. You ask yourself, “Is this a good industry? Are things going uphill or downhill?” The analytical-tools sector is driven by secular drivers—the need for more medicines, the need for safer food and water—which suggests that this remains a growing market for Waters. Also, there were competitors during the time of the transformation that were performing extremely well. I also had personal experience working in this sector and knowing that companies can succeed in this sector. Of course, you can never tell until the story is finished.

McKinsey: You saw a viable path toward change. What were the next steps in Waters’ transformation?

Udit Batra: My team and I spent the first six weeks staring at and ingesting all the facts. Team members came into our office and reported to us about financials, products, customers, geography. We talked to external stakeholders, including the board, to find out what, in their view, needed to change. We talked to customers. We talked to shareholders. We read a lot of journals and other resources to learn about technologies and who was doing what. If you do that for weeks, discussing the facts together, you can establish a common understanding of the situation.

During those weeks, you learn a few things: Number one, you learn about the team, which is critical. Who’s with you? Who wants to be with you? Who do you want to have with you?

The second thing you learn, based on that deep dive and the market context, is what the plan should be. You spend serious time trying to understand the success factors for the business, and you come up with a road map. For consumer health at Merck, for instance, we used to operate in 40 different countries. But we said, “We cannot succeed in 40 countries.” We narrowed it down to eight countries, with only two rules: First, you must have at least 3 percent market share so you can sustain your infrastructure. And second, you must have at least three leading brands so you can allocate marketing spend efficiently across them.

At Waters, we said we must replace instruments, and we need a higher service attachment rate, so we came up with some protocols. Simple rules help you develop the business model for the future and give you a plan. Then, of course, you need to implement the plan with a lot of feedback, keeping the context in mind and changing the plan as the context changes.

McKinsey: What sort of team is necessary to implement a transformation, whether it's an executive team or a broader work team?

Udit Batra: There is an individual component to teams required for transformation, as well as a collective component. At the individual level, we wanted people who are, of course, competent in their discipline. If you're in finance, you'd better know how to add. We also wanted people who are courageous, who are not coming back to leaders each time and asking, "What should I do?"

We wanted people who showed compassion. Compassion is important for understanding teams' and customers' points of view, and with that understanding, the implementation of transformation initiatives becomes much more robust. We measure this rigorously across our teams: Are you competent? Are you courageous? Are you compassionate?

At the collective level, at the executive-team level, I'm the first among equals. There is no number two. Every one of my eight team members is equal to me. There's no one else you have to go through to get a point across to me. We emphasize extreme transparency in the group. Whatever you have to say in a meeting, say it in the meeting.

McKinsey: How exactly do you measure individuals against these three C's—competence, courage, and compassion?

Udit Batra: Competence is the most straightforward to measure. There are facts. Did people do what they said they were going to do, and did they do it with excellence? Courage—you could consider it a bit more squishy, but it's hardly that. The key question is, do people make decisions on their own?

Here's an example. At Waters, we said very early on that we would invest in five growth areas. One of them was to set up a clinical business unit, and in that business unit, we said, "We're going to give you disproportionate resources, but you've got to grow beyond what you've done in the past," which was in the low single digits. We asked the team to come up with the plan. In response, the leader of that team went out and struck collaborations with a bunch of other companies in the space. Because of those collaborations, the clinical business unit was able to add automation and sample prep capabilities to its mass spec business. The business unit leader and his team went off and did this without really consulting a lot of people internally. And the business unit went

‘Simple rules help you develop the business model for the future and give you a plan.’

from being a low-single-digit grower to a double-digit grower. They had the courage of their convictions, and they had done the analysis. Had they come back to me and the executive team, we would've asked for lots of data, but we might not have added any value to the decision.

McKinsey: Besides getting the team structure right, what are the most important focus areas for organizations to succeed with transformations?

Udit Batra: The biggest, by far, is simplification. In every transformation I've been involved in, we were doing too many things. We had an ongoing initiative in whatever area was interesting and hot—pharmaceuticals, life sciences, you name it. We had to pause and ask ourselves, "What are we really good at?"

Our business model is simple and repeatable. It's a framework we have developed, and we have consistently mapped our transformation plan back to each part. It's replacing instruments, it's providing the software to ensure regulatory compliance, it's providing the chemistry, it's the idea that the columns we develop should be in the hands of every customer through e-commerce, and it's ensuring that the service team is excellent in attaching the service to more and more instruments. We put it all on a piece of paper, using the symbol of a flywheel. This type of simplification is the most important thing a leader can do for an organization.

McKinsey: What's the role of the board during a transformation?

Udit Batra: I keep them, particularly the chairman, fully informed on the changes in context, changes in earnings—they should hear things from me first before they read them somewhere else. They're also a huge resource when it comes to transformation, given their experiences in finance, strategy, and industry. At Waters, we bring them into the problem-solving—we're not always going in with the solution, but sharing the situation and the ambition, asking for guidance, and debating alternatives. With the board, you need to create a collaborative environment where you are learning from each other and having fun with each other. It's no different than working with your own team—you want to be with people you like, respect, and trust.

McKinsey: What other lessons can you share with CEOs and organizations pursuing transformation?

'Context matters as you traverse any sort of transformation—that's the main lesson.'



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Udit Batra: The most important lesson from these past four years is to keep an eye on the context and make sure you understand what your assumptions are in the initial plan and how they need to change as the context does. Think about it: Since I joined Waters in 2020, we've had a pandemic. We've had an explosion of demand postpandemic. Then we had a supply chain crisis because the demand went through the roof. Then we had a deep slowdown with biotech and the crisis in China.

But in the fourth quarter of 2024, we started to see some growth. All through that period, we clarified how the context was changing, how the demand was changing, how the supply chain was changing, how our R&D programs were changing, what was working, and discussed all this regularly with teams. We continue to have a standing meeting once a week where a team reports on changes in the external environment and their potential impact on Waters. We do this every single week.

Most important, we had the humility to change our assumptions. Four years ago, for instance, we said biologics would grow, clinical would grow, batteries would grow, and sustainable polymers would be an investment area. Three out of the four assumptions were fine; sustainable polymers are growing, but not as fast as we had anticipated, so we took those resources and put them into the other three areas. During the past four years, GLP-1 [glucagon-like peptide-1] testing became a big opportunity. Genetics in India became a big opportunity. PFAS [per- and polyfluoroalkyl substances] testing became a huge opportunity. So we redirected resources in those areas.

Context matters as you traverse any sort of transformation—that's the main lesson. Spend the time and do the deep dive on context, create a common understanding of the situation in your team, and then trust your team to react.

Dr. Udit Batra is the president and CEO of Waters Corporation and an alumnus of McKinsey's New Jersey office. **John Chartier** is a partner in the Boston office, where **Roberta Fusaro** is an editorial director.

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Global economic profit bounces back to an all-time high

After years of decline, economic profits rebounded with a vengeance—driven by tech companies, performance in the energy and materials sector, and capital growth in China and North America.

by *Marc de Jong and Peter Stumpner*



G

lobal economic profit pools have rebounded over the past four years, reflecting a recharged ability among companies to create value, according to our examination of the world's 4,000 largest nonfinancial companies by market cap each year, starting in 2005.¹

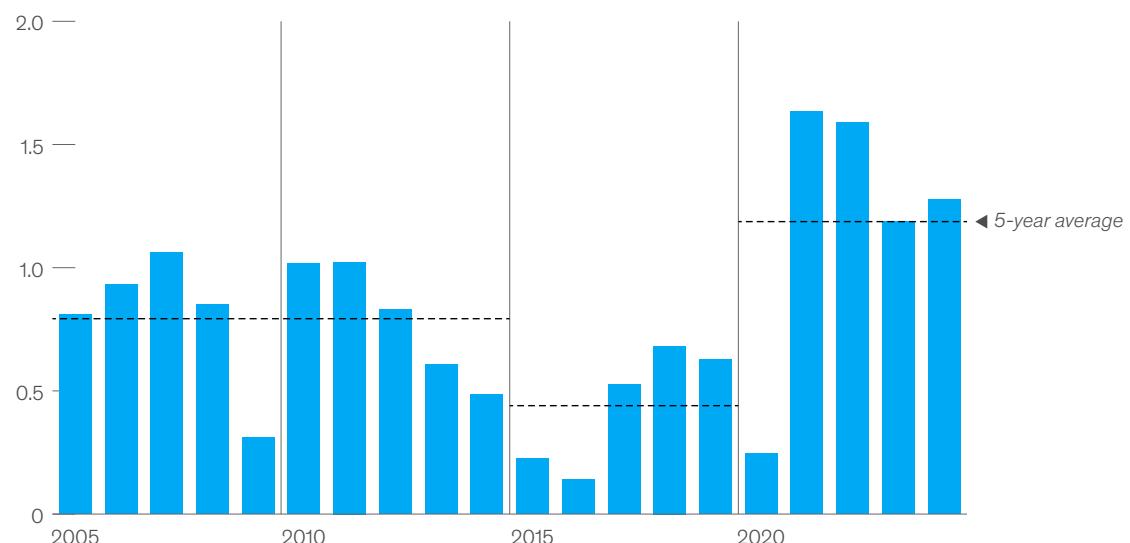
When adjusted for inflation, and despite the impact of the COVID-19 pandemic, economic profit between 2020 and 2024 increased to about \$1.2 trillion per annum—50 percent above levels between 2005 and 2009. This is a notable shift from the past 15 years, when, [as our previous research showed](#), companies' aggregate economic profit—or their profit above the total cost of capital—mostly shrank (Exhibit 1).

Interestingly, global economic profits did not outgrow GDP during this period but rather caught up to it again: The comparison between global economic profit and GDP was 1.1 percent in 2005–09 and, after dropping to 0.5 percent just before the pandemic years, rebounded to 1.1 percent in 2020–24. Note that we're using data up through 2024; more recent trends relating to tariffs, geopolitics, and other factors that have the potential to affect economic profit are not reflected here.

Exhibit 1

Since 2021, economic profit has been higher than in the previous 15 years.

Global economic profit,¹ \$ trillion (2023 prices)



¹Including goodwill.
Source: McKinsey Value Intelligence

¹ We define "economic profit" as the spread between a company's ROIC and its weighted average cost of capital.

Much of this increase (\$247 billion) has been driven by the so-called Magnificent Seven companies from the technology sector: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.² This is not surprising, given how central tech-enabled and digital solutions have become to companies' business models, products, and processes—and given their importance to people and society at large.

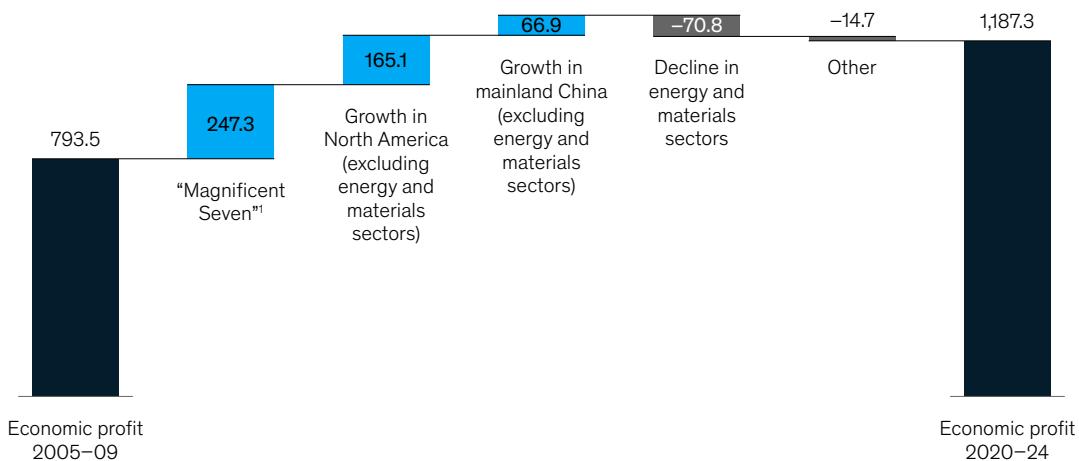
But the relative rebound in global economic profit is not just a technology story; the tale also involves companies in other regions and sectors. For instance, US and Canadian companies outside the technology sector, excluding energy and materials, accounted for \$165 billion of the increase. And companies in mainland China, excluding those in energy and materials, added \$67 billion. Companies in the energy and materials sector slightly offset the rebound in economic profit, declining by \$71 billion (in aggregate, as it is a complex result of varied performance across regions). All other companies, including all European companies, remained flat (in aggregate) (Exhibit 2).

In this article, we'll take a closer look at the data, but the top-level message from these numbers is clear: There has been no permanent erosion of economic profit; it remains possible to create value—and some companies and regions have succeeded in doing so. It's critical for businesses

Exhibit 2

A range of factors are increasing global economic profit.

Change in global economic profit between 2005–09 and 2020–24, \$ billion (2023 prices)



¹Refers to group of top-performing technology stocks: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. Stock analysts and business reporters adopted term in 2023, and its use continues.
Source: McKinsey Value Intelligence

² The term "Magnificent Seven" refers to the group of top-performing technology stocks: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. The term was adopted by stock analysts and business reporters in 2023 and continues to be used today.

to create value well above their cost of capital, regardless of industry or region, as this will attract more capital and spur more investment and further growth, enabling winning businesses to truly scale.

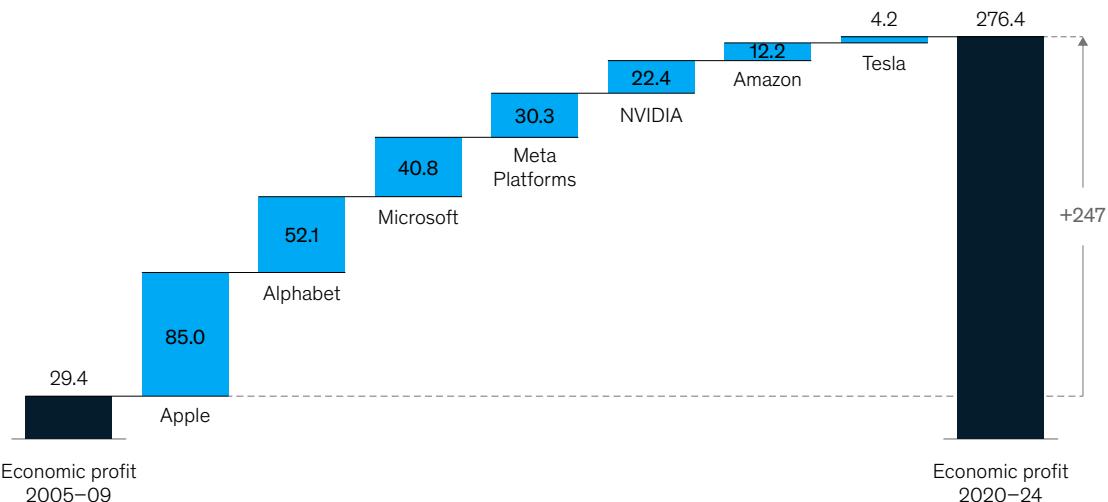
The Magnificent Seven

These seven tech companies are well known for having created significant increases in shareholder returns over the past decade; a look at the trajectory of economic profit among these companies can help explain why (Exhibit 3). The Magnificent Seven collectively realized \$247 billion in economic profit between 2020 and 2024—a staggering 840 percent increase over the past 15 years. That \$247 billion accounts for almost a quarter of all the economic profit generated globally. The Magnificent Seven realized an 852 percent increase in invested capital over the same period, with very high profitability. ROIC among these companies has declined somewhat recently, given the need for tech players to make significant capital investments in data centers and other infrastructure requirements. Still, ROIC among the Magnificent Seven remains much higher than for the average company (41 percent between 2020 and 2024 compared with 10 percent for others between 2020 and 2024).

Exhibit 3

The so-called Magnificent Seven added \$247 billion to global economic profit from 2020 to 2024.

Change in global economic profit from ‘Magnificent Seven’¹ between 2005–09 and 2020–24, \$ billion (2023 prices)



¹Refers to group of top-performing technology stocks: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. Stock analysts and business reporters adopted term in 2023, and its use continues.
Source: McKinsey Value Intelligence

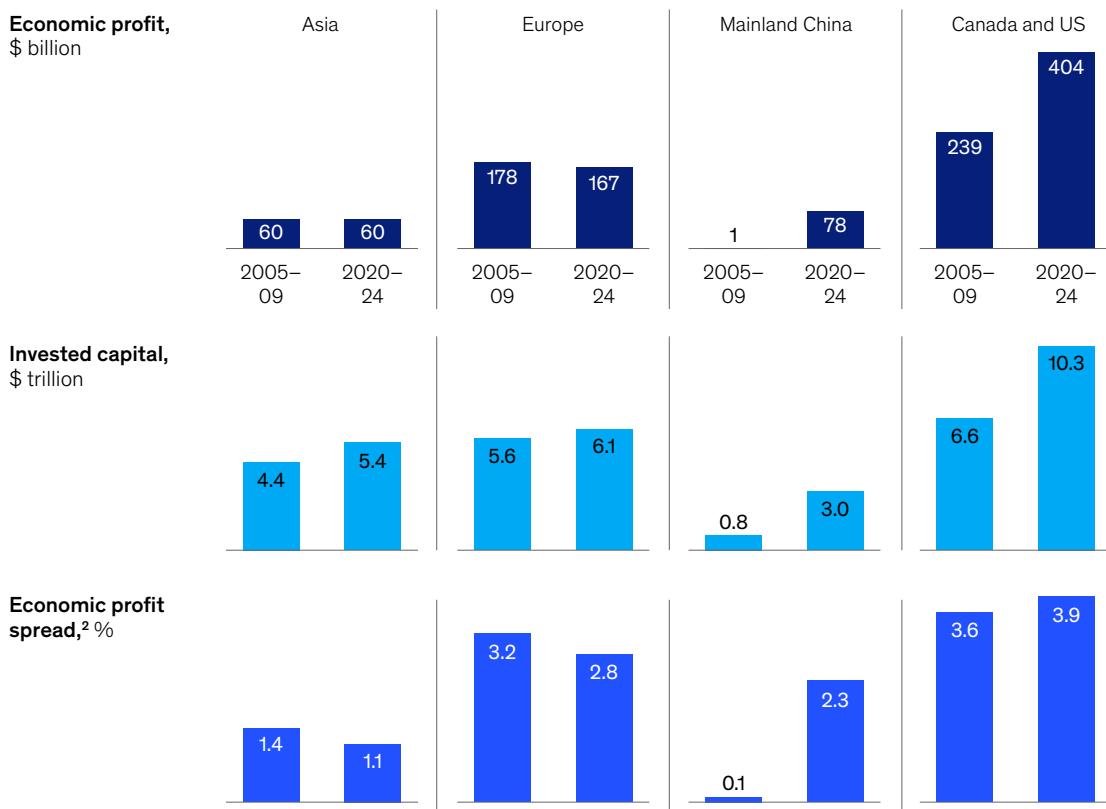
Regional trends

If we put the Magnificent Seven companies and the cyclical energy and materials sector to the side for a moment, we can get a more nuanced picture of the amount of value global companies created above the cost of capital. For instance, in our review of economic profit expansion in four of the world's largest regions—excluding Africa, Latin America, and the Middle East—we see that economic profit in North America grew 165 percent, from \$239 billion to \$404 billion, between 2005–09 and 2020–24. The region experienced a 55 percent increase in invested capital, likely because of its relatively high net profitability, or economic spread,³ compared with Asia, Europe, and mainland China (Exhibit 4).

Exhibit 4

North American companies realized growth in economic profit, invested capital, and economic profit spread from 2020 to 2024.

Financial trends, by region¹



¹Excluding Africa, Latin America, and Middle East; “Magnificent Seven” companies; and businesses in energy and materials sectors.

²ROIC minus weighted average cost of capital.

Source: McKinsey Value Intelligence

³ “Economic spread” is defined as the ROIC minus the weighted average cost of capital.

This growth in economic profit in North America was primarily propelled by activity in consumer goods (\$62 billion), pharmaceuticals and medical products (\$47 billion), and industrials (\$20 billion).

Meanwhile, mainland China, excluding its energy and materials sector, contributed \$77 billion in annual economic profit to the world over the past 15 years. Growth in economic profit was created by consumer products (\$47 billion), technology and media (\$21 billion), and pharmaceuticals and medical products (\$10 billion). Invested capital in this part of the world almost quadrupled to about \$3 trillion, but what really drove the increase in economic profit was the corresponding increase in profitability: The economic profit spread, or the difference between ROIC and the cost of capital, is now at 2.3 percent after being close to zero in earlier years.

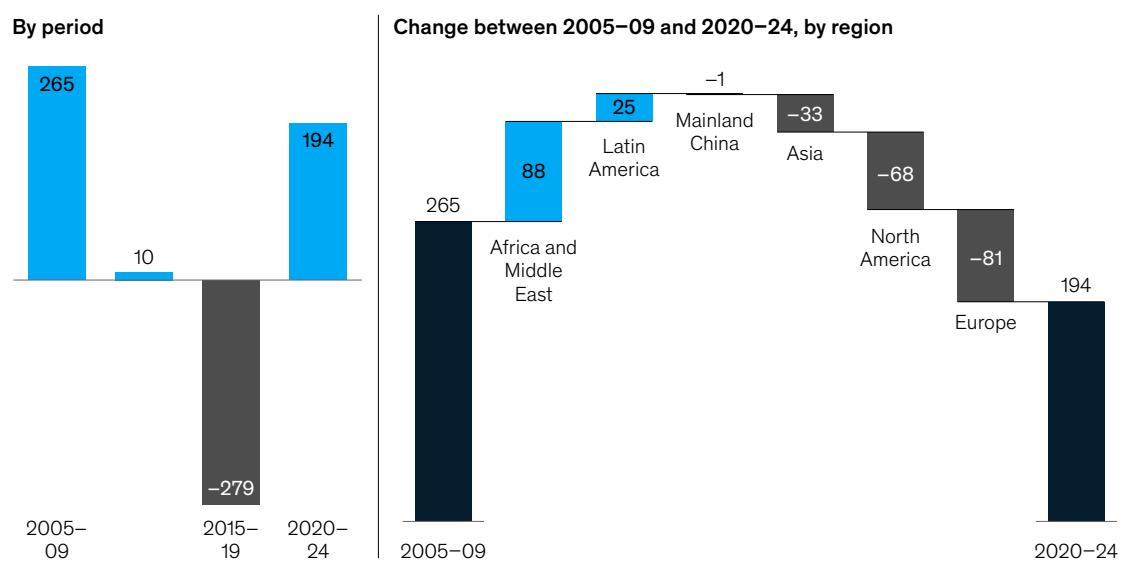
Industry performance

Of course, not everyone contributed evenly to the global rebound in economic profit. We set it aside earlier, but one sector that warrants special attention because of its price-driven volatility is energy and materials. It experienced an overall decrease of \$71 billion in economic profit between 2005–09 and 2020–24, though we did observe a rebound from much lower lows between 2015 and 2019. The most significant drops were in Asia (−\$33 billion), Europe (−\$81 billion), and North America (−\$68 billion). Of course, these were offset by substantial increases in economic profit in Latin America (\$25 billion) and the Middle East (\$88 billion) (Exhibit 5).

Exhibit 5

Aggregate economic profit in the energy and materials sectors rebounded from cyclical lows and shifted among regions.

Global economic profit from energy and materials sectors, \$ billion (2023 prices)



Note: Figures do not sum, because of rounding.
Source: McKinsey Value Intelligence



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At a regional level, net profitability declined over the past 15 years in Africa, Asia, Europe, and the Middle East. As a result, the amount of invested capital grew more slowly in those places than in mainland China and North America. At an industry level, there was considerable growth in economic profit among Asian industrials, European industrials, and European consumer companies, but some erosion among European and Asian telcos.

Economic profit has seemingly recovered from a financial crisis, a global pandemic, and other macroeconomic shocks and increased to new heights. Within this recovery, we are seeing profound shifts in profit pools: North America is playing a dominant role in the rebound, accounting for 86 percent of the growth in economic profit over the past five years. China has turned around its performance, and energy and materials companies in Africa, Latin America, and the Middle East are blossoming. The rest of Asia is on a slower trajectory, and Europe is in decline.

Whether or not the rebound in economic profit takes hold for the longer term will depend on several factors, including whether the Magnificent Seven can continue to outperform as well as the trajectory of capital growth and profitability in Europe, mainland China, and North America. Particularly in Europe, business and government leaders will need to find ways to [circumvent or remove barriers to investment](#) that are preventing growth—chief among them, higher energy costs (given European countries' heavy reliance on imports), country-specific business and labor regulations, and exposure to global geopolitical risk.⁴

What's clear is that global leaders should continue to pursue strategies that allow their organizations to create value above cost of capital—for instance, allocating resources toward energy capacity, transition, and innovation; creating conditions for growth (scaling flagship products or companies); rethinking executive compensation; or controlling the growth of goodwill and intangible capital on corporate balance sheets.

Regardless of the path, leaders should start the journey toward increased economic profit now.

Marc de Jong is a senior partner in McKinsey's Amsterdam office, and **Peter Stumpner** is a partner in the New York office.

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⁴ ["Investment: Taking the pulse of European competitiveness,"](#) McKinsey Global Institute, June 20, 2024.



How Nestlé's CFO sharpens focus across a global portfolio

The focus involved in decision-making in running a company this size is hard to overstate—the sheer number of markets, categories, and channels can be overwhelming. Previously, Nestlé tended to deploy resources according to the law of averages, which lacks granularity. Once you bring greater granularity to your decision-making, the question is, where should we invest disproportionately to build a winning business for the future? And then, which areas are underperforming so significantly that we need to be performance-managing against them? Focusing the executive board on around 20 top- and 20 bottom-performing areas is both a signal to the organization that we're thinking about things differently and a template for the regions and countries to use as they drive focus.”

—Anna Manz, CFO and executive vice president, Nestlé



Manz shared these and other insights with McKinsey Senior Partner [Michael Birshan](#). Scan this code to listen to or read the [complete interview](#) on McKinsey.com.

Closing Japan's
valuation gap
by
**changing
corporate
traditions**



Cultural and structural reform can help Japanese companies realize their full potential.

by *Daisuke Nozaki, Tim Koller, and Yohan Kochi with Prateek Gakhar*



Investors and companies have long perceived Japan's equity markets, where multiples consistently trail those of other developed markets, to be undervalued. Nearly 40 percent of the top 2,000 Japanese companies by market cap have price-to-book ratios below one, compared with just 10 percent of the US cohort, according to our analysis.

This disparity is partly a function of market composition: US indexes are dominated by high-growth sectors, such as technology and software, and Japanese indexes have a higher concentration of traditional industrial companies. Such a concentration inherently limits the Japanese market's growth potential and valuation multiples.

But much of Japan's lower valuation is due to companies underperforming their global peers in key financial metrics. The lag reflects structural and cultural legacies, including conservative capital allocation, entrenched cross-shareholdings, inefficient manufacturing, rigid labor practices, and governance that prioritizes stability over returns. These factors have weighed on Japanese companies' efficiency, growth, and valuations.

After decades of caution, there's now a stronger climate for reform in Japan. Regulators have introduced new governance standards, and investors are pressuring companies to improve returns, reduce cross-shareholdings, and put excess cash to work. Japanese companies have become more receptive to private equity buyouts, fueling a record pace of take-private transactions.¹

At the same time, cultural norms are beginning to shift, prompting companies to experiment with adjusting compensation practices, bringing more independence to boards, and offering voluntary retirement. Together, these forces are creating an opening to address the structural and cultural legacies behind Japan's chronic undervaluation.

This article provides data that illuminates Japanese companies' underperformance. It then describes five aspects of Japanese corporate culture that have historically contributed to lower valuations, notes recent shifts, and suggests how companies can continue pushing for improvement. The final section examines how regional peers with some commonalities have been able to effect change.

¹ Anton Bridge and Miho Uranaka, "From vultures to defenders, Japan private equity deals head for record year," Reuters, August 27, 2025.

Japanese companies' performance helps account for lower valuations

Japanese companies' comparatively low valuations largely reflect underlying financial performance, with returns on equity well below those of their global peers (Exhibit 1).

On average, Japanese companies generate returns on invested capital of about 8 percent, compared with 21 percent for US companies and 15 percent for European ones. Their EBITA margins, at roughly 8 percent, also trail the 15 and 13 percent averages seen in the United States and Europe, respectively. This combination of lower profitability and less-efficient use of capital has kept Japanese companies' returns on equity well below those of their counterparts in other markets (Exhibit 2).

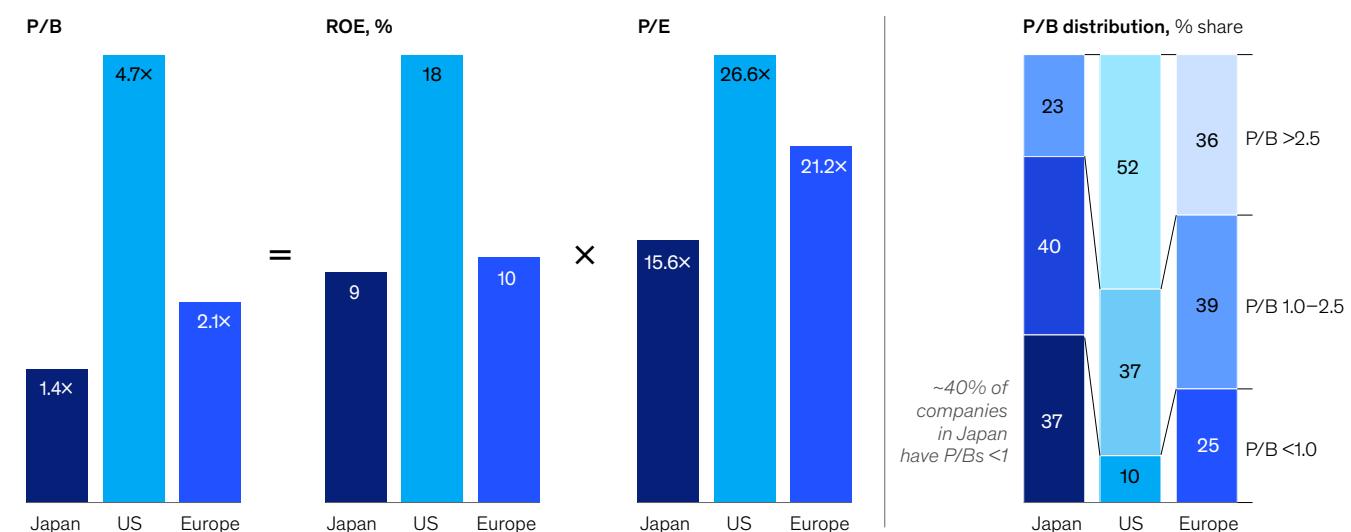
What holds Japanese companies back and how they can improve

Many of the practices that weigh on Japanese companies today were established in response to past crises. In the post–World War II decades, systems such as cross-shareholdings and lifetime employment helped stabilize industries, preserve jobs, and protect companies from outside pressure. Later, the crashes of the 1990s produced a new wave of defensive behavior—most notably, the accumulation of large cash reserves.

Exhibit 1

Japanese companies' low valuations are largely driven by lower returns on equity.

Drivers of price-to-book ratio (P/B)¹

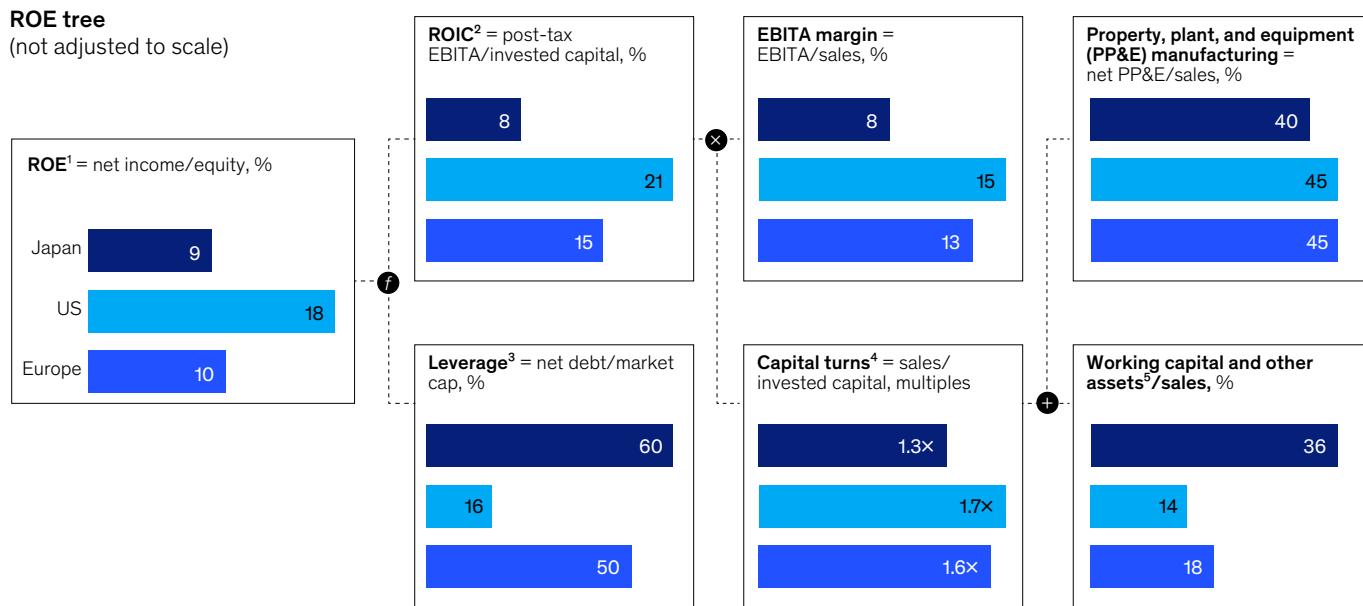


Note: This exhibit is based on the authors' analysis of the top 2,000 European, Japanese, and US companies by market cap. Figures may not sum to 100%, because of rounding.

¹P/B is calculated as cumulative market cap divided by equity. ROE is calculated as cumulative net income divided by equity. P/E is based on P/B and ROE. Market cap is as of July 31, 2025, and common equity is as of FY 2024.

Source: Bloomberg; company filings; S&P Capital IQ

Exhibit 2

Lower return on equity is a combination of lower margins and less capital efficiency.

Note: Sample is based on top 2,000 European, Japanese, and US companies by market cap.

¹Based on cumulative net income divided by cumulative equity. ²Excludes goodwill and intangibles; based on average invested capital. ³Net debt divided by current market cap. ⁴Based on sales divided by average invested capital excluding goodwill and other intangibles. ⁵Core working capital (receivables plus inventory minus payables) plus other operating assets net of liabilities.

Source: Bloomberg; company filings; S&P Capital IQ

While these practices were understandable in their times, they have persisted long after the original shocks and now constrain efficiency, profitability, and valuations. The problems themselves suggest corrections, some of which have recently begun but need further acceleration.

Cash hoarding: Trauma after the bubble and inefficient capital allocation

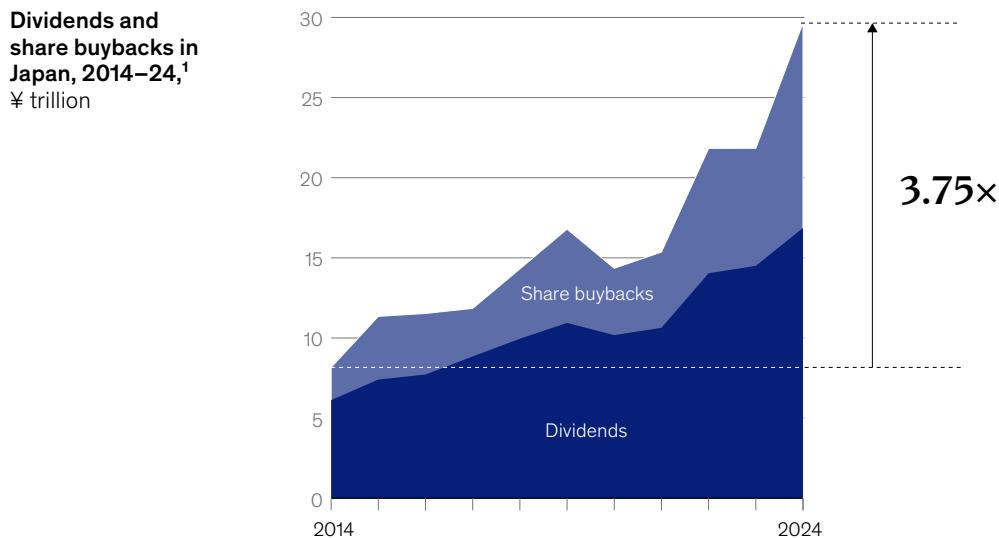
After the stock market and real estate crashes of the 1990s, many Japanese companies became devoted to “fortress balance sheets.” Company leaders saw holding large cash positions as protection against banking crises, deflation, and shareholder pressure.

This conservative financial posture persists to this day. According to our proprietary analysis, Japanese nonfinancial corporate companies today hold over \$1 trillion in cash (the highest ratio of cash to market cap among developed markets). Many companies still hold 15 to 25 percent of their assets in cash or cash equivalents. However, rising activist investor pressure over the past three to five years has started to change this pattern, and Japanese companies have substantially stepped up shareholder distributions (Exhibit 3).²

² For more, see “Japan’s share buybacks nearly triple as governance push gains pace,” *Financial Times*, April 30, 2025, and Kosaku Narioka, “Nissan becomes activist investor’s next prestigious Japanese target,” *Wall Street Journal*, November 15, 2024.

Exhibit 3

Japanese companies' shareholder distributions have more than tripled over the past decade.



¹Shows cumulative data for top 2,000 Japanese companies by market cap (as of July 31, 2025).
Source: Bloomberg; company filings; S&P Capital IQ

To address the performance constraints created by large cash balances, [Japanese companies can consider several options](#). These include returning more to shareholders through dividends or buybacks, redeploying capital into higher-growth opportunities, and streamlining portfolios by exiting underperforming businesses. Companies can consider taking bigger bets, including investing in innovation, new growth verticals, and adjacencies with higher return potential, even if it means a few quarters of underperformance relative to stock market expectations. Such moves could enhance capital efficiency, strengthen competitiveness, and help reduce the valuation discount.

Circular ownership: Cross-shareholdings and keiretsu structures

In Japan, many companies within a group hold equity stakes in one another, often cemented through long-term banking, customer, and supplier relationships. These networks, or keiretsu, are corporate groups in which banks, manufacturers, and suppliers maintain reciprocal shareholdings to reinforce stability and protect against hostile takeovers.

These traditional arrangements have tied up considerable capital in assets that generate poor returns and weaken governance, as shareholders in a network rarely push for efficiency or restructuring. According to recent data, cross-shareholdings account for roughly 25 percent of the Tokyo Stock Exchange's market cap, down from roughly 60 percent in 1990.³

³ "The era of disappearing shares," Nomura, May 2025.

To continue moving beyond the constraints of cross-shareholdings, Japanese companies can undertake rigorous, data-driven assessments of each business unit to identify underperforming segments and then redeploy capital. They can consider gradually unwinding reciprocal stakes and [reallocating capital to higher-return uses](#). Reducing circular ownership would not only free up resources but also strengthen governance by giving boards and investors greater ability to hold management teams accountable. Over time, loosening these legacy ties could help improve efficiency.

Overcapacity: A legacy of export-led industrial expansion

After World War II, Japan's "economic miracle" was driven by export-led manufacturing, mainly of automobiles, consumer electronics, shipbuilding, and steel. Scale and output were national priorities. By the 1980s, Japan had become the global leader in many heavy industries.

However, after the asset bubble burst in the early 1990s, domestic demand stagnated and global competition—primarily from the South Korea and Taiwan markets, and later from the China market—intensified.⁴ But unlike Western counterparts, Japanese companies were reluctant to restructure by scaling down production capacity. Instead, influenced by government pressure to preserve jobs and by industrial policy priorities, firms often kept extensive manufacturing networks intact. This has left many industries fragmented with too many players and excess capacity, limiting scale efficiencies and keeping margins low.

To address the challenges of overcapacity and fragmentation, Japanese companies can consider consolidating and streamlining their production networks. Steps such as optimizing manufacturing footprints, exiting noncore businesses, and aligning capacity more closely with demand could help improve efficiency and restore profitability. By reducing fragmentation, Japanese firms would be [better positioned to compete globally](#) in industries that have grown more concentrated elsewhere.

Labor rigidity: Lifetime employment and its costs

Most large Japanese companies ascribe to the concept of *shūshin koyō*, or lifetime employment. Layoffs are culturally unacceptable, and corporate headquarters are often bloated with administrative staff. This custom has left many firms with SG&A expenses well above those of leaner advanced-economy peers, according to our analysis.

A persistently high full-time-employee base limits cost flexibility and keeps productivity lower than in the United States and Europe.⁵ Compensation tied more to tenure than performance further reduces efficiency and discourages stronger incentives for output. Together, these factors weigh on profitability and market valuations.

There are early signs of change.⁶ Several large companies have introduced voluntary early retirement programs and are beginning to change compensation practices. Shifting toward performance-based systems and gradually reducing workforce rigidity can help Japanese firms rightsize their workforces. By [matching workforces with strategic priorities](#), companies can introduce greater organizational flexibility and reduce costs.

⁴ For more, see "Life after the bubble: How Japan lost a decade," *New York Times*, October 18, 2008.

⁵ For more, see Yukari Kuramoto, Shojiro Uegaki, and Ryota Inayoshi, *Why is Japan sales productivity so low?*, McKinsey, February 2021.

⁶ For more, see Megumi Fujikawa, "Japanese workers call it quits on a firm tradition: The job for life," *Wall Street Journal*, April 11, 2018.

Weaker governance: Prioritizing stability over shareholder returns

Traditionally, Japanese corporate boards were dominated by company veterans and individuals with limited business management experience, such as former bureaucrats, lawyers, and accountants. Boards prioritized employment harmony, security, and stability over delivering shareholder returns, meaning that CEOs were rarely removed for underperformance.

This governance model insulated management teams from accountability and discouraged bold decision-making. With little external pressure, companies often avoided restructuring, tolerated inefficiency, and allowed underperforming assets to remain in place.

Reforms have begun to change the landscape. In 2014, Japan's Stewardship Code encouraged institutional investors to engage with companies on governance and capital efficiency, and the 2015 Corporate Governance Code required listed firms to appoint independent outside directors and emphasized improving capital efficiency.⁷ Still, cultural change has been slow, with many boards continuing to treat governance as a compliance exercise rather than as a way to improve performance.

Companies can consider empowering boards to play an active role in strategic and capital allocation decisions. Boards can implement performance-linked evaluations and succession-planning frameworks to increase executive accountability. They can also align executive compensation with shareholder outcomes to encourage long-term, value-creating decisions.

Regional counterparts demonstrate that change is possible

The perceived undervaluation phenomenon isn't unique to Japan. We see similar dynamics in the South Korea and Taiwan markets, where underlying operational performance and modest growth expectations have long kept valuation multiples below those of global peers.

Japanese companies can consider empowering boards to play an active role in strategic and capital allocation decisions.

⁷ For more, see Morikawa Masayuki, "Outside directors, firm behaviour, and performance: Evidence from a quasi-natural experiment in Japan," VoxEU, February 27, 2020, and Una Galani and Anshuman Daga, "Japan's value push will turn into a shove," Reuters, May 15, 2024.



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The South Korea market, historically dominated by large conglomerates and export-led industries, faced many of the same structural challenges as the Japan market. South Korean companies have responded with governance reforms, streamlined holding structures, digital transformation, and stronger shareholder returns through dividends and buybacks.⁸

Taiwan offers another example. Its economy, shaped by technology and global supply chains, has demonstrated how innovation and international integration can enhance capital productivity and shift investor perceptions.⁹

Together, these regional peers show that [sustained reform and modernization](#) can turn undervaluation into opportunity. Japanese companies can draw on lessons from both markets, adapting approaches to their own cultural and organizational contexts while moving toward global standards of performance and governance.

A convergence of regulatory shifts, investor activism, record-high private equity activity, and global competition represents an opportunity for Japanese companies to reset their value creation agendas. Companies that embrace operational rigor, sharpen capital discipline, and reform governance structures will be better positioned to attract long-term capital, boost valuation multiples, and create sustainable shareholder returns.

Incrementalism won't unlock value in Japan. Instead, bold, decisive action is needed across multiple dimensions of the country's businesses.

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The authors wish to thank Ravi Kant for his contributions to this article.

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⁸ For more, see Morikawa Masayuki, "Outside directors, firm behaviour, and performance: Evidence from a quasi-natural experiment in Japan," VoxEU, February 27, 2020, and Una Galani and Anshuman Daga, "Japan's value push will turn into a shove," Reuters, May 15, 2024.

⁹ Ibid.

How CEOs can play the long game

FCLTGlobal's Sarah Keohane Williamson discusses the importance of resisting "short termism."



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arah Keohane Williamson is the CEO of FCLTGlobal, a nonprofit coalition of global pension funds, sovereign wealth funds, asset managers, private equity firms, and major corporations that champions long-term capital allocation across the investment ecosystem. In her new book, *The CEO's Guide to the Investment Galaxy* (Wiley, September 2025), Williamson draws on her extensive experience and research to demystify today's diverse investment community landscape. She offers CEOs and business leaders actionable strategies to understand different investor motivations, resist short-term pressures, and align capital decisions with long-term growth.

In a conversation with McKinsey's Tim Koller, Williamson discusses her new book, her leadership of FCLTGlobal, and her mission to foster long-term thinking in both investors and companies. The conversation has been edited for length and clarity.

Tim Koller: Thanks for speaking with us and congratulations on your new book. What prompted you to write it?

Sarah Williamson: For roughly the last decade, at FCLTGlobal, we have been working on the connections between investors and companies. One of the things we've learned is that company leaders and investors have different time frames, different incentives, and sometimes even different languages. In short, there's often a disconnect between investors and companies.

Let's say you're the CEO of a company. Perhaps you came up specializing in a particular area of the business, or maybe running a big division, and then took over the company. Now, all of a sudden, it's time to deal with the investment community. But it's not clear who's who.

Companies and investors need to understand each other, but most investment books are just written for the investors. This book is an investment book that's written for businesspeople.

Tim Koller: What are the most important misconceptions or deficits of understanding that you see among CEOs about the investment community?

Sarah Williamson: The most important one is that CEOs tend to believe their shareholders are "on their team" and that they want their company to succeed over time. Unfortunately, it's not quite that simple.

Some shareholders are retail shareholders, and so they probably are on the company's team, in that they just want to see the stock go up. But then there are index managers, who tend to own shares in a majority of companies. They might want the company to do well, but they might want their competitors to do well, too. And then there are active managers. If they're overweight, maybe they really do want the company to succeed. But maybe they're underweight, which means they don't want the company to succeed. These are the sort of things that drive CEOs crazy because it's unclear who's really rooting for them and who's not.

Tim Koller: Should CEOs and CFOs strive to figure out [which investors are on their team](#)?

Sarah Williamson: Absolutely, and then they should spend the time with ones who either are or could be on their team. Investors play very different roles in the market, and they can influence companies in different ways.

Tim Koller: I love the title of chapter two in your book, “Building great companies with short-term investors is a challenging mission.” How do companies overcome the fact that they are going to have a lot of short-term investors in their stock?

Sarah Williamson: The first step is encouraging long-term investors. The second is not playing into the hands of the short-term ones. The latter requires the classic things: Don’t give quarterly guidance, don’t do the things that really attract short-term investors, which is, of course, because they’re trading. The other thing is, frankly, don’t listen to them.

What matters to the real economy is not so much the stock price or its volatility. It’s how management reacts to it. And I know it’s easy for me to say, but CEOs need to not react to volatility in their stock. The volatility could be the result of a hedge fund trade or someone trading a factor. These investors are trading not because of a worry about the company itself but because of what it represents in a portfolio.

If the CEO responds by saying, “We need to cut our marketing,” or “We need to cut our R&D,” that creates a problem. It’s the classic issue of separating the signal from the noise. If it’s short-term trading around news, factors, or something else, that’s noise.

Tim Koller: That sounds like it puts some burden on [the investor relations team](#) to figure out what’s going on so that they can educate the CEO. Is that something you would support?

Sarah Williamson: That’s right. Here’s how I think about it: If you ask almost any CEO what their customer strategy is, they would have a really good answer for you. There is the same need for an investor strategy. Which investors do you want to have, and therefore which investors are you going after? Which investors do you care about? Which investors do you spend time with?

There’s a tendency to say, “The market wants this, or the market wants that.” But “the market” is not all one thing. It’s important to look under the hood and ask, “Who do we care about?”

It’s also important to be very careful about the sell side. You have to remember that the sell side is, by definition, not a shareholder. When I hear, “Our investors think such and such,” I ask: “Are you talking about an investor or a sell-side analyst?” The book refers to sell-side analysts as

‘What matters to the real economy is not so much the stock price or its volatility. It’s how management reacts to it.’



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weather forecasters, which is not meant to be derogatory. Weather forecasters take in all the available data and try to predict the future. That's what the sell side does. But they're not shareholders, and every company, every CEO, every board has a fiduciary duty to their shareholders. They do not have a fiduciary duty to the sell side or the financial press.

Tim Koller: If you're the CEO, how do you get the board to support [focusing on long-term fundamentals](#) and not on what the press and the sell-side analysts are saying? Have you seen people do that effectively?

Sarah Williamson: Some people do it very effectively, and the primary way they do it is they have a long-term road map. They try to control the narrative rather than being responsive. They know what their strategy over the next several years is, and they communicate it.

They repeat it in the sell-side meetings, with the shareholders, and with the board. Sometimes, CEOs are hesitant to broadcast their long-term plans because they think that something might change. I always say that they're better off setting a long-term plan and then explaining that there was a change due to a big event, such as COVID-19 or a geopolitical issue. An investor will understand that the plan needs to change in response. What they won't understand is an opaque, black box.

Tim Koller: Do you have any advice for how a CEO should go about [identifying the right investors or attracting investors](#) they don't have right now?

Sarah Williamson: The first question is, who really owns the stock? And then, who are the investors you wish owned your stock? If one of the big, long-term institutional investors owns it and another one doesn't, well, why not? You want to go talk to them. There are also investors who may not be household names, but it's not too hard to figure out who they are.

It's extremely important to talk to the people who actually make the buy and sell decisions. Though the sell side is important in terms of the press, it's not as important as it used to be in terms of who's making buy and sell decisions. Those are portfolio managers, who are very important because they're knowledgeable. As a general rule, the ones who start with an index and over- or underweight are making decisions at the margins. Whereas the ones who start with a blank piece of paper and build a portfolio—like a Warren Buffett, for example—would be much more knowledgeable about a company.

Tim Koller: How should the CEO and maybe the CFO spend their time with investors?

Sarah Williamson: They have to follow the law of whatever country they're operating in—that's the baseline, of course. Then, they should spend their time asking interesting questions of the people who know their company and their competitors well.

It would be great to talk to boutique managers who are betting on the company for some reason. It would be helpful to learn why they are or aren't investing a certain way.

Tim Koller: You say in the book that [companies should not issue quarterly guidance](#). Can you elaborate on that and what they should do instead?

‘It’s very clear that companies should not issue quarterly guidance.’

Sarah Williamson: Right. It’s very clear that companies should not issue quarterly guidance. Over the last ten years, the fraction of US companies that do it has reduced from over a third to under a quarter, according to our analysis. Outside the US, it’s virtually unheard of.¹

The reason that guidance about future earnings is a detrimental practice is that if I say, “Next quarter, we’re going to earn \$1.27 to \$1.30,” and then it looks like we’re not, human nature makes company leaders think, “Uh-oh. I’ve promised that we’re going to do this, so I’m going to do something to make it happen.” Companies inevitably do something on the revenue or the cost side to hit the number. If they do that again and again, they’ve gotten themselves on this short-term track.

What they should do instead is have a long-term road map and then talk about how the quarter is a step on that path. Maybe they are hitting what “the street” says, and maybe they’re not. If the street says that the company is going to deliver \$1.27, that doesn’t create the same sense of obligation as if the CEO says it. If companies don’t do what the street says they’re going to do, that’s OK. But issuing quarterly guidance puts the burden on the companies and makes them more likely to do something reactive.

Now, in many places, there’s this roundabout pattern where the CFO or investor relations executive hints to the street that they’re going to hit a certain number. They give the street the numbers, but then they let them do the math themselves. And then the CFO puts those numbers in board presentations and says, “The consensus is such and such,” which, of course, the people making up the consensus received from the company itself. Then the company tries to hit that consensus.

It’s really quite nonsensical and a massive waste of time. There’s a common argument that delivering quarterly guidance lowers volatility, that if you tell them what the right number is, they’re more likely to get the number right, and therefore, there will be less volatility. It’s not true. Giving quarterly guidance actually increases volatility.

The best thing to do is to have a long-term road map—let the street say what they’re going to say, report the numbers as they are, and talk about what you’re trying to accomplish over time.

Tim Koller: What does FCLTGlobal do to encourage markets to [think and behave in more long-term ways](#)?

Sarah Williamson: We do three main things: build community, conduct research, and get the word out.

¹ EU rules require companies listed on EU-regulated stock exchanges to publish annual and half-yearly reports (quarterly reports aren’t mandated). In the United States, President Trump and others have advocated exploring twice-yearly reporting.

We have built a community of companies and investors that care about this. We create opportunities for investors, company leaders, and CEOs to talk to each other about these issues. We get people together, and sometimes that's when the light bulb goes on.

We do a lot of research. We try to make it very practical, things that people can just really get done. You can see our research on our website.

Last, we share our research and findings and get the word out about being long term. We talk about how it can be done.

We don't focus on policy recommendations, because we don't think there's a real policy solution here. The solution is to fix markets from the inside out.

Tim Koller: How would you assess the progress that you've made so far?

Sarah Williamson: I'm very confident in our diagnosis of the issues and what causes them. I would give us a good grade for understanding why "short termism" happens. But there is still work to do to change the system significantly. It's hard because the incentives are built for the short term.

So can we declare victory and go home? No, not yet.

Tim Koller: How can boards do a better job of picking CEOs who are more focused on the long term?

Sarah Williamson: Though I believe there are some things people are born with, a lot of people are driven by incentives. We've done a lot of work on CEO compensation and incentives, and I absolutely think boards can align incentives with long-term thinking. One of the recommendations we've made for some time is having CEOs who have stock that's locked up four or five years post their tenure.

Sarah Keohane Williamson is the CEO of FCLTGlobal and an alumna of McKinsey's Boston office. **Tim Koller** is a partner in the Denver office.

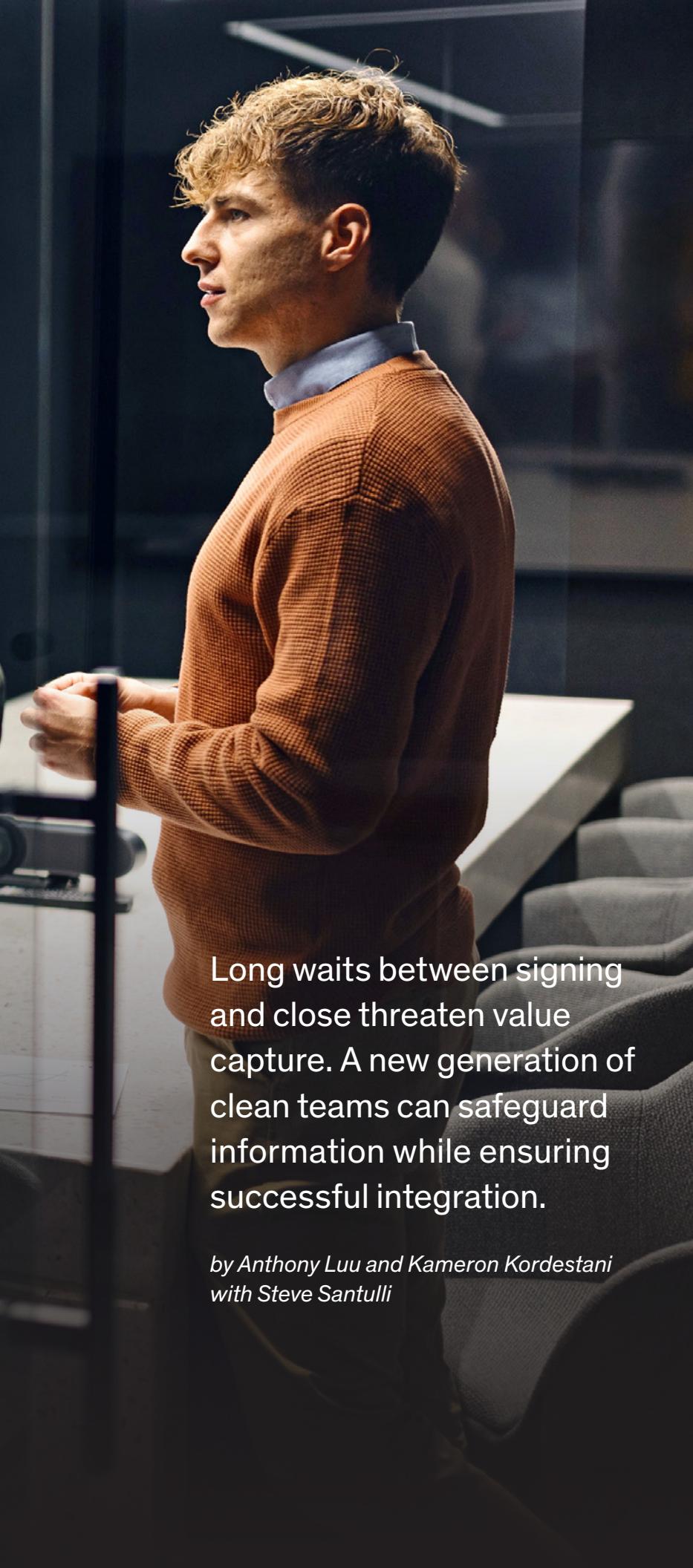
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Deal delays are
the new normal.

Clean teams
are the fix.



Long waits between signing and close threaten value capture. A new generation of clean teams can safeguard information while ensuring successful integration.

by Anthony Luu and Kameron Kordestani with Steve Santulli

Over the past two decades, the path from signing to closing an M&A deal has slowed. The median lag has stretched to about

6.4 months—a 25 percent increase compared with about 20 years ago. Nearly one in six transactions today requires over a year to close (compared with one in 20 in the early 2000s). Longer “sign to close” periods, often due to regulatory scrutiny, create more uncertainty, make it harder to retain talent, and slow momentum. Perhaps most important, long gaps complicate synergy capture, which can threaten deal value.

In this environment, clean teams—once considered a “nice to have” during integration—have become a necessity in many deals. In the past, clean teams were used primarily during due diligence to enable acquirers and targets to safely analyze competitively sensitive data and make decisions relating to valuation, terms, or whether to do the deal at all. Today, companies involved in M&A continue to use clean teams for due diligence, but they also use them to start critical synergy planning months ahead of deal close. Clean teams can help buyers and sellers prevent value leakage, prepare for day one readiness, and preserve momentum when it matters most (see sidebar, “What is a clean team? A refresher course”).

This article describes how M&A has changed in recent years and why clean teams have become more important. We share examples of companies that have used them successfully and review what clean teams do and how their role has evolved in the new M&A landscape. Finally, we distill the five best practices for making clean teams a source of accelerated value creation.

Longer delays between deal signing and closing

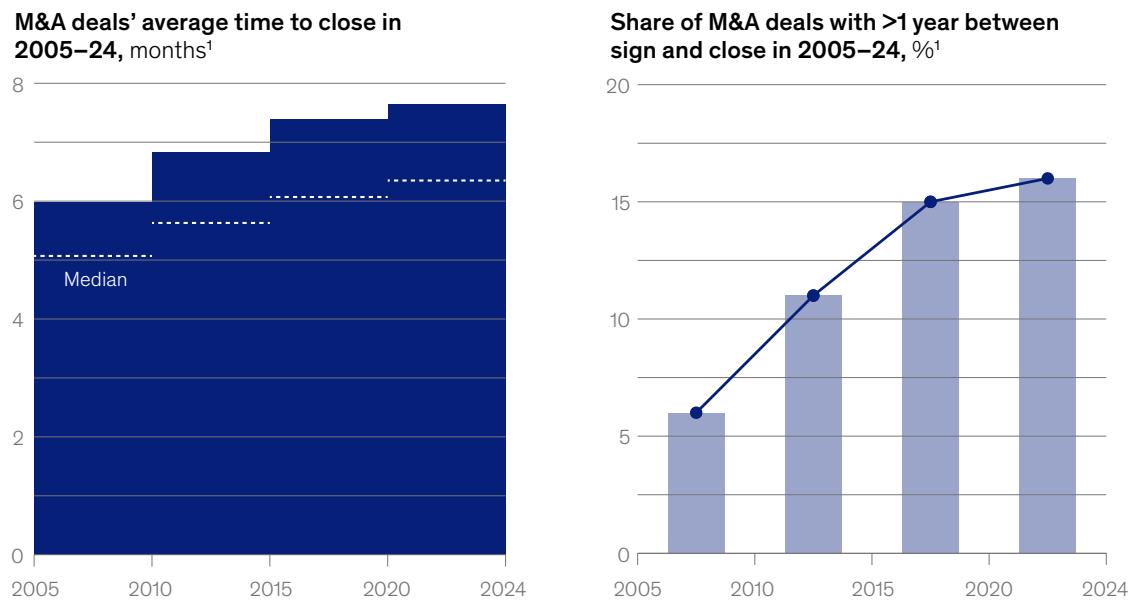
In most public M&A transactions, there is a gap between when a deal is signed and announced and when it can close. After signing, shareholders from both companies must approve the combination, and relevant regulatory authorities are given the opportunity to review the transaction for potential antitrust concerns. This gap, to be sure, is nothing new. But over the past two decades, the time between signing and closing has grown significantly (exhibit).

[McKinsey's research suggests regulatory scrutiny](#) is a primary cause of the growing lag across industries and geographies. Lengthy regulatory reviews in the United States and Europe, for example, increased by 50 percent between 2017 and 2022.

Broadcom's acquisition of VMware is a prime example of a significant regulatory delay. The deal, announced in May 2022,¹ faced intense examination in multiple jurisdictions, including China, the European Union, and the United States, due to concerns over competition in software and chip markets. Regulators ultimately approved the transaction, which closed in November 2023 after a roughly 18-month delay.²

Exhibit

The median time to close M&A deals rose by 25 percent from 2005 through 2024, with nearly three times as many taking longer than one year.



¹Analysis of 808 closed transactions (excl private equity buyers) >\$5 billion in Europe and US between Jan 1, 2005, and Dec 31, 2024.
Source: S&P Capital IQ, S&P Global Market Intelligence, accessed September 2025

¹ "Broadcom to acquire VMware for approximately \$61 billion in cash and stock," Broadcom press release, May 26, 2022.

² "Broadcom completes acquisition of VMware," Broadcom press release, November 22, 2023.

Going beyond due diligence

Today, amid extended deal timelines, clean teams have shifted from being optional—and often diligence focused—to being essential. Acquirers continue to utilize clean teams to analyze competitively sensitive data during due diligence to make more informed decisions about a potential acquisition's value, risks, and opportunities. Increasingly, however, they find ways to use this data to uncover synergies, mitigate risks, [ensure day one readiness](#), and accelerate integration.

An integration leader at a global packaging company in the midst of a merger with a complementary, cross-border player described how a clean team helped enable synergies. "Comprehensive and fast data collection, early stakeholder engagement, and detailed negotiation planning are enabling us to quickly exceed our total savings targets," the leader said.

The following two cases illustrate examples of how clean teams not only safeguard information but also enable better outcomes.

Utilizing a clean team resulted in a successful day one

An application software company acquired a complementary player and announced a \$100 million growth synergy target for the subsequent 12 months. The acquirer and the target worked together within the structure of a clean team for three months between signing and closing to develop a detailed cross-sell plan. The clean team identified specific target customers, crafted a joint value proposition, and prepared sales representatives with training and day one sales packages (including rules of engagement, joint value propositions, and other customer communications guidelines). On the day of closing, the newly combined sales organization launched its comprehensive cross-sell campaign, generating value almost immediately.

Had the companies waited until close to begin planning, synergy realization would have likely been delayed by at least three months, potentially costing the combined company millions of dollars in year-one value. Instead, the clean team allowed the new entity to get off to a running start.

A clean team is 'enabling us to quickly exceed our total savings targets,' said one integration leader.



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A clean team enabled preclose planning

Two distribution companies merged, and their more than 2,000 overlapping accounts comprised over 15 percent of their combined revenue. If the merged entity were to experience substantial customer attrition, the entire value of the transaction could have been wiped out.

The clean team helped the companies avert this possibility. Operating under strict legal compliance and using advanced analytics, the team matched customers, resolved issues relating to sales rep assignments, and designed new sales territories before the merger closed. This preclose planning allowed for smooth customer migration on day one and led to nearly 100 percent retention of the combined customer base.

Without a clean team, planning could not have been done until the transaction officially closed. The companies would have likely faced delays in resolving account overlaps and sales rep assignments, leading to confusion and dissatisfaction among internal teams and customers. The lack of preclose planning could have exacerbated revenue risks because the companies would have been unable to address pricing, discounting, and terms-and-conditions differences in a timely manner.

Clean teams can translate data findings into concrete integration actions

The following are some of the major areas that clean teams scrutinize and the steps they take to accelerate integration before the deal closes:

- Revenue:
 - Assess customer overlap to identify cross-sell opportunities and mitigate risk.
 - Streamline pricing and margins on exchangeable products to simplify offerings.
 - Harmonize loyalty programs to strengthen retention.
 - Transition and rightsize the selling organization to fit the combined company.
- Manufacturing:
 - Optimize production allocation by analyzing cost positions and utilization.
 - Review fixed and closure costs to potentially restructure sites.
 - Explore raw material substitution by assessing suppliers and costs.
- Procurement:
 - Review supplier lists, terms, and product-level prices to identify potential synergies.
 - Renegotiate or safeguard long-term supply contracts to balance value with continuity risk.
 - Analyze freight routes and rates, aiming to maximize transportation synergies.
 - Seek opportunities to reduce working capital.
- R&D:
 - To identify overlaps and synergies, standardize R&D project summaries to ensure an apples-to-apples comparison.
 - Evaluate large, near-term projects for strategic alignment with the new entity.
 - Assess organizational setups to inform consolidation opportunities.

Guidelines for setting up clean teams

Clean teams are evolving as regulations, data privacy, and technology advance. Increasingly, AI and automated data redaction can streamline clean-team analysis while reducing compliance risks. In heavily regulated or cross-border deals, clean teams are likely to expand their scope beyond competitive data to include personal and customer data, merging privacy compliance with integration planning.

As clean teams become increasingly critical to accelerate value capture and prevent value leakage, dealmakers have the opportunity to apply the following five best practices.

What is a clean team? A refresher course

A **clean team** is a neutral body that works under strict confidentiality policies to support companies during various stages of M&A transactions. For signed transactions, clean teams enable preclose collaborative synergy analysis and planning in areas deemed competitively sensitive and/or that have antitrust implications. This typically includes anything that, if shared, could hurt one party's ability to compete should the transaction not close, including customer information, pricing and profitability data, production costs, and utilization data.

A clean team typically consists of five to 15 people named by both the acquiring and target companies, with external advisers forming the backbone, and a small number of internal employees added for institutional knowledge. They work under a strict confidentiality framework developed by the parties' legal counsel.

The clean team can share and analyze detailed, competitively sensitive information. Once an aggregated view of this information has received legal clearance from both sides of the deal, it can be shared with leaders outside the clean team. This approach puts the parties in the best position to quantify opportunities and risks and [prepare postclose action plans](#) while awaiting approval from authorities and/or shareholders. It also allows companies to prepare stakeholders with information about the new entity, including customer communications plans and a compelling long-term growth story.

Review deal rationale and decide where a clean team can create the most value

In any M&A transaction, the strategic rationale of the deal should guide integration planning. This ensures that integration efforts are aligned with strategic objectives, tailored to the unique aspects of the deal, and focused on value creation. Clean teams are no different: The deal rationale should guide when and where clean teams should be used. If the deal rationale is predicated on substantial cost takeout or cross-sell, a clean team could be highly accretive. However, if the deal is intended to strengthen the talent and capabilities of the acquirer, or allow the acquirer to enter a new geography, a clean team may not be necessary.

For example, an industrial player expanding into a new geography through M&A considered using a clean team. A clean team could have accelerated certain aspects of preclose integration planning, such as by reviewing confidential supplier contracts to pinpoint potential scale leverage savings. But the primary objective of the transaction was to grow by establishing a foothold in a new, fast-growing market and gaining access to new customers. With limited cost synergy potential, the company concluded that the benefits of deploying a clean team were not worth the effort and risk.

Jointly develop a robust clean-team agreement, establish clear guidelines, and ensure strong process management

The clean-team agreement ensures a mutual understanding of what information can be shared, who can access it, and how it will be used and stored. This clarity helps prevent disputes, data leaks, or misunderstandings that could delay or derail the transaction. Further, deep collaboration on the details signals good faith, fostering trust between the parties. It also reassures regulators, board members, and stakeholders that the deal is being managed responsibly.

When possible, staff clean teams with personnel from both the acquiring and target companies, along with external consultants

Internal employees bring institutional knowledge that external advisers often lack. They understand, in nuanced detail, the company's products, processes, people, pricing structures, and systems, enabling more efficient and effective analyses and planning. Internal employees, including sales leaders, product managers, and financial planning and analysis (FP&A) heads, often have better insight into overlapping processes, can spot operational risks earlier, and can interpret sensitive data within the right business context.

However, if a proposed acquisition falls through, the situation for employees who were part of the clean team is governed by the agreements established beforehand and may also be subject to general employment laws. For example, employees who accessed competitively sensitive information while working on the clean team might be temporarily restricted from working in areas that directly compete with the counterparty or may be subject to other restrictions for a certain period. As such, decisions regarding which employees to staff to a clean team must be made thoughtfully and with contingency plans (for example, some clean-team members could take on new roles within the organization) should the deal fall through.

Rigorously deprioritize work that does not have to go through a clean team

While clean teams enable faster integration planning by allowing access to otherwise restricted data, working outside a clean team is more efficient. Any analysis and resulting findings developed within a clean team must typically be sanitized, aggregated, and evaluated by each

Deep collaboration on the details signals good faith, fostering trust between the parties.

party's legal counsel before it can be released to a joint steering committee. This process may require multiple iterations and take considerable time. Thus, it's critical to weigh the incremental impact of receiving sensitive data against the ease and efficiency of analysis.

For instance, assessing general and administrative (G&A) synergies outside of a clean team lets dealmakers directly access data and involve key experts—like the buyer's head of FP&A—without clean-team restrictions. This approach could limit access to competitively sensitive information, but such a level of granularity might not be required. In contrast, analyzing G&A synergies within a clean team could enable a more comprehensive assessment. However, because clean-team protocols require data sanitization, aggregation, and legal review, the process can be slow. Further, experts' clean-team involvement may limit their ability to support other aspects of the transaction.

Recognize that it's not just about numbers but also about preparing for action

Analyzing sensitive data through a clean team can often provide a higher level of fidelity than what might otherwise be available. However, the true advantage of utilizing clean teams during preclose integration planning is that it allows dealmakers to hit the ground running with value capture and other integration execution activities on day one. Speed is critical in synergy capture: [A deal is 2.6 times more likely to succeed](#) (and deliver 40 percent more total returns to shareholders) if synergy targets are met within the first two years postclose (as opposed to taking more than four years). Integration leaders can therefore guide their teams to use the clean team's data and insights to better prepare for postclose activities, rather than focusing narrowly on improving synergy or cost estimates.

As deal timelines lengthen, the ability to capture value quickly has never been more important. Clean teams, once a tactical option to improve due diligence, are more often a strategic necessity that accelerates value capture; by supporting integration planning, they can ensure day one success. For leaders navigating today's complex M&A landscape, investing in robust clean-team practices is one of the most effective ways to maximize deal outcomes.

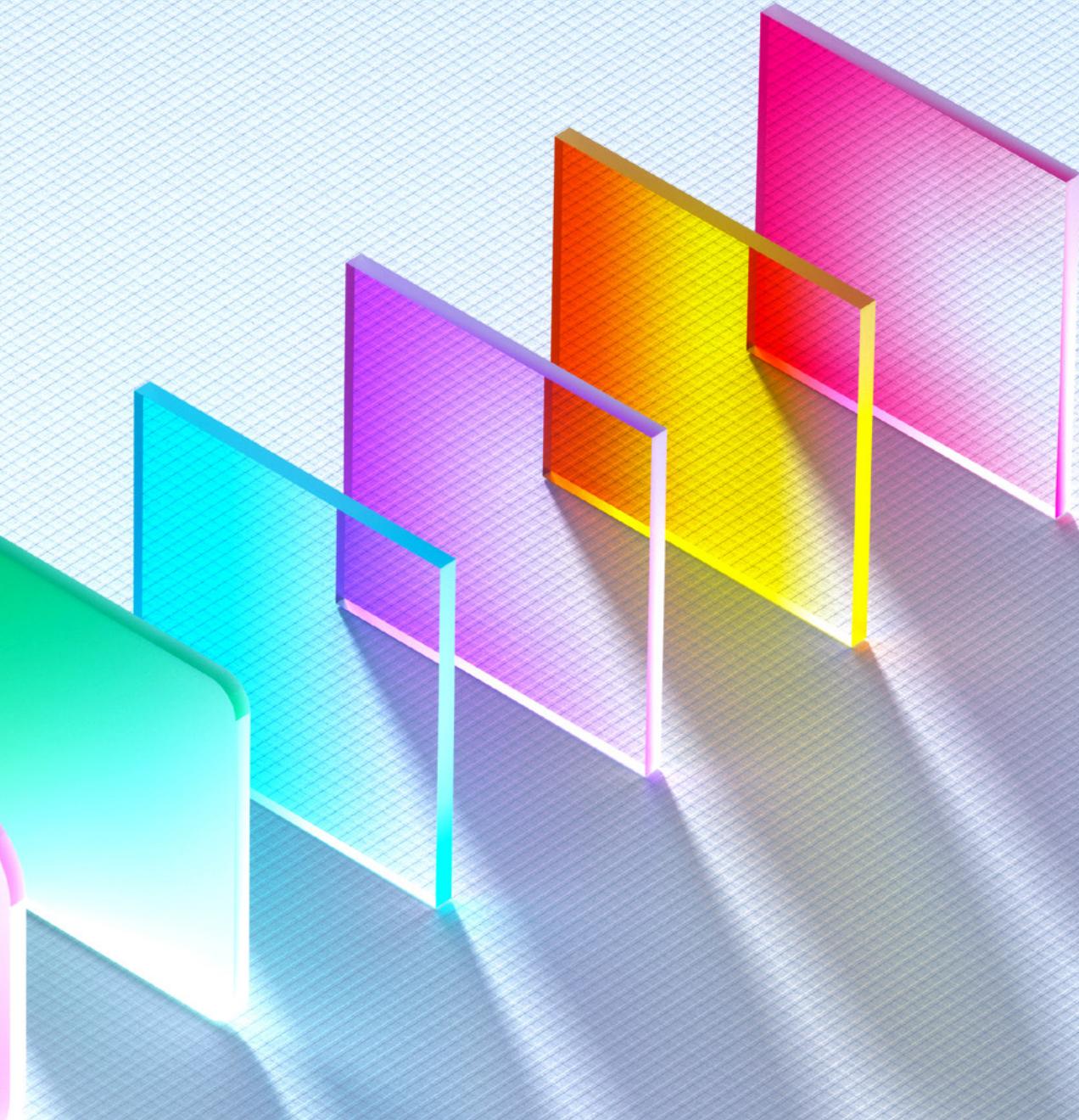
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The power of performance

What long-term intrinsic
investors really want
from companies





Strong communications with long-term investors may be enough to attract them. Evidence of active resource allocation, increasing market share, and transformation will keep them.

by Tim Koller with Prateek Gakhar

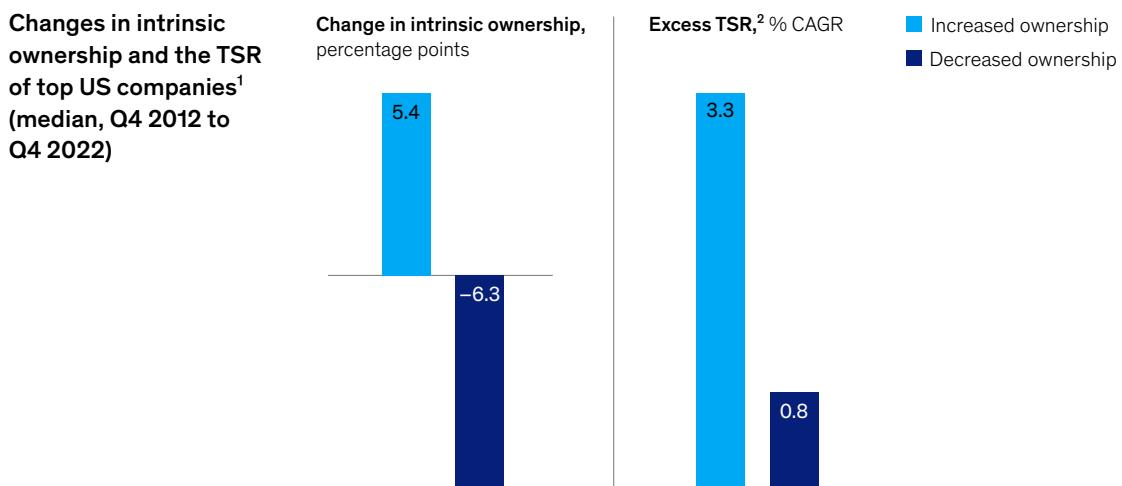
Most executives know that they need to [communicate early and often with long-term intrinsic investors](#). Compared with, for instance, mechanical investors and traders, intrinsic investors are paying closer attention to companies' performance metrics, potential to create value over the long term, and strategic decisions—and making their investment decisions accordingly. Long-term intrinsic investors are also the ones most likely to champion a company's prospects in the market, influencing other investor segments to follow suit. They are the ones who provide valuable guidance and feedback to management, and who will likely ride out volatility with a company.

We analyzed data for just over 320 of the largest US companies by market value and found that companies that experienced an increase in ownership by long-term intrinsic investors between 2012 and 2022 also saw an increase in TSR (Exhibit 1).

What's more, these US companies grew almost two percentage points faster than companies that experienced a decline in intrinsic-investor holdings did and improved their ROIC (excluding goodwill) by nearly three percentage points during the period studied (Exhibit 2). By contrast, the companies that experienced a decline in intrinsic-investor holdings between 2012 and 2022 showed considerably slower growth and saw little or no improvement in margins and ROIC.

Exhibit 1

Companies with increased intrinsic-investor ownership delivered higher excess TSR than companies with decreased ownership.



Note: "Increased ownership" means positive change in ownership >1%; "decreased ownership" means negative change in ownership >-1%. N = 321 S&P 500 companies, excluding real estate investment trusts, companies with inconsistencies in ownership data, and outliers in cyclical industries, including materials, energy, and utilities. Of that total, 88 companies experienced an increase in intrinsic ownership during the period studied, and 198 experienced a decrease.

*Excess TSR calculated relative to relevant sectoral indexes.

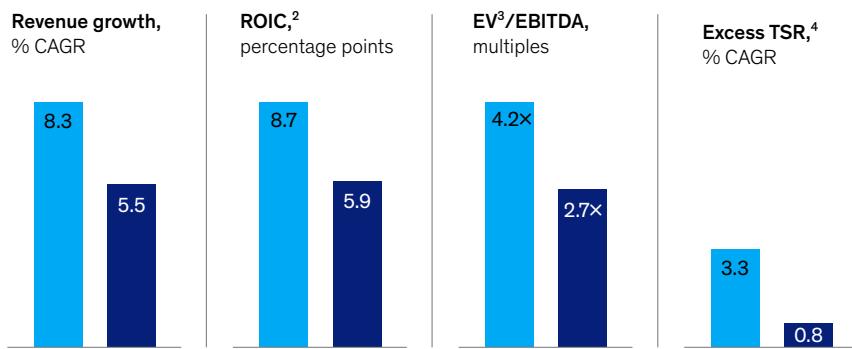
Source: S&P Capital IQ

Exhibit 2

Companies with rising intrinsic-investor stakes showed superior performance over a ten-year period.

Changes in intrinsic ownership and the fundamentals and TSR of top US companies,¹ (median, Q4 2012 to Q4 2022)

■ Increased ownership
■ Decreased ownership



Note: "Increased ownership" means positive change in ownership >1%; "decreased ownership" means negative change in ownership >-1%.
¹N = 321 S&P 500 companies, excluding real estate investment trusts, companies with inconsistencies in ownership data, and outliers in cyclical industries, including materials, energy, and utilities. Of that total, 88 companies experienced an increase in intrinsic ownership during the period studied, and 198 experienced a decrease. ²Represents net income margin, return on tangible equity, and price-to-book value multiple for banks and insurance companies. FY 2012 to FY 2022. ³Enterprise value. ⁴Excess TSR calculated relative to relevant sectoral indexes.

Source: S&P Capital IQ

Why did the long-term intrinsic investors reward certain companies over others? In short, it all came down to performance. The US companies that demonstrated *increased ownership by intrinsic investors* tended to fall into one of three categories:

- *Market share gainers*: These companies used commercial excellence (including doubling down on digital channels), geographic expansion, and product innovation, among other actions, to increase market share relative to competitors.
- *Active capital allocators*: These companies consistently and effectively allocated resources to grow business and operate more efficiently. One large industrial company, for instance, allocated a higher share of its cash flows to build its digital capabilities and technology stack over a decade, which ultimately allowed it to offer more innovative products to customers than its peers did and to solidify its competitive advantage.
- *Operational transformers*: These companies embarked on full-scale transformations and sustained that performance over time. In some cases, the transformation was triggered by an external factor (such as an activist investor campaign), while in other cases, leadership changes prompted operating changes.



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By contrast, the companies with *decreased intrinsic-investor ownership* fell into one of three categories:

- *Ineffective capital allocators*: Most of these companies made less-than-optimal allocation decisions, particularly in M&A and integration situations. They often couldn't realize deal synergies they had initially projected or overpaid for targets.
- *Growth decelerators*: Companies facing secular declines—for instance, those making and selling tobacco products—also tended to face meaningful declines in growth over time, making them less attractive to intrinsic investors.
- *Valuation outliers*: While many of the companies in this category delivered solid operational performance, their valuation levels appeared to discount most of the positives, prompting intrinsic investors to trim their holdings or completely exit.

Our analysis reveals a close connection between companies' focus on fundamental performance and long-term intrinsic investors' ownership. The lesson is clear: All companies get the investors they deserve. Focus on operating performance, and the right investors will follow over time.

Tim Koller is a partner in McKinsey's Denver office, and **Prateek Gakhar** is a senior knowledge expert in the Gurugram office.

The authors wish to thank Vrinda Vrinda for her contributions to this article.

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How to value cyclical companies



Scenario-based valuation
that accounts for multiple
potential cycles can yield
more accurate forecasts.

*by David Wessels and Tim Koller
with Marc Goedhart*

A

cyclical company is one whose earnings demonstrate a repeating pattern of significant increases and decreases. The earnings of cyclical companies, including those in the steel, mining, paper, and chemical industries, fluctuate because the prices of their products change dramatically as demand and/or supply varies. The companies themselves often create too much capacity. Volatile earnings within the cycle introduce additional complexity into the valuation of these cyclical companies. For example, historical performance must be assessed in the context of the cycle. A decline in recent performance does not necessarily indicate a long-term negative trend but rather may signal a shift to a different part of the cycle.

In this chapter excerpt from the eighth edition of our book, *Valuation: Measuring and Managing the Value of Companies* (Wiley, May 2025), we explore the valuation issues particular to cyclical companies.¹ This section of the chapter examines how the share prices of cyclical companies behave and suggests an approach for valuing them.

Cyclical companies' share price behavior

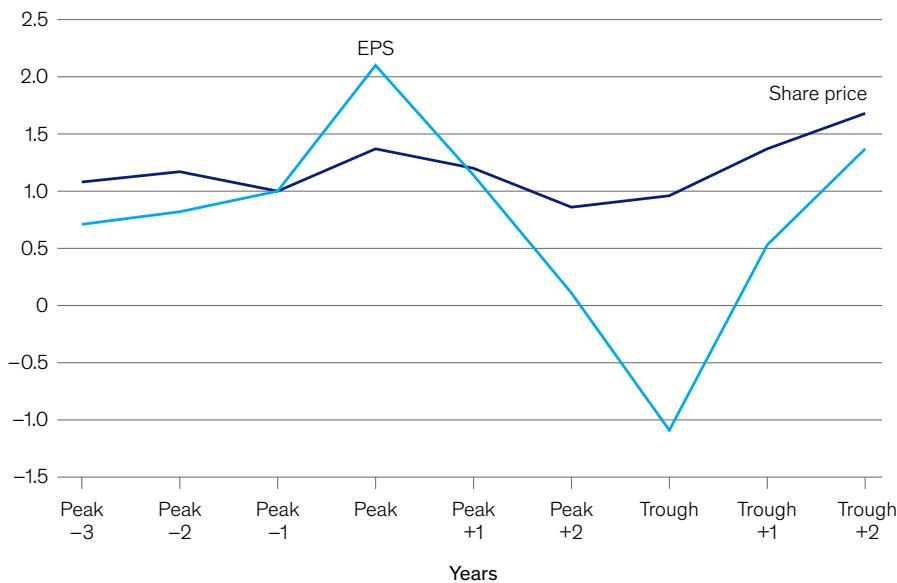
Suppose you were using the discounted-cash-flow (DCF) approach to value a cyclical company and had perfect foresight about the industry cycle. Would the company's value and earnings behave similarly? No. A succession of DCF values would exhibit much lower volatility than the earnings or cash flows. DCF reduces future expected cash flows to a single value. As a result, any single year is unimportant. For a cyclical company, the high cash flows cancel out the low cash flows. Only the long-term trend really matters.

Exhibit 1 shows the earnings per share (EPS) and share prices, both indexed, for 15 companies with a four-year cycle. The share prices are more volatile than the DCF approach would predict, which suggests that market prices exhibit the bias of anchoring on current earnings.

Consensus earnings forecasts for cyclical companies appeared to ignore cyclical entirely.

¹ Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, eighth edition, Wiley, May 2025. Marco de Heer contributed to book chapter 42, "Cyclical companies."

Exhibit 1

In cyclical industries, current earnings strongly influence share prices.**Average share prices and earnings per share of 15 cyclical companies, index (year prior to peak = 1.0)**Source: Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, eighth edition, Wiley, May 2025

What might explain this pattern? We examined equity analysts' consensus earnings forecasts for cyclical companies, looking for clues to these companies' volatile stock prices. Consensus earnings forecasts for cyclical companies appeared to ignore cyclicity entirely. The forecasts invariably showed an upward-sloping trend, whether the companies were at the peak or trough of the cycle.

What became apparent was not that the DCF model was inconsistent with the facts, but that the analysts' projections of earnings and cash flow were to blame (assuming the market followed the analysts' consensus). This conclusion was based on an analysis of 36 US cyclical companies during the period from 1985 to 1997. We divided them into groups with similar cycles (for example, three, four, or five years from peak to trough) and calculated scaled average earnings and earnings forecasts. We then compared actual earnings with consensus earnings forecasts over the cycle.²

²Note that we have already adjusted downward the normal positive bias of analyst forecasts to focus on just the cyclicity issue. For more, see Vijay Kumar Chopra, "Why so much error in analysts' earnings forecasts?", *Financial Analysts Journal*, 1998, Volume 64, Number 6.

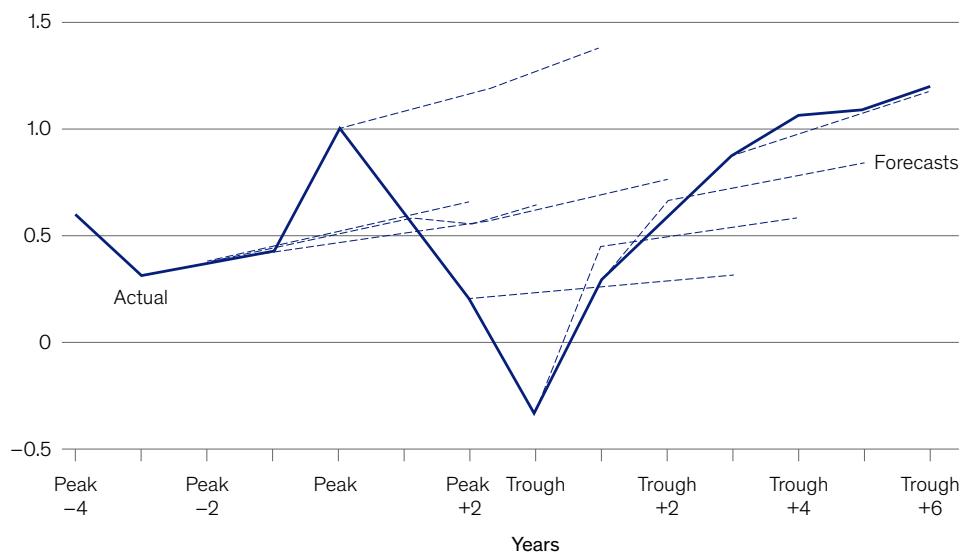
Exhibit 2 plots the actual earnings and consensus earnings forecasts for the set of 15 companies with four-year cycles in primary metals and manufacturing transportation equipment. The consensus forecasts do not predict the earnings cycle at all. In fact, except for the next-year forecasts in the years following the trough, the earnings per share are forecast to follow an upward-sloping path with no future variation.³

One explanation could be that equity analysts have incentives to avoid predicting the earnings cycle, particularly the down part. Academic research has shown that earnings forecasts have a positive bias that is sometimes attributed to the incentives facing equity analysts.⁴ Pessimistic earnings forecasts may damage relations between an analyst's employer and a particular company. In addition, companies that are the target of negative commentary might cut off an analyst's access to management. From this evidence, we could conclude that analysts as a group are unable or unwilling to predict the cycles for these companies. If the market followed analyst forecasts, that behavior could account for the high volatility of cyclical companies' share prices.

Exhibit 2

Consensus forecasts are consistently overly optimistic.

Actual earnings per share (EPS) and consensus EPS forecasts, 15 cyclical companies, \$



Source: Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, eighth edition, Wiley, May 2025

³Similar results were found for companies with three- and five-year cycles.

⁴For more, see Brett Trueman, "On the incentives for security analysts to revise their earnings forecasts," *Contemporary Accounting Research*, 1990, Volume 7, Number 1; Jennifer Francis and Donna Philbrick, "Analysts' decisions as products of a multi-task environment," *Journal of Accounting Research*, 1993, Volume 31, Number 2; K. Schipper, "Commentary on analysts' forecasts," *Accounting Horizons*, December 1991, Volume 5; and M. R. Clayman and R. A. Schwartz, "Falling in love again: Analysts' estimates and reality," *Financial Analysts Journal*, 1994, Volume 50, Number 5.

We know it is difficult to predict cycles, particularly their inflection points. So, it is unsurprising that the market does not get them exactly right. However, we would be surprised if the stock market entirely missed the cycle, as the analysis of consensus forecasts suggests. To address this issue, we returned to the question of how the market should behave. Should it be able to predict the cycle and therefore exhibit little share price volatility? That would probably be asking too much. At any point, the company or industry could break out of its cycle and move to one that is higher or lower.

Suppose you are valuing a company that seems to be at a peak in its earnings cycle. You will never have perfect foresight of the market cycle. Based on past cycles, you expect the industry to turn down soon. However, there are signs that the industry is about to break out of the old cycle. A reasonable valuation approach, therefore, would be to build two scenarios and weight their values. Suppose you assumed, with a 50 percent probability, that the cycle will follow the past and that the industry will turn down in the next year or so. The second scenario, also with a 50 percent probability, would be that the industry will break out of the cycle and follow a new long-term trend based on current improved performance. The value of the company would then be the weighted average of these two values.

We found evidence that this is, in fact, the way the market behaves. We valued the four-year cyclical companies three ways:

- with perfect foresight about the upcoming cycle
- with zero foresight, assuming current performance represents a point on a new long-term trend (essentially the consensus earnings forecast)
- with a 50-50 forecast: 50 percent perfect foresight and 50 percent zero foresight

Managers and investors can benefit from explicitly following a multiple-scenario probabilistic approach to valuing cyclical companies.

Exhibit 3 summarizes the results, comparing them with actual share prices. As shown, the market does not follow either the perfect-foresight or the zero-foresight path; it follows a blended path, much closer to the 50-50 path. So, the market has neither perfect foresight nor zero foresight. One could argue that this 50-50 valuation is the right place for the market to be.

An approach to valuing cyclical companies

No one can precisely predict the earnings cycle for an industry, and any single forecast of performance must be wrong. Managers and investors can benefit from explicitly following a multiple-scenario probabilistic approach to valuing cyclical companies. The probabilistic approach avoids the traps of a single forecast and allows exploration of a wider range of outcomes and their implications.

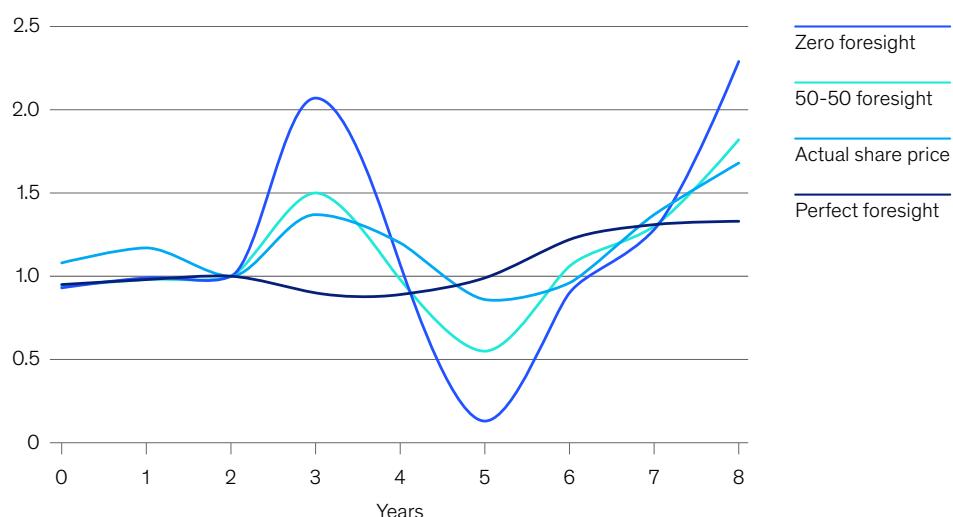
Here is a two-scenario approach for valuing cyclical companies in four steps (of course, this approach would also work with more than two scenarios):

- *Construct and value the normal cycle scenario*, using information about past cycles. Pay particular attention to the long-term trend lines of operating profits, cash flow, and return on invested capital (ROIC), because they will have the largest impact on the valuation. Make sure the continuing value is based on a normalized level of profits (that is, a point on the company's long-term cash flow trend line), not a peak or trough.

Exhibit 3

A forecast based on 50-50 foresight best aligns with the actual share price.

Average market value of 15 cyclical companies, index (year 2 = 1.0)



Source: Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, eighth edition, Wiley, May 2025



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- *Construct and value a new trend line scenario* based on the company's recent performance. Once again, focus primarily on the long-term trend line, because it will have the largest impact on value. Do not worry too much about modeling future cyclical (although future cyclical will be important for financial solvency).
- *Develop the economic rationale for each of the two scenarios*, considering factors such as demand growth, companies entering or exiting the industry, and technology changes that will affect the balance of supply and demand.
- *Assign probabilities to the scenarios* and calculate their weighted values. Use the economic rationale and its likelihood to estimate the weights assigned to each scenario.

This approach provides an estimate of the value as well as scenarios that put boundaries on the valuation. Managers can use these boundaries to improve their strategy and respond to signals about which scenario is likely to occur.

Another consideration when valuing cyclical companies in commodity-linked industries is that starting with revenues may not be the best way to model performance. Consider a polyethylene manufacturer, which processes natural gas into polyethylene. The traditional approach to valuation would be to model sales volumes and polyethylene prices to estimate revenues, from which you would subtract the cost of purchasing natural gas (volume times natural-gas prices) and operating costs to estimate operating profits. It may be simpler, however, to model only volumes and the "crack spread"—the difference between polyethylene prices and the cost of natural gas—and then subtract operating costs. What ultimately matters is the crack spread, not the revenues. The crack spread will often be set by the demand-supply balance for polyethylene, not the level of natural-gas prices. For example, during a decline in natural-gas prices, the crack spread might remain constant as producers pass on the reduction in natural-gas prices to customers by lowering polyethylene prices. If volumes were stable, operating profits would be too, despite a decline in revenues.⁵

At first glance, the share prices of cyclical companies appear too volatile to be consistent with the DCF valuation approach. This chapter excerpt shows, however, that share price volatility can be explained by the uncertainty surrounding the industry cycle. Using scenarios and probabilities, managers and investors can take a systematic DCF approach to valuing and analyzing cyclical companies.

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⁵The analysis is more complicated than this example suggests, because some polyethylene producers use naphtha rather than natural gas as their raw material.



Final account

The long game gets short shrift.



A McKinsey survey of 500 global leaders, including CEOs, presidents, and other C-suite executives, from a wide range of industries revealed gaps between executives' growth ambitions and their ability to translate them into practices and results. Through-cycle outperformers are leaders of companies that grow revenue faster, are more profitable, and produce higher excess TSR than their peers. To prioritize growth, leaders should deliberately allocate real time and resources to longer-term growth initiatives that build competitive advantage. Yet, on average, respondents say that only 22 percent of their time is spent on long-term growth initiatives, with the remainder of their time dedicated to short- and medium-term projects (exhibit).

For more, see "[Achieving growth: Putting leadership mindsets and behaviors into action](#)" on [McKinsey.com](#).

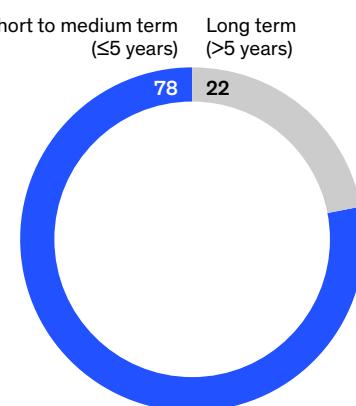
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Exhibit

Leaders spend more time on short-term growth initiatives than on long-term ones.

Average distribution of executive team's time spent on growth initiatives, by project timeline, %

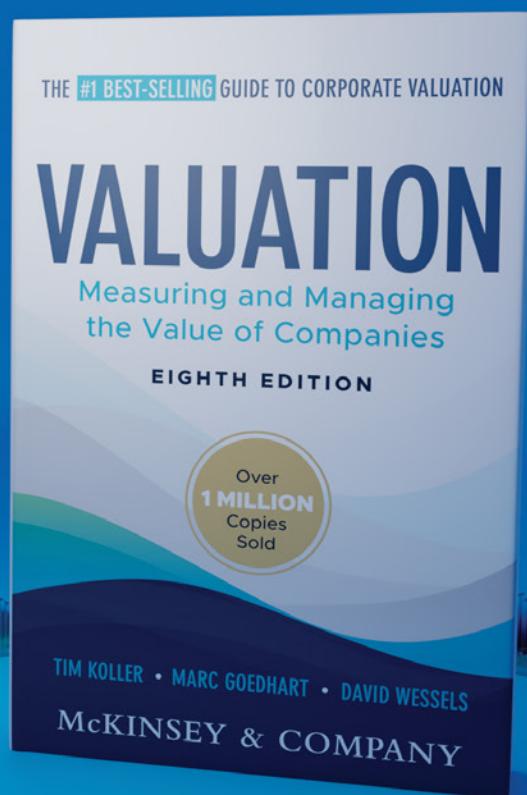


Source: McKinsey Growth Leaders Mindset Survey, June 7–July 18, 2024 (n = 500)

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The new and timeless truths of valuation

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Tim Koller and Marc Goedhart, with Sean Brown

How Nestlé's CFO sharpens focus across a global portfolio

The CFO's challenge has long been one of translating data into a story that the CEO and their management team can use to set strategy and make other decisions. As gen AI advances, the way that CFOs fulfill this role is changing, as Nestlé CFO Anna Manz describes.

Anna Manz, with Michael Birshan and Sean Brown

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Charlie Lewis, with Sean Brown

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Anna Mattsson and Jamie Koenig, with Sean Brown

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Clayton O'Toole, Matt Banholzer, and Rebecca Doherty, with Sean Brown

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