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How to avoid losses and prune projects proactively

It’s common for companies to hang on for too long to projects or parts of the business that are underperforming. Two effective techniques can help executives decide when to hold on to an asset and when to let it go.

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In this episode of the *Inside the Strategy Room* podcast, McKinsey partner Tim Koller, professor of business strategy at the University of Sydney Dan Lovallo, and Sean Brown address the emotional biases and legacy attachments that stand in the way of executives making effective decisions about underperforming projects and business units. (For more conversations on the strategy issues that matter, subscribe to the series on iTunes.)

Podcast transcript

Sean Brown: From McKinsey's Strategy & Corporate Finance Practice, I'm Sean Brown. Welcome to *Inside the Strategy Room*. Joining me today in our New York office are McKinsey partner Tim Koller, and Dan Lovallo, a former McKinsey consultant and a professor of business strategy at the University of Sydney. They, along with Zane Williams, a senior expert at McKinsey, recently wrote an article about pruning projects and divesting proactively. This is part of our Bias Busters series. Tim, Dan, welcome.

Let's talk about what you call the "dilemma": projects or business units that simply won't die.

Dan Lovallo: There are a lot of them. That's the first thing. There are a number of attachments people have to projects. Sometimes the projects won't die. Or maybe something that started the company has a big legacy and is important, but it's not doing very well.

The main thing about projects that won't die is that they take a really, really long time dying. We did some research that looked at projects that were both unprofitable and cash needy. In other words, their sales growth couldn't sustain the investment. You would think that somebody would kill them at some point. But the situation is those projects or businesses had an 80 percent chance of surviving ten years.

Sean Brown: Ten years?

Dan Lovallo: This is really common. It's about as common as you get. Part of the difficulty is there's a lot of emotion tied to firing people. Naturally, people don't want to do it. And so they don't, and these projects tend to keep living. If people don't have processes in place, it's very unlikely to happen.

Tim Koller: We also found, in some other research, that this applies to business units. For example, we found that companies often would not divest a business unit until a year or so after people had already started talking about it in the press.

Sean Brown: Until it was too late, almost?

Tim Koller: Yeah, too late. I've been in many conversations with clients where they realized that a business unit should be divested, and the rule of thumb seems to be that it takes about two years after a company starts to have the conversation before they actually get around to doing anything about it. Or they come into the mode of, "Oh, we'll fix this thing before we sell it," which never happens, of course. Two years seems to be common, and you lose a lot of value over those two years by waiting. In addition to projects, divesting or pruning whole business units in the portfolio is also something that companies need to be better at in order to maximize the value creation.

Sean Brown: You talked about how long these projects last. Is that for 90 percent of companies? How common is this?

Dan Lovallo: The data that I was talking about was based on the entire US economy. In the US economy, for stand-alone companies, that's about 30 percent of the companies. And for multi-business-unit companies, that's about 43 percent of the companies that have at least one business segment that's not dying soon enough. It's a ubiquitous problem.

Sean Brown: One of your suggested remedies is something you call the "burden of proof." Can you say more about that, Tim?

Tim Koller: The burden of proof is the idea that instead of making the case for divesting, you have to change it to, "Why should we keep this business?"

Obviously, you can't do it for the whole company every year, but one approach is, for 5 or 10 percent of the big projects or units every year, you ask that question, "Why should we hold onto this particular unit?" Or, "Why should we keep pursuing this particular project?" It's a way of changing the sequence around so that if you can't prove the case that you absolutely need to keep it, then the assumption is, "OK, we're going to get rid of it."

Dan Lovallo: Psychologically, changing the burden of proof makes an awful lot of sense. An example that's been in the press was that Google used to allow people to spend 20 percent of their time doing these projects. And what it found out was a lot of those projects could be seeds that are going to grow into new businesses, or they could be weeds that need to die. A few years ago, it found out most of those were weeds, and it stopped doing them. It killed a lot of those projects. That kind of constant pruning is what you need to do to be successful in getting rid of these kinds of projects.

Tim Koller: Actually, the word "pruning" comes to mind when we bring up a friend and former colleague of ours who used that analogy because if you're thinking about an apple tree, you have to prune it in order for it to grow successfully. The same thing works with businesses. You really do have to get rid of the dead branches in order for the company to be successful and thrive.

Dan Lovallo: In our last conversation, we talked about the importance of resources flowing across the corporation and how that improves performance. And this is one of the main mechanisms to free up resources to move to other opportunities. Pruning is not something that typically works if you just do it as a one-off. It should …

Sean Brown: … be systematic?

Dan Lovallo: That's right. It should be a systematic process you employ every year. It also makes it less painful to do, year after year, if you're changing the burden of proof, if that's the process, if that's what people expect. If you come in, and you do it once every ten years, the political resistance and the emotional toll it's going to take on the decision maker and the people who are going to be pruned is much, much tougher to take, psychologically.

Tim Koller: By the way, one of the things we've also found is that sometimes the pruned businesses are better off after they've been pruned. Oftentimes those businesses are constrained in what they can do. And as a result, when they are either spun off or sold to somebody else, even with the same management team, we find that their performance improves because they're no longer subject to certain rigid things that the corporate parent has imposed on them. They're allowed to be more creative, maybe invest more, maybe be more aggressive about closing or shifting resources around. It's not always a big thing for the managers and employees of the businesses that are pruned. I know one company where they celebrate "independence day" every year, which is the day that they were spun off from their parent company.

Sean Brown: But a spin-off is decidedly different from just a shutdown.

Tim Koller: Oh, yes.

Sean Brown: Have you seen any companies that are really good at pruning? Or that create a redeployment pool for the people who would otherwise be pruned? I'm assuming that part of the value of pruning is that you can redeploy that capital in other, more productive projects? Has the same held for the human capital? And how are they redeployed?

Tim Koller: Yeah. Unfortunately, redeployment typically only works in companies where they have lots of similar kinds of projects—if you think about oil and gas companies, where you can move an oil engineer from one project to another, or a pharmaceutical company. It doesn't necessarily work if you've got entirely different business units—or even with engineers with different skills. Unfortunately, it's not always going to be the case that you can reallocate and keep those resources around. It really depends on the nature of the business.

“One approach is … ‘stage-gating.’ Every time you want to spend more money on a project, at a certain phase of that project’s life … you have to go back and get permission to keep it going.”

Dan Lovallo: One of the things that we do to help with large transformations is pruning so that you can then reinvest in better growth opportunities. And if companies want to make a large transformation, it almost always involves quite a bit of pruning and then reallocating to better opportunities.

Now the danger when you’re making one of those transformations is that you overestimate the opportunities and spend all the savings you’ve got rather than waiting for new opportunities. Oftentimes, the new spending happens almost as soon as it can rather than holding onto those huge savings that you’ve pruned and spending them as the opportunities arise. I would say spending the savings too soon is the biggest danger with a large transformation.

Tim Koller: Just to pick up on something Dan was saying about the ten-year projects that hang on too long when in many of those cases those things should’ve been shut down within one or two years. The reason they fall into this trap is typically because of the sunk-cost fallacy: “We’ve invested all this capital and time and energy into it, so let’s keep it going.”

We all know this does not make any sense at all. Just recently my daughter—a freshman in college—took her first economics courses and brought that up at the dinner table with my wife. I was quite surprised that she absolutely absorbed the concept and was able to apply it. I don’t remember what she applied it to, but we fall into that trap, and companies are really bad at it. You need to have processes to eliminate that.

One approach is something that we sometimes call “stage-gating.” Every time you want to spend more money on a project, at a certain phase of that project’s life to move onto the next phase, you have to go back and get permission to keep it going. There’s not the automatic presumption that once a project gets started, it will go to completion. The presumption is at certain milestones that are predefined ahead of time, you have to get permission to keep going with the project.

Dan Lovallo: There’s a point in there that I really want to put emphasis on. You have to define these milestones in advance, or else you’re going to get slippage and you’re going to fall into the sunk-cost fallacy. You have to have somebody who’s in charge who’s going to actually stop things if you don’t meet those milestones.

Sean Brown: Venture-capital investments, for example, typically have multiple series, and it sounds like what you’re advocating is that, in some ways, companies treat their investments the same way?

Tim Koller: Absolutely. Same kind of thing. It's just the organizational dynamics are more difficult inside a large company.

Sean Brown: Sure. In your article, you raised the notion of categorizing business investments. Could you say more about that, please?

Tim Koller: It's similar to changing the burden of proof, but in this case, what you need to do is make sure that every unit or every investment is put into one of three or more categories.

There are those businesses or things that we want to accelerate. There are those that we want to maintain or defend. And then there are those that we need to dispose. And you force yourself to categorize each business into one of those so that, once again, if you can't make the case for maintaining or accelerating a project or a business, then it automatically goes into the dispose category using some criteria that you don't let the processes get in the way of.

You have to be pretty objective and nonemotional about it. But if you force yourself to categorize the units, you're more likely to dispose of those units that are at the bottom of the list.

Dan Lovallo: And just to reiterate, this has to be a continual process that you need to do every time you analyze how much you're going to invest, not a one-off. It's got to be part of your process.

Sean Brown: Have you found companies that have established this as part of their process? You talked about stage-gating in terms of ongoing investments, but what are some of the most effective ways that companies can bring this discipline to the review of their projects? Is it annual? Is it a quarterly review? How do they systematize that?

Tim Koller: I think it really depends on the life cycles of the businesses. If you do it too frequently, relative to the changes in the business, then it becomes mechanical. You have to use a little bit of a judgment, but you want to make sure that there's a regular process in terms of how fast the industry is changing and how fast things are going. For some businesses, it may be every year. For some businesses, it may be a longer horizon. For some projects, it could be shorter—for example, if you're doing something in the tech world, where things are changing very fast.

There's not one right answer. You need to figure it out for your company and for the individual projects and units, as to what the right time is. But I think having a regular schedule of doing this is absolutely essential, as Dan was saying. If you don't force yourself to do it on a regular basis, whatever that cycle is, then you're going to fall back into the sloppy ways of making those decisions.

Sean Brown: It's not necessarily tied to an annual budgeting process.

Tim Koller: Not necessarily, no.

Dan Lovallo: One thing that's absolutely important is this won't happen if it doesn't come from the top. It simply won't happen. The CEO has to make a call, and this has to be driven from the top.

Sean Brown: Tim, Dan, thanks again for joining us today.

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