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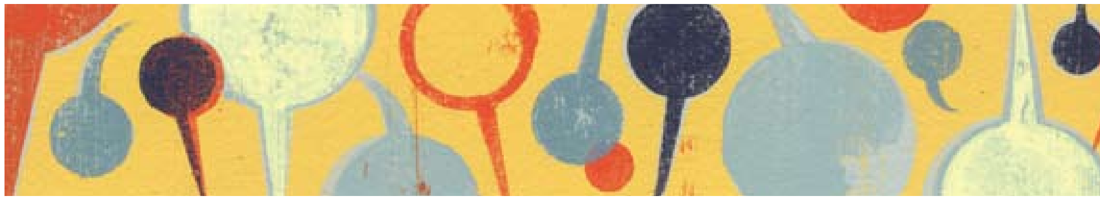

Communicating with **the right investors**

Executives spend too much time talking with investors who don't matter. Here's how to identify those who do.

Robert N. Palter, Werner Rehm, and Jonathan Shih

Many executives spend too much time communicating with investors they would be better off ignoring. CEOs and CFOs, in particular, devote an inordinate amount of time to one-on-one meetings with investors, investment conferences, and other shareholder communications,[1] often without having a clear picture of which investors really count.

The reason, in part, is that too many companies segment investors using traditional methods that yield only a shallow understanding of their motives and behavior; for example, we repeatedly run across investor relations groups that try to position investors as growth or value investors—mirroring the classic approach that investors use to segment companies. The expectation is that growth investors will pay more, so if a company can persuade them to buy its stock, its share price will rise. That expectation is false: many growth investors buy after an increase in share prices. More important, traditional segmentation approaches reveal little about the way investors decide to buy and sell shares. How long does an investor typically hold onto a position, for example? How concentrated is the investor's portfolio? Which financial and operational data are most helpful for the investor? We believe that the answers to these and similar questions provide better insights for classifying investors.

Once a company segments investors along the right lines, it can quickly identify those who matter most. These important investors, whom we call "intrinsic" investors, base their decisions on a deep understanding of a company's strategy, its current performance, and its potential to create long-term value. They are also more likely than other investors to support management through short-term volatility. Executives who reach out to intrinsic investors, leaving others to the investor relations department,[2] will devote less time to investor relations and communicate a clearer, more focused message. The result

[1] Including a wide range of communications activities, such as annual shareholder meetings, conferences with sell-side analysts, quarterly earnings calls, and market updates.

[2] This article deals only with institutional investors, since management usually spends the most time with them. We also exclude activist investors, as they represent a different investor relations issue for management.

Exhibit 1

Thorough due diligence

Intrinsic investors make a significant effort to understand the companies they invest in.

Activities of long-term intrinsic investors[1]

	Uncover investment idea	Conduct initial review	Due diligence	Monitor company
Time	**Ongoing** • Investment analyst identifies opportunity (through electronic scans, networking, conferences)	**2 weeks** • Analyst develops preliminary view based on public information • Analyst reviews with portfolio manager; portfolio manager makes go/no go decision	**4–8 weeks** • Analyst conducts in-depth due diligence with focus on developing proprietary knowledge, information (review models, consultant work) • Completes investment thesis with focus on long-term position of company, associated value	**3–5 years** • Analyst monitors operating performance, share price • Portfolio manager tweaks exposure, depending on changes in outlook and price
Relevant information on company	• Past financials, consensus estimates, trading information, implied valuation	• Web site, press releases, management press, sell-side analyst calls and reports, industry reports	• Past operations and unit-level information, management's future strategy and forecasts, industry outlook, management's background • Detailed follow-up information from company	• Quarterly updates on performance, significant changes in outlook
Interaction with company	• Limited; if any, probably through investment conferences	• Limited, usually through telephone discussions with investor relations unit	• Multiple in-depth meetings with executives at all senior leadership levels • Follow-up conversations, if necessary, with investor relations unit	• Occasional meetings, calls with investor relations unit • Semiannual or annual senior-management meetings

[1]For short-term intrinsic investors, review and due diligence could be a matter of days, and their hold period can be as short as 6 to 18 months.

should be a better alignment between a company's intrinsic value and its market value, one of the core goals of investor relations.[3]

A better segmentation

No executive would talk to important customers without understanding how they make purchase decisions, yet many routinely talk to investors without understanding their investment criteria. Our analysis of typical holding periods, investment portfolio concentrations, the number of professionals involved in decisions, and average trading volumes—as well as the level of detail investors require when they undertake research on a company—suggests that investors can be distributed among three broad categories.

Intrinsic investors

Intrinsic investors take a position in a company only after rigorous due diligence of its intrinsic ability to create long-term value (Exhibit 1). This scrutiny typically takes more than a month. We estimate that these investors hold 20 percent of US assets and contribute 10 percent of the trading volume in the US market.

In interviews with more than 20 intrinsic investors, we found that they have concentrated portfolios—each position, on average, makes up 2 to 3 percent of their portfolios and perhaps as much as 10 percent; the average position of other investors is less than 1 percent. Intrinsic investors also hold few positions per analyst (from four to ten companies) and hold

[3]If this goal sounds counterintuitive, consider the alternatives. Clearly, undervaluation isn't desirable. An overvaluation is going to be corrected sooner or later, and the correction will, among other things, distress board members and employees with worthless stock options issued when the shares were overvalued.

Exhibit 2

Concentrated impact

When intrinsic investors trade, they trade more per day than other investors do.

Investor segment	Annual trading activity per segment, $ trillion	Annual trading activity per investor in segment, $ billion	Annual trading activity per investor in segment per investment, $ million	Trading activity per investor in segment per investment per day,[1] $ million
Intrinsic	3	6	72	79–109
Trading-oriented	11	88	277	1
Mechanical	6	6	17	2

[1]Includes only days when investor traded.

shares for several years. Once they have invested, these professionals support the current management and strategy through short-term volatility. In view of all the effort intrinsic investors expend, executives can expect to have their full attention while reaching out to them, for they take the time to listen, to analyze, and to ask insightful questions.

These investors also have a large impact on the way a company's intrinsic value lines up with its market value—an effect that occurs mechanically because when they trade, they trade in high volumes (Exhibit 2). They also have a psychological effect on the market because their reputation for very well-timed trades magnifies their influence on other investors. One indication of their influence: there are entire Web sites (such as GuruFocus.com, Stockpickr.com, and Mffais.com) that follow the portfolios of well-known intrinsic investors.

Mechanical investors

Mechanical investors, including computer-run index funds and investors who use computer models to drive their trades, make decisions based on strict criteria or rules. We also include in this category the so-called closet index funds. These are large institutional investors whose portfolios resemble those of an index fund because of their size, even though they don't position themselves in that way.[4]

We estimate that around 32 percent of the total equity in the United States sits in purely mechanical investment funds of all kinds. Because their approach offers no real room for qualitative decision criteria, such as the strength of a management team or a strategy, investor relations can't influence them to include a company's shares in an index fund. Similarly, these investors' quantitative criteria, such as buying stocks with low price-to-equity ratios or the shares of companies below a certain size, are based on mathematical models of greater or lesser sophistication, not on insights about fundamental strategy and value creation.

In the case of closet index funds, each investment professional handles, on average, 100 to 150 positions, making it impossible to do in-depth research that could be influenced by meetings with an investment target's management. In part, the high number of positions per professional reflects

[4]For more on closet index funds, see Martijn Cremers and Antti Petajist, "How active is your fund manager? A new measure that predicts performance," AFA Chicago Meetings Paper, January 15, 2007.

the fact that most closet index funds are part of larger investment houses that separate the roles of fund manager and researcher. The managers of intrinsic investors, by contrast, know every company in their portfolios in depth.

Traders

The investment professionals in the trader group seek short-term financial gain by betting on news items, such as the possibility that a company's quarterly earnings per share (EPS) will be above or below the consensus view or, in the case of a drug maker, recent reports that a clinical trial has gone badly. Traders control about 35 percent of US equity holdings. Such investors don't really want to understand companies on a deep level—they just seek better information for making trades. Not that traders don't understand companies or industries; on the contrary, these investors follow the news about them closely and often approach companies directly, seeking nuances or insights that could matter greatly in the short term. The average investment professional in this segment has 20 or more positions to follow, however, and trades in and out of them quickly to capture small gains over short periods—as short as a few days or even hours. Executives therefore have no reason to spend time with traders.

Focused communications

Most investor relations departments could create the kind of segmentation we describe. They should also consider several additional layers of information, such as whether an investor does (or plans to) hold shares in a company or has already invested elsewhere in its sector. A thorough segmentation that identifies sophisticated intrinsic investors will allow companies to manage their investor relations more successfully.

Don't oversimplify your message

Intrinsic investors have spent considerable effort to understand your business, so don't boil down a discussion of strategy and performance to a ten-second sound bite for the press or traders. Management should also be open about the relevant details of the company's current performance and how it relates to strategy. Says one portfolio manager, "I don't want inside information. But I do want management to look me in the eye when they talk about their performance. If they avoid a discussion or explanation, we will not invest, no matter how attractive the numbers look."

Interpret feedback in the right context

Most companies agree that it is useful to understand the views of investors while developing strategies and investor communications. Yet management often relies on simple summaries of interviews with investors and sell-side analysts about everything from strategy to quarterly earnings to share repurchases. This approach gives management no way of linking the views of investors to their importance for the company or to their investment strategies. A segmented approach, which clarifies each investor's goals and needs, lets executives interpret feedback in context and weigh messages accordingly.

Prioritize management's time

A CEO or CFO should devote time to communicating only with the most important and knowledgeable intrinsic investors that have professionals specializing in the company's sector. Moreover, a CEO should think twice before attending conferences if equity analysts have arranged the guest lists, unless management regards those guests as intrinsic investors. When a company focuses its communications on them, it may well have more impact in a shorter amount of time.

In our experience, intrinsic investors think that executives should spend no more than about 10 percent of their time on investor-related activities, so management should be actively engaging with 15 to 20 investors at most. The investor relations department ought to identify the most important ones, review the list regularly, and protect management from the telephone calls of analysts and mechanical investors, who are not a high priority. Executives should talk to equity analysts only if their reports are important channels for interpreting complicated news; otherwise, investor relations can give them any relevant data they require, if available.

Marketing executives routinely segment customers by the decision processes those customers use and tailor the corporate image and ad campaigns to the most important ones. Companies could benefit from a similar kind of analytic rigor in their investor relations. MoF

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Running a **winning M&A shop**

Picking up the pace of M&A requires big changes in a company's processes and organization—even if the deals are smaller.

Robert T. Uhlaner and Andrew S. West

Corporate deal making has a new look—smaller, busier, and focused on growth. Not so long ago, M&A experts sequenced, at most, 3 or 4 major deals a year, typically with an eye on the benefits of industry consolidation and cost cutting. Today we regularly come across executives hoping to close 10 to 20 smaller deals in the same amount of time, often simultaneously. Their objective: combining a number of complementary deals into a single strategic platform to pursue growth—for example, by acquiring a string of smaller businesses and melding them into a unit whose growth potential exceeds the sum of its parts.

Naturally, when executives try to juggle more and different kinds of deals simultaneously, productivity may suffer as managers struggle to get the underlying process right.[1] Most companies, we have found, are not prepared for the intense work of completing so many deals—and fumbling with the process can jeopardize the very growth companies seek. In fact, most of them lack focus, make unclear decisions, and identify potential acquisition targets in a purely reactive way. Completing deals at the expected pace just can't happen without an efficient end-to-end process.

Even companies with established deal-making capabilities may have to adjust them to play in this new game. Our research shows that successful practitioners follow a number of principles that can make the adjustment easier and more rewarding. They include linking every deal explicitly to the strategy it supports and forging a process that companies can readily adapt to the fundamentally different requirements of different types of deals.

Eyes on the (strategic) prize

One of the most often overlooked, though seemingly obvious, elements of an effective M&A program is ensuring that every deal supports the corporate strategy. Many companies, we have found, believe that they are following an M&A strategy even

[1] These results were among the findings of our June 2007 survey of business-development and merger integration leaders.

Exhibit 1

The value in different types of deals

Managers must understand not only which types of deals they desire but also which ones they know how to execute.

Types of M&A deals

Size of acquired company relative to acquirer

Large	**Overcapacity** • Reduce industry capacity and overhead • Present fundamentally similar product offering Pay mainly for clear cost synergies	**Product/market consolidation** • Create economies of scale and consolidate back office; expand market presence Pay for some growth and channel access	**Transformation/ convergence** • Use deal to transform the way industry works • Create new value proposition Pay for opportunity to attack new markets and grow through new capabilities
Small	**Roll-up** • Transfer core strengths to target business(es) Pay for lower cost of operating new businesses, potential to increase revenue by leveraging brand strength	**Acquire products/markets** • Expansion of market offering and/or geographic reach Pay largely for growth and channel access; revenue synergy potential via pull-through also exists	**Strategic growth bet** • Seek skill transfer into new and/or noncore business Pay for high-risk option value and ability to act in market space

Stand-alone cost improvements — Cross-selling existing products — Building new customer relationships — Creating new products — Building a new business

Low Short-term cost synergies → **High** Long-term top-line synergies

Need to expand current capabilities

if their deals are only generally related to their strategic direction and the connections are neither specific nor quantifiable.

Instead, those who advocate a deal should explicitly show, through a few targeted M&A themes, how it advances the growth strategy. A specific deal should, for example, be linked to strategic goals, such as market share and the company's ability to build a leading position. Bolder, clearer goals encourage companies to be truly proactive in sourcing deals and help to establish the scale, urgency, and valuation approach for growth platforms that require a number of them. Executives should also ask themselves if they have enough people developing and evaluating the deal pipeline, which might include small companies to be assembled into a single business, carve-outs, and more obvious targets, such as large public companies actively shopping for buyers.

Furthermore, many deals underperform because executives take a one-size-fits-all approach to them—for example, by using the same process to integrate acquisitions for back-office cost synergies and acquisitions for sales force synergies. Certain deals, particularly those focused on raising revenues or building new capabilities, require fundamentally different approaches to sourcing, valuation, due diligence, and integration. It is therefore critical for managers not only to understand what types of deals they seek for shorter-term cost synergies or longer-term top-line synergies (Exhibit 1), but also to assess candidly which types of deals they really know how to execute and whether a particular transaction goes against a company's traditional norms or experience.

Companies with successful M&A programs typically adapt their approach to the type of deal at hand. For example, over the past six years, IBM has acquired 50 software companies, nearly 20 percent of them market leaders in their segments. It executes many different types of deals to drive its software strategy, targeting companies in high-value, high-growth segments that would extend its current portfolio into new or related markets. IBM also looks for technology acquisitions that would accelerate the development of the capabilities it needs. Deal sponsors use a comprehensive software-segment strategy review and gap analysis to determine when M&A (rather than in-house development) is called for, to identify targets, and to determine which acquisitions should be executed.

IBM has developed the methods, skills, and resources needed to execute its growth strategy through M&A and can reshape them to suit different types of deals. A substantial investment of money, people, and time has been necessary. In 2007, IBM's software group alone was concurrently integrating 18 acquisitions; more than 100 full-time experts in a variety of functions and geographies were involved, in addition to specialized teams mobilized for each deal. IBM's ability to tailor its approach has been critical in driving the performance of these businesses. Collectively, IBM's 39 acquisitions below $500 million from 2002 to 2005 doubled their direct revenue within two years.

Organization and process

When companies increase the number and pace of their acquisitions, the biggest practical challenge most of them face is getting not only the right people but also the right number of people involved in M&A. If they don't, they may buy the wrong assets, underinvest in appropriate ones, or manage their deals and integration efforts poorly. Organizations must invest to build their skills and capabilities before launching an aggressive M&A agenda.

Support from senior management

In many companies, senior managers are often too impressed by what appears to be a low price for a deal or the allure of a new product. They then fail to look beyond the financials or to provide support for integration. At companies that handle M&A more productively, the CEO and senior managers explicitly identify it as a pillar of the overall corporate strategy. At GE, for example, the CEO requires all business units to submit a review of each deal. In addition to the financial justification, the review must articulate a rationale that fits the story line of the entire organization and spell out the requirements for integration. A senior vice president then coaches the business unit through each phase of a stage gate process. Because the strict process preceding the close of the deal outlines what the company must do to integrate the acquisition, senior management's involvement with it after the close is defined clearly.

The most common challenge executives face in a deal is remaining involved with it and accountable for its success from inception through integration. They tend to focus on sourcing deals and ensuring that the terms are acceptable, quickly moving on to other things once the letter of intent is signed and leaving the integration work to anyone who happens to have the time. To improve the process and the outcome, executives must give more thought to the appointment of key operational players, such as the deal owner and the integration manager.[2]

The deal owner

Deal owners are typically high-performing managers or executives accountable for specific acquisitions, beginning with the identification of a target and running through its eventual integration. The most successful acquirers appoint the deal owner very early in the process, often as a prerequisite for granting approval to negotiate with a target. This assignment, which may be full or part time, could go to someone from the business-development team or even a line organization, depending on the type of deal. For a large one regarded as a possible platform for a new business unit or geography, the right deal owner might be a vice president who can continue to lead the business once the acquisition is complete. For a smaller deal focused on acquiring a specific technology, the right person might be a director in the R&D function or someone from the business-development organization.

The integration manager

Often, the most underappreciated and poorly resourced role is that of the integration manager—in effect, the deal owner's chief of staff. Typically, integration managers are not sufficiently involved early in the deal process. Moreover, many of them are chosen for their skills as process managers, not as general managers who can make decisions, work with people throughout the organization, and manage complicated situations independently.

Integration managers, our experience shows, ought to become involved as soon as the target has been identified but before the evaluation or negotiations begin. They should drive the end-to-end merger-management process to assure that the strategic rationale of a deal informs the due diligence as well as the planning and implementation of the integration effort. During IBM's acquisition of Micromuse, for example, a vice president–level executive was chosen to take responsibility for integration. This executive was brought into the process well before due diligence and remains involved almost two years after the deal closed. IBM managers attribute its strong performance to the focused leadership of the integration executive.

Sizing a professional merger-management function

Companies that conclude deals only occasionally may be able to tap functional and business experts to conduct due diligence and then build integration teams around specific deals. But a more ambitious M&A program entails a volume of work—to source and screen candidates, conduct preliminary and final due diligence, close deals, and drive integration—that demands capabilities and processes on the scale of any other corporate function. Indeed, our experience with several active acquirers has taught us that the number of resources required can be quite large (Exhibit 2). To do 10 deals a year, a company must identify roughly 100 candidates, conduct due diligence on around 40, and ultimately integrate the final 10. This kind of effort requires the capacity to sift through many deals while simultaneously managing three or four data rooms and several parallel integration efforts. Without a sufficient (and effective) investment in resources, individual deals are doomed to fail.

A rigorous stage gate process

A company that transacts large numbers of deals must take a clearly defined stage gate approach to making and managing decisions. Many organizations have poorly defined processes or are plagued with

[2] In some smaller deals, the integration manager and deal owner can be the same person in complementary roles.

Exhibit 2

Investing in resources

Making a large number of deals requires a real investment in resources.

Resources required—junior or senior employees—to handle 10 M&A deals in a year (assumes an even distribution of large and small deals), FTEs[1]

Screened deals: 100 → 60 → 40 → 20 → 10 Closed deals

	Deals	Deal owners, integration managers	M&A management: HR	M&A management: Finance
Screened deals	100			
Strategy approval	60	4 months, senior 6 months, junior	2 months, senior 3 months, junior	10 months, senior 15 months, junior
Approval to negotiate	40	6 months, senior 14 months, junior	8 months, senior 6 months, junior	10 months, senior 14 months, junior
Deal approval (definitive agreements)	20			
Closed deals	10	12 months, senior 28 months, junior	9 months, senior 20 months, junior	9 months, senior 8 months, junior
Total monthly FTEs required, by level of experience		22 months, senior 48 months, junior	19 months, senior 29 months, junior	29 months, senior 37 months, junior
Permanent team required		**5.0**	**4.0**	**5.5**

[1]FTEs = full-time-equivalent work hours.

choke points, and either fault can make good targets walk away or turn to competitive bids. Even closed deals can get off to a bad start if a target's management team assumes that a sloppy M&A process shows what life would be like under the acquirer.

An effective stage gate system involves three separate phases of review and evaluation. At the strategy approval stage, the business-development team (which includes one or two members from both the business unit and corporate development) evaluates targets outside-in to assess whether they could help the company grow, how much they are worth, and their attractiveness as compared with other targets. Even at this point, the team should discuss key due diligence objectives and integration issues. A subset of the team then drives the process and assigns key roles, including that of the deal owner. The crucial decision at this point is whether a target is compatible with the corporate strategy, has strong support from the acquiring company, and can be integrated into it.

At the approval-to-negotiate stage, the team decides on a price range that will allow the company to maintain pricing discipline. The results of preliminary due diligence (including the limited exchange of data and early management discussions with the target) are critical here, as are integration issues that have been reviewed, at least to some extent, by the corporate functions. A vision for incorporating the target into the acquirer's business plan, a clear operating program, and an understanding of the acquisition's key synergies are important as well, no matter what the size or type of deal. At the end of this stage, the team should have produced a nonbinding term sheet or letter of intent and a roadmap for negotiations, confirmatory due diligence, and process to close.

The board of directors must endorse the definitive agreement in the deal approval stage. It should resemble the approval-to-negotiate stage if the process has been executed well; the focus ought to be on answering key questions rather than raising new strategic issues, debating valuations, or looking ahead to integration and discussing how to estimate the deal's execution risk.

Each stage should be tailored to the type of deal at hand. Small R&D deals don't have to pass through a detailed board approval process but may instead be authorized at the business or product unit level. Large deals that require significant regulatory scrutiny must certainly meet detailed approval criteria before moving forward. Determining in advance what types of deals a company intends to pursue and how to manage them will allow it to articulate the trade-offs and greatly increase its ability to handle a larger number of deals with less time and effort.

As companies adapt to a quicker, more complicated era of M&A deal making, they must fortify themselves with a menu of process and organizational skills to accommodate the variety of deals available to them. **MoF**

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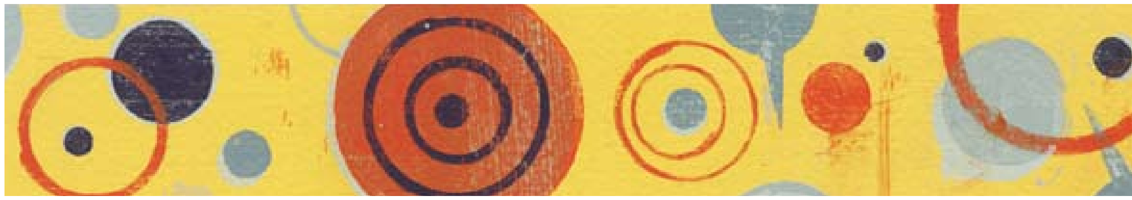


Starting up as CFO

There are a few critical tasks that all finance chiefs must tackle in their first hundred days.

Bertil E. Chappuis, Aimee Kim, and Paul J. Roche

In recent years, CFOs have assumed increasingly complex, strategic roles focused on driving the creation of value across the entire business. Growing shareholder expectations and activism, more intense M&A, mounting regulatory scrutiny over corporate conduct and compliance, and evolving expectations for the finance function have put CFOs in the middle of many corporate decisions—and made them more directly accountable for the performance of companies.

Not only is the job more complicated, but a lot of CFOs are new at it—turnover in 2006 for Fortune 500 companies was estimated at 13 percent.[1] Compounding the pressures, companies are also more likely to reach outside the organization to recruit new CFOs, who may therefore have to learn a new industry as well as a new role.

To show how it is changing—and how to work through the evolving expectations—we surveyed 164 CFOs of many different tenures[2] and interviewed 20 of them. From these sources, as well as our years of experience working with experienced CFOs, we have distilled lessons that shed light on what it takes to succeed. We emphasize the initial transition period: the first three to six months.

Early priorities

Newly appointed CFOs are invariably interested, often anxiously, in making their mark. Where they should focus varies from company to company. In some, enterprise-wide strategic and transformational initiatives (such as value-based management, corporate-center strategy, or portfolio optimization) require considerable CFO involvement. In others, day-to-day business needs can be more demanding and time sensitive—especially in the Sarbanes–Oxley environment—creating significant distractions unless they are carefully managed. When CFOs inherit an organization under stress, they may have no choice but to lead a turnaround, which requires large amounts of time to cut costs and reassure investors.

[1] *Financial Officers' Turnover, 2007 Study*, Russell Reynolds Associates.

[2] We surveyed 164 current or former CFOs across industries, geographies, revenue categories, and ownership structures. For more of our conclusions, see "The CFO's first hundred days: A McKinsey Global Survey," mckinseyquarterly.com, December 2007.

Yet some activities should make almost every CFO's short list of priorities. Getting them defined in a company-specific way is a critical step in balancing efforts to achieve technical excellence in the finance function with strategic initiatives to create value.

Conduct a value creation audit

The most critical activity during a CFO's first hundred days, according to more than 55 percent of our survey respondents, is understanding what drives their company's business. These drivers include the way a company makes money, its margin advantage, its returns on invested capital (ROIC), and the reasons for them. At the same time, the CFO must also consider potential ways to improve these drivers, such as sources of growth, operational improvements, and changes in the business model, as well as how much the company might gain from all of them. To develop that understanding, several CFOs we interviewed conducted a strategy and value audit soon after assuming the position. They evaluated their companies from an investor's perspective to understand how the capital markets would value the relative impact of revenue versus higher margins or capital efficiency and assessed whether efforts to adjust prices, cut costs, and the like would create value, and if so how much.

Although this kind of effort would clearly be a priority for external hires, it can also be useful for internal ones. As a CFO promoted internally at one high-tech company explained, "When I was the CFO of a business unit, I never worried about corporate taxation. I never thought about portfolio-level risk exposure in terms of products and geographies. When I became corporate CFO, I had to learn about business drivers that are less important to individual business unit performance."

The choice of information sources for getting up to speed on business drivers can vary. As CFOs conducted their value audit, they typically started by mastering existing information, usually by meeting with business unit heads, who not only shared the specifics of product lines or markets but are also important because they use the finance function's services. Indeed, a majority of CFOs in our survey, and particularly those in private companies, wished that they had spent even more time with this group (Exhibit 1). Such meetings allow CFOs to start building relationships with these key stakeholders of the finance function and to understand their needs. Other CFOs look for external perspectives on their companies and on the marketplace by talking to customers, investors, or professional service providers. The CFO at one pharma company reported spending his first month on the job "riding around with a sales rep and meeting up with our key customers. It's amazing how much I actually learned from these discussions. This was information that no one inside the company could have told me."

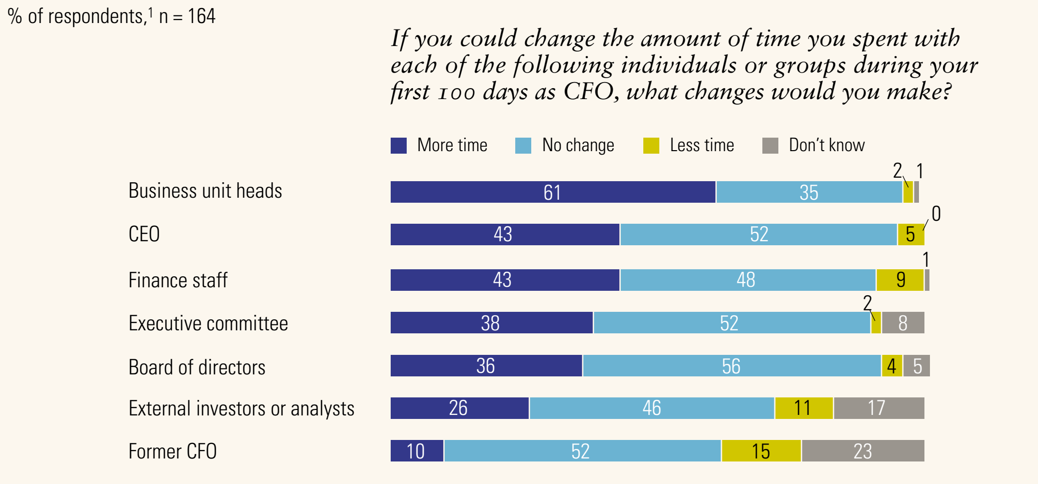
Lead the leaders

Experienced CFOs not only understand and try to drive the CEO's agenda but also know they must help to shape it. CFOs often begin aligning themselves with the CEO and board members well before taking office. During the recruiting process, most CFOs we interviewed received very explicit guidance from them about the issues they considered important, as well as where the CFO would have to assume a leadership role. Similarly, nearly four-fifths of the CFOs in our survey reported that the CEO explained what was expected from them—particularly that they serve as active members of the senior-management team, contribute to the company's performance, and make the finance organization efficient (Exhibit 2). When one new CFO

Exhibit 1

Wanted: More time with the right people

The majority of CFOs in our survey wished they'd had even more time with business unit heads.

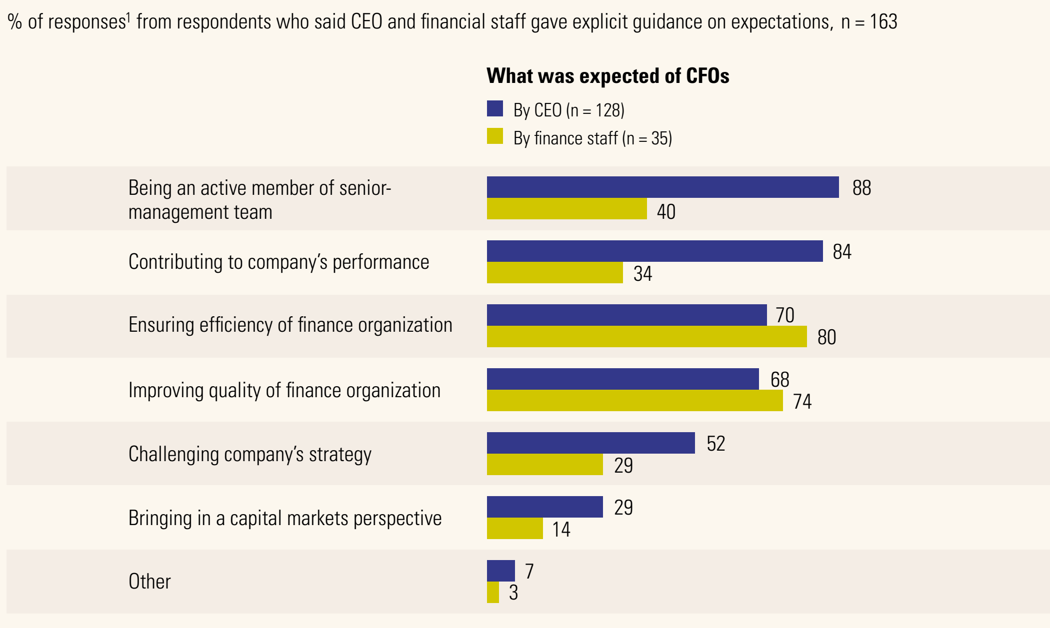


[1]Figures may not sum to 100%, because of rounding.

Exhibit 2

Diverse expectations

Many CFOs received very explicit guidance from their CEOs on the key issues of concern.



[1]Respondents could select more than 1 answer.

asked the CEO what he expected at the one-year mark, the response was, "When you're able to finish my sentences, you'll know you're on the right track."

Building that kind of alignment is a challenge for CFOs, who must have a certain ultimate independence as the voice of the shareholder. That means they must immediately begin to shape the CEO's agenda around their own focus on value creation. Among the CFOs we interviewed, those who had conducted a value audit could immediately pitch their insights to

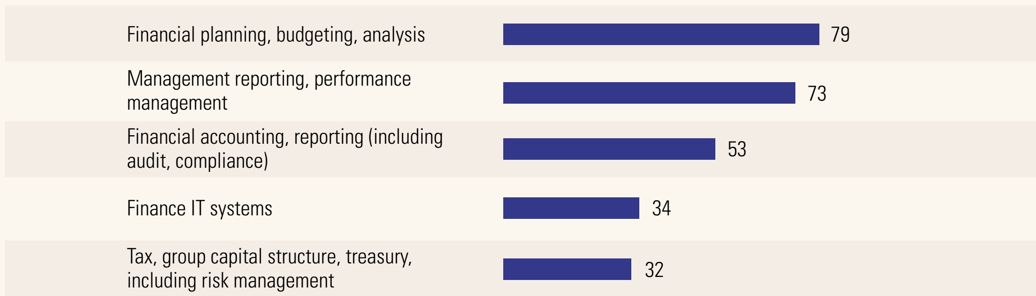
Exhibit 3

Taking action

About three-quarters of new CFOs initiated (or developed a plan to initiate) fundamental changes in the function's core activities during the first hundred days.

% of responses[1]

In which of the given areas did you initiate (or develop a plan to initiate) fundamental changes during your first 100 days as CFO?



[1]Respondents (n = 164) could select more than 1 answer; those who answered "none of these" are not shown.

the CEO and the board—thus gaining credibility and starting to shape the dialogue. In some cases, facts that surfaced during the process enabled CFOs to challenge business unit orthodoxies. What's more, the CFO is in a unique position to put numbers against a company's strategic options in a way that lends a sharp edge to decision making. The CFO at a high-tech company, for example, created a plan that identified several key issues for the long-term health of the business, including how large enterprises could use its product more efficiently. This CFO then prodded sales and service to develop a new strategy and team to drive the product's adoption.

To play these roles, a CFO must establish trust with the board and the CEO, avoiding any appearance of conflict with them while challenging their decisions and the company's direction if necessary. Maintaining the right balance is an art, not a science. As the CFO at a leading software company told us, "It's important to be always aligned with the CEO and also to be able to factually call the balls and strikes as you see them. When you cannot balance the two, you need to find a new role."

Strengthen the core

To gain the time for agenda-shaping priorities, CFOs must have a well-functioning finance group behind them; otherwise, they won't have the credibility and hard data to make the difficult arguments. Many new CFOs find that disparate IT systems, highly manual processes, an unskilled finance staff, or unwieldy organizational structures hamper their ability to do anything beyond closing the quarter on time. In order to strengthen the core team, during the first hundred days about three-quarters of the new CFOs we surveyed initiated (or developed a plan to initiate) fundamental changes in the function's core activities (Exhibit 3).

Several of our CFOs launched a rigorous look at the finance organization and operations they had just taken over, and many experienced CFOs said they wished they had done so. In these reviews, the CFOs assessed the reporting structure;

evaluated the fit and capabilities of the finance executives they had inherited; validated the finance organization's cost benchmarks; and identified any gaps in the effectiveness or efficiency of key systems, processes, and reports. The results of such a review can help CFOs gauge how much energy they will need to invest in the finance organization during their initial 6 to 12 months in office—and to fix any problems they find.

Transitions offer a rare opportunity: the organization is usually open to change. More than half of our respondents made at least moderate alterations in the core finance team early in their tenure. As one CFO of a global software company put it, "If there is a burning platform, then you need to find it and tackle it. If you know you will need to make people changes, make them as fast as you can. Waiting only gets you into more trouble."

Manage performance actively

CFOs can play a critical role in enhancing the performance dialogue of the corporate center, the business units, and corporate functions. They have a number of tools at their disposal, including dashboards, performance targets, enhanced planning processes, the corporate review calendar, and even their own relationships with the leaders of business units and functions.

Among the CFOs we interviewed, some use these tools, as well as facts and insights derived from the CFO's unique access to information about the business, to challenge other executives. A number of interviewees take a different approach, however, exploiting what they call the "rhythm of the business" by using the corporate-planning calendar to shape the performance dialogue through discussions, their own agendas, and metrics. Still other CFOs, we have observed, exert influence through their personal credibility at performance reviews.

While no consensus emerged from our discussions, the more experienced CFOs stressed the importance of learning about a company's current performance dialogues early on, understanding where its performance must be improved, and developing a long-term strategy to influence efforts to do so. Such a strategy might use the CFO's ability to engage with other senior executives, as well as changed systems and processes that could spur performance and create accountability.

First steps

Given the magnitude of what CFOs may be required to do, it is no surprise that the first 100 to 200 days can be taxing. Yet those who have passed through this transition suggest several useful tactics. Some would be applicable to any major corporate leadership role but are nevertheless highly relevant for new CFOs—in particular, those who come from functional roles.

Get a mentor

Although a majority of the CFOs we interviewed said that their early days on the job were satisfactory, the transition wasn't without specific challenges. A common complaint we hear about is the lack of mentors—an issue that also came up in our recent survey results, which showed that 32 percent of the responding CFOs didn't have one. Forty-six percent of the respondents said that the CEO had mentored them, but the relationship appeared to be quite different from the traditional mentorship model, because many CFOs felt uncomfortable telling the boss everything about the challenges they faced. As one CFO put it during an interview, "being a CFO is probably one of the loneliest jobs out there." Many of the CFOs we spoke with mentioned the value of having one or two mentors outside the company to serve as a sounding board. We also know CFOs who have joined high-value roundtables and other such forums to build networks and share ideas.

Listen first . . . then act

Given the declining average tenure in office of corporate leaders, and the high turnover among CFOs in particular, finance executives often feel pressure to make their mark sooner rather than later. This pressure creates a potentially unhealthy bias toward acting with incomplete—or, worse, inaccurate—information. While we believe strongly that CFOs should be aggressive and action oriented, they must use their energy and enthusiasm effectively. As one CFO reflected in hindsight, "I would have spent even more time listening and less time doing. People do anticipate change from a new CFO, but they also respect you more if you take the time to listen and learn and get it right when you act."

Make a few themes your priority—consistently

Supplement your day-to-day activities with no more than three to four major change initiatives, and focus on them consistently. To make change happen, you will have to repeat your message over and over—internally, to the finance staff, and externally, to other stakeholders. Communicate your changes by stressing broad themes that, over time, could encompass newly identified issues and actions. One element of your agenda, for example, might be the broad theme of improving the efficiency of financial operations rather than just the narrow one of offshoring.

Invest time up front to gain credibility

Gaining credibility early on is a common challenge—particularly, according to our survey, for a CFO hired from outside a company. In some cases, it's sufficient to invest enough time to know the numbers cold, as well as the company's products, markets, and plans. In other cases, gaining credibility may force you to adjust your mind-set fundamentally.

The CFOs we interviewed told us that it's hard to win support and respect from other corporate officers without making a conscious effort to think like a CFO. Clearly, one with the mentality of a lead controller, focused on compliance and control, isn't likely to make the kind of risky but thoughtful decisions needed to help a company grow. Challenging a business plan and a strategy isn't always about reducing investments and squeezing incremental margins. The CFO has an opportunity to apply a finance lens to management's approach and to ensure that a company thoroughly examines all possible ways of accelerating and maximizing the capture of value.

As an increasing number of executives become new CFOs, their ability to gain an understanding of where value is created and to develop a strategy for influencing both executives and ongoing performance management will shape their future legacies. While day-to-day operations can quickly absorb the time of any new CFO, continued focus on these issues and the underlying quality of the finance operation defines world class CFOs. MoF

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Preparing for a slump in **earnings**

Historic trends suggest earnings may fall more than most executives expect. Companies should prepare for steeper declines and take steps to strengthen their positions when times improve.

Richard Dobbs, Bin Jiang, and Timothy Koller

As the aftershocks of the subprime-lending crisis rumble on, executives understandably find it difficult to read the conflicting US economic and business indicators they rely on to make strategic choices. Some are encouraged by sharp interest rate cuts, fiscal help, and export growth resulting from the dollar's weakness, hoping that these will save the US economy from a prolonged recession. Others observe that although corporate earnings were considerably lower in the fourth quarter of 2007 than they were in the same period a year earlier, earnings forecasts from consensus analysts point to a rebound later this year, with overall US 2008 earnings growth expected to grow by more than 10 percent.

Investors, executives, and boards might therefore be tempted to face the rest of 2008 cautiously, but not to feel any need to develop radical contingency plans for a substantial and sustained reduction in earnings. Yet giving in to that temptation would be a mistake because such plans will probably be needed. A study of historic trends shows that corporate earnings might well retreat by as much as 40 percent from their 2007 levels.

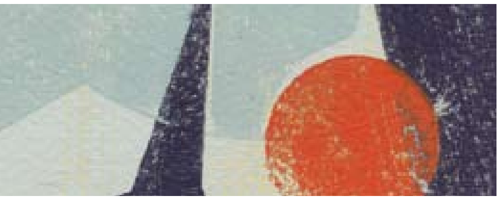
Few companies as yet anticipate such a blow to their earnings and general economic health. Fewer still have begun to put in place the rigorous contingency plans needed to weather it and to build the financial and operational flexibility that would make them more competitive at a time of substantial and sustained reductions in corporate earnings.

Booms and busts

Valuation multiples and corporate earnings drive stock market valuations. A look back at the US stock market's peak, in 2000, can help illuminate the dynamics behind booms and busts.

Between 1973 and 2000, rising price-to-earnings (P/E) multiples drove the market's growth.[1] Falling real interest rates and

[1] Marc Goedhart, Bin Jiang, and Timothy Koller, "Market fundamentals: 2000 versus 2007," mckinseyquarterly.com, September 2007.



lower inflation were the underlying reasons, and these trends, unfortunately, are not repeatable. From 1996 to 2000, P/E multiples rose especially sharply, particularly for Internet-related stocks. The bullish psychology underlying much of that market activity reflected a mistaken belief among many investors that the Internet age had so changed the economic fundamentals that historic ratios were irrelevant and could safely be ignored.

This belief in a paradigm shift generated P/E multiples that reached a high of around 25 at the stock market's 2000 peak, compared with a long-run average of 14. Acquisitions at inflated prices became increasingly common. Of course, a four-year bear market decline of 40 percent followed the peak as multiples reverted to levels more in line with the long-run average. Earnings, too, dipped, as companies wrote off the goodwill associated with the high-priced acquisitions made at the time of the stock market peak.

The underpinnings of the 2004–07 stock market rally were quite different from those of the earlier ones. During the recent run-up, P/E multiples weren't unusual, hovering around the levels seen in the late 1960s—which was also a time of low interest rates. Instead, strong corporate earnings drove the market's growth.

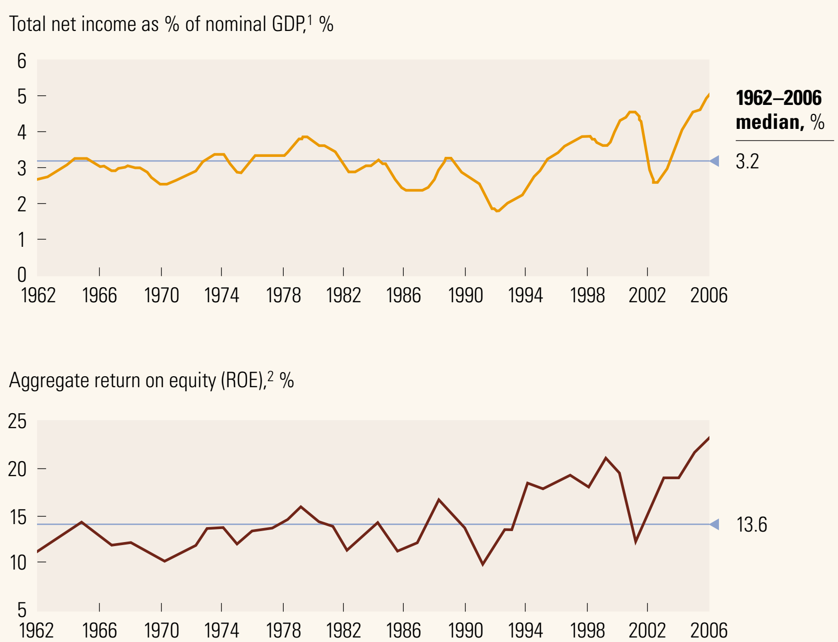
How strong? Gauged either by earnings as a share of GDP or by returns on equity, US companies apparently fared better than they ever had, at least during the 45 years of our data (Exhibit 1). Between 2004 and

Exhibit 1

New heights for corporate earnings

Returns on equity are strong.

For all companies in S&P 500



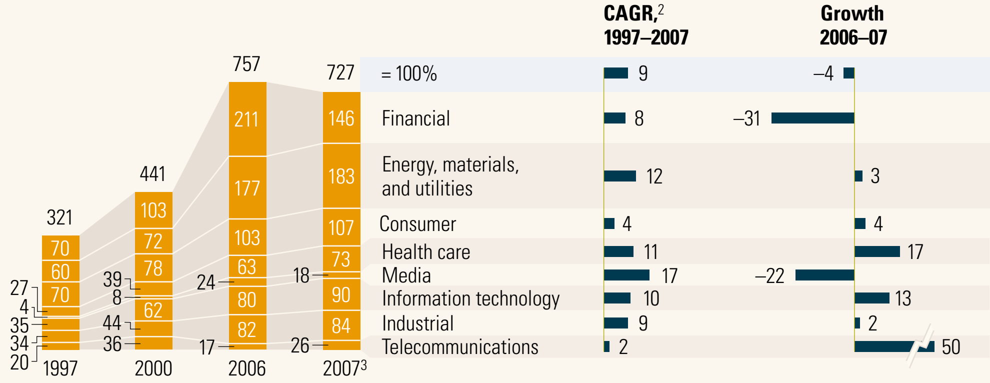
[1]Before extraordinary items; adjusted for goodwill impairment.
[2]Adjusted for goodwill and goodwill impairment.

Exhibit 2

Some reversion has begun

The decline in earnings during the fourth quarter of 2007 took place largely in the financial and energy sectors.

Total net income by sector for S&P 500 before extraordinary items and adjusted for goodwill,[1] $ billion



[1]Figures may not sum to 100%, because of rounding.
[2]Compound annual growth rate.
[3]Based on reported net income and preliminary net income from continuing operations (314 companies) and available analysts' earnings forecasts (177 companies).

Source: Company filings; DataStream; McKinsey analysis

2007, the earnings of S&P 500 companies as a proportion of GDP expanded to around 6 percent, compared with a long-run average of around 3 percent, with the increase most acute in the financial and energy sectors.

At the heart of this widely enjoyed earnings growth was a sales-driven expansion of net income rather than improved overall operating margins, growth in investments, or invested capital, each of which grew only slightly. In effect, companies increased their capital efficiency by selling more without making proportionate investments. In the nonfinancial sector, this meant squeezing greater capital efficiency from plants and working capital, so that returns on capital employed rose some 40 percent above the long-run US trend.[2] Credit-driven consumer expenditures provided much of this revenue boost.

In the financial sector, higher volumes and fees stoked returns on equity that were around 60 to 80 percent above the historical trend. Some of these returns, however, came from subprime products and instruments—such as collateralized debt obligations, or CDOs—which created an earnings bubble that has now burst.

All fall down?

Some reversion to the norm is already under way. The decline in earnings during last year's fourth quarter took place largely in the financial and energy sectors (Exhibit 2). How far could earnings fall? If we exclude the energy and financial sectors, they would have to drop by at least 20 percent from their 2007 levels to reach long-run average levels and by around 40 percent to reach the low points in the previous earnings cycles.

For S&P 500 earnings overall—including the energy and financial sectors—to reach their long-run average proportion of GDP, they would have to decline by 30 percent

[2]Europe experienced a similar effect, but its magnitude was much smaller, with returns on equity only some 20 percent above the long-run trend line.

from the 2007 level. And they would have to drop by as much as 60 percent for earnings to reach the lower points of previous cycles, such as in 1991. This scenario is less likely, since the current strength in the energy sector is less dependent on the general health of the US economy.

Preparing for a downturn

The recent fiscal stimulus by central banks (particularly in the United States), combined with strong ongoing Asian growth and historically low interest rates, could well mitigate the effects of a radical reduction in earnings to mean levels. What's more, the dollar's weakness will support US exports and thus boost manufacturing. Even if the US economy adjusts well to the current turmoil, however, the process will probably take longer than most executives and analysts optimistically assume.

Against that backdrop, executives should more actively take precautions against a sharp economic downturn or a prolonged earnings slump—or both. The starting point for such preparations is to understand the history and microeconomics of your industry and know how a downside scenario might look. What did companies do during past downturns, and how did some of them position themselves to be more successful afterward?

The prospect of a prolonged downturn should lead to the introduction of more severe contingency plans for managing credit risk, freeing up cash, selling assets, and reassessing growth. But executives should also think through the opportunities that a downturn provides. Research shows that it is at the start of a downturn—when costs such as capital expenditures, R&D, and advertising are low—that executives who have planned in advance can make countercyclical moves to build competitive advantage when times improve. A downturn can be a great opportunity to hire talent, to continue spending on long-term strategic initiatives, and to target acquisitions.[3] Companies that now enjoy strong balance sheets have a good position to take advantage of current credit market conditions and reap outsized value for shareholders.

In many cases, building in financial and operational flexibility forms the core of efforts to benefit from a downturn. Executives must therefore understand how to make costs more variable, and CFOs need to understand how to get their balance sheets ready to do so. The desirable moves include shaping the investor base to generate support for ideas that might seem to go against conventional wisdom in a downturn and could require a reduction in dividends. Companies shouldn't rule out investigating and approaching potential financial partners, such as private-equity players or sovereign wealth funds, whose resources could help their allies to make the most of a slump.

If the past is prologue, corporate earnings may face a more substantial and prolonged decline than the current consensus expects. Boards and executives shouldn't postpone efforts to plan for a downturn—plans that might include initiatives to seize the competitive opportunities a slump might unearth. MoF

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[3] Richard F. Dobbs, Tomas Karakolev, and Francis Malige, "Learning to love recessions," mckinseyquarterly.com, June 2002.

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