

McKinsey on **Finance**



Perspectives on Corporate Finance and Strategy

Number 17, Autumn
2005

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McKinsey on Finance is a quarterly publication written by experts and practitioners in McKinsey & Company's Corporate Finance practice. This publication offers readers insights into value-creating strategies and the translation of those strategies into company performance. This and archived issues of *McKinsey on Finance* are available online at www.corporatefinance.mckinsey.com.

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Measuring stock market **performance**

TRS doesn't reflect a company's performance or health. What does?

**Richard Dobbs and
Timothy Koller**

In the previous issue of *McKinsey on Finance*,¹ we explored how investors can assess a company by examining its past performance and its health—that is, its ability to sustain performance over the long run. In an ideal world, we would need only to examine a company's stock market performance to see how well it was doing. Yet this third measure is anything but easy to interpret.

The most common approach to measuring a company's stock market performance is to calculate its total returns to shareholders (TRS)² over time. This approach has severe limitations, however, because over short periods TRS embodies changes in expectations about a company's future performance more so than its actual underlying performance and health. Companies that consistently meet high performance standards can thus find it hard to deliver high TRS: the market may think that management is doing an outstanding job, but this belief has already been factored into share prices.

One way to understand the problem is by way of analogy with a treadmill whose speed represents the expectations of future performance implicit in a company's share price. If managers exceed them, the market not only raises the share price but also accelerates the treadmill. As the company's

performance improves, the expectations treadmill turns more quickly. The better these managers perform, the more the market expects from them; they must run ever faster just to keep up. This effect explains why extraordinary managers may deliver ordinary short-term TRS; conversely, managers of companies with low performance expectations might find it easy to earn high TRS. This predicament illustrates the old saying about the difference between a good company and a good investment: in the short term, good companies may not be good investments, and vice versa.

Overcoming the limitations of TRS

Companies can compensate for the shortcomings of TRS by employing complementary measures of stock market performance. One of them is market value added (MVA): the difference between the market value of a company's debt and equity and the amount of capital invested. A related metric is the market-value-to-capital ratio—a company's debt and market equity compared with the amount of capital invested.

MVA and market-value-to-capital ratios complement TRS by measuring different aspects of a company's performance. TRS measures it against the financial markets' expectations and changes in them. MVA and the market-value-to-capital ratio, by contrast, measure the financial markets' view of a company's future performance relative to the capital invested in it, so they assess expectations about its absolute level of performance.

Let's examine home-improvement giant The Home Depot and the other large retailers in terms of their stock market performance. The market value of Home Depot's debt and equity (including capitalized operating

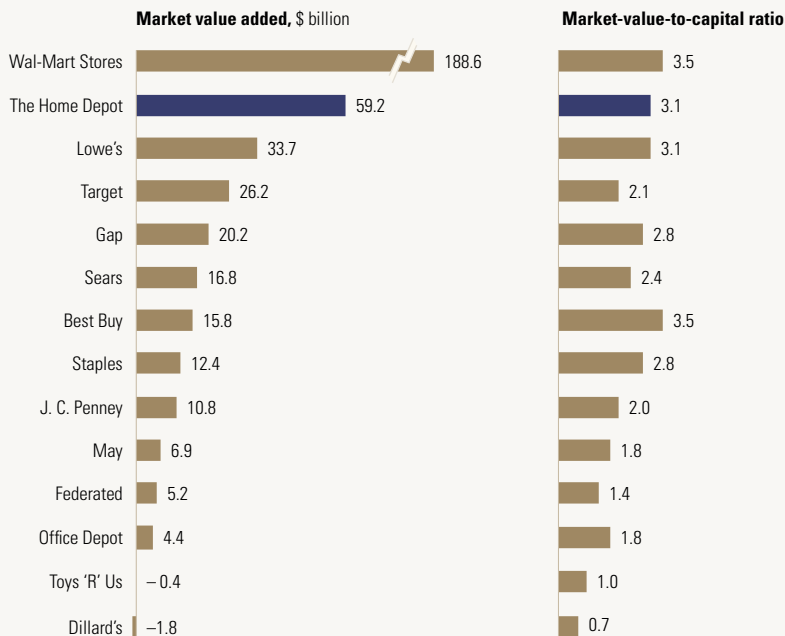
¹Richard Dobbs and Timothy Koller, "Measuring long-term performance," *McKinsey on Finance*, Number 16, Summer 2005, pp. 1–6 (www.mckinseyquarterly.com/links/18226).

²TRS is defined as share price appreciation plus dividend yield.

EXHIBIT 1

Absolute and relative measures

Dec 2003



leases) was \$88 billion at the end of 2003, when it had \$29 billion invested in operating capital (working capital, the capitalized value of operating leases, and property in plant and equipment). Home Depot's MVA was therefore \$59 billion and its market-value-to-capital ratio was 3.1.

The MVA of Home Depot was the industry's second highest, behind only Wal-Mart Stores and far ahead of the rest. Home Depot's market-value-to-capital ratio was also at the top end of the scale, though not as high as some other well-performing companies (Exhibit 1).

What about TRS? For the five years ending in 2003, Home Depot's—at -2.3 percent annually—was near the bottom of the group. The company did deliver the second-highest MVA, a strong market-value-to-capital ratio, and the second-highest

economic profit, but it had very low TRS. Evidently, Home Depot's performance over recent years wasn't up to what the market had expected at the start of the measurement period (1999).

Exhibit 2 illustrates the “expectations treadmill matrix.” The matrix plots market-value-to-capital ratios on the horizontal axis and TRS on the vertical axis, and the dashed lines represent the median for both measures. Companies in quadrant 1 have both a high TRS and a high market-value-to-capital ratio, while those in quadrant 3 are low on both measures. These quadrants are easy to understand because both metrics are high or low.

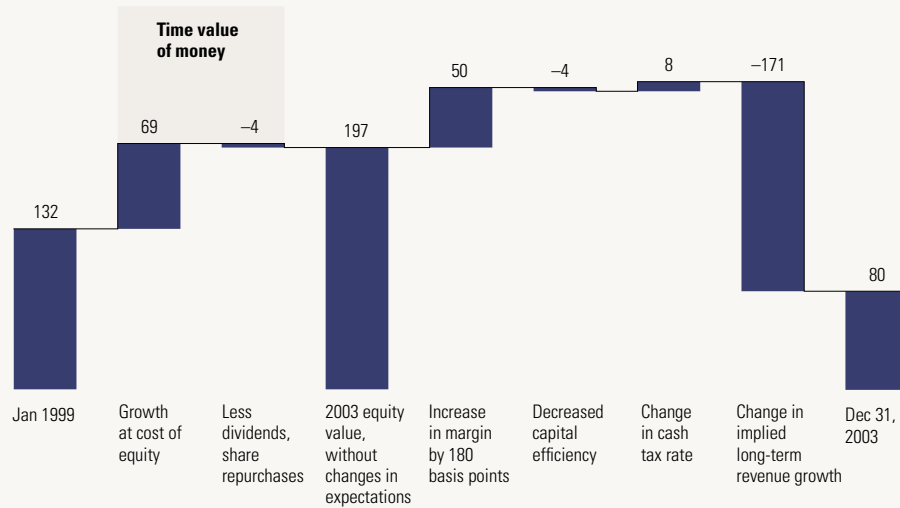
Recovering underperformers reside in quadrant 2: they have low market-value-to-capital ratios, which were even lower five years earlier. These companies have a high TRS because they have improved their performance relative to weak expectations—thus accelerating the treadmill, though their market-value-to-capital ratios remain below the median.

In quadrant 4 is Home Depot, with a low TRS but a high market-value-to-capital ratio, along with other retailers such as Gap, Staples, and Walgreen. Historically, these retailers have been some of the best in the United States. What's going on? It is impossible to say whether their position results from unrealistic market expectations at the beginning of the period or from the inability of managers to realize their company's potential. The treadmills may have simply been moving too fast for the companies to keep running at the required pace. But note that 1999, the beginning of our TRS measurement period, was near the top of the stock market cycle, when large-capitalization

EXHIBIT 3

Changing growth expectations result in reduction in market value

Change in market value for The Home Depot, \$ billion



We return to the company's negative five-year TRS. Exhibit 3 shows an analysis of the change in Home Depot's value over the five years through 2003. We start with the market value in 1999 of \$132 billion. If Home Depot had performed exactly as expected, its equity value would have increased by the cost of equity (less dividends and share repurchases), to \$197 billion at the end of 2003. The difference between that number and its \$80 billion market value is the result of changes in the market's expectations of the company's performance.

Assume that in 1999 the market forecast Home Depot's margins and capital turnover to remain at 1998 levels. Since its operating margins actually grew, the market *should have* increased the company's value by \$50 billion. The cost of equity, capital efficiency, and the cash tax rate did not change significantly during this period, so we attribute the remaining gap to changes

in expectations for revenue growth. In Home Depot's case, growth expectations declined significantly, accounting for a \$171 billion drop in value. At the end of 2003, we estimated the revenue growth consistent with Home Depot's share price to be about 8 percent annually for the next ten years. Investors in 1998 would have had to expect the company to grow at 26 percent annually to justify the market value at the time. Such high growth expectations would have required Home Depot to triple its store count over ten years—from 760 in 1998 to more than 2,300 in 2008—with continued healthy growth until at least 2013, far beyond the saturation level predicted by some market observers. From this analysis, we are tempted to conclude that Home Depot's poor TRS since 1999 results more from an overly optimistic market value at the beginning of the period than from ineffective management.

Measuring a company's performance in the stock market isn't as easy as looking at TRS, which is driven as much by how the company was valued at the beginning of the measurement period as by its performance. MVA and the market-value-to-invested-capital ratio help to put TRS in context, but to really understand a company's stock market performance, its value must be linked to historical and projected growth and returns on capital. **MoF**

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Reducing the **risks** of early M&A discussions

Used early in negotiations, a third-party clean team can help companies assess a deal and protect sensitive data.

**Seraf De Smedt,
Vincenzo Tortorici, and
Erik van Ockenburg**

Every executive knows what a high-stakes game M&A talks can become. But even before the formal negotiations start, a one-on-one conversation that plants the seed of a deal or a back-of-the-envelope sketch of the business case for it may present deal makers with conflicts of interest and strategic vulnerabilities. Who would get what value from a deal? Who would govern the new entity? What legal boundaries must prospective partners be careful not to cross? Moreover, deal makers also know that failing to close a transaction can turn today's potential partner into tomorrow's better-informed competitor.

Tension often grows as each company increases its investment in time and advisers. The longer negotiations go on, the more anxiety builds to complete the deal—if only to avoid the embarrassment of failing to deliver it. Transaction costs rise, constraining a company's ability to capture synergies and in some cases even causing good opportunities to vanish.

To successfully navigate the complexities of even the earliest discussions about mergers, acquisitions, and joint ventures, some companies are borrowing an approach that merger specialists sometimes use much later in the process to expedite postmerger integration plans and business strategies: they appoint

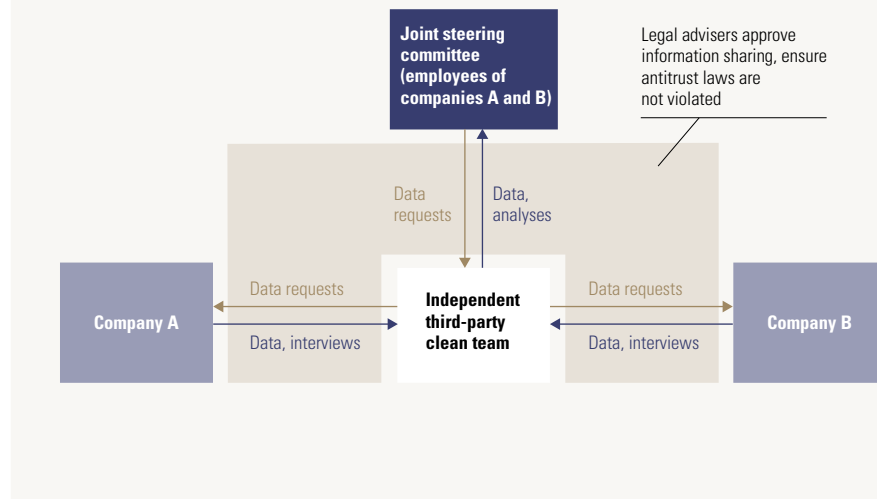
a clean team. In the preannouncement period, such a team can serve as a neutral and objective resource that supports the executives of the companies involved during the very earliest stages of their discussions. The team conducts analyses that neither party can complete by itself (or complete as accurately) to assess a potential deal. A clean team adds the greatest value in specific types of M&A transactions, such as mergers of equals, alliances and joint ventures in industries with close regulatory scrutiny, or deals involving more than two partners.

When the use of a preannouncement clean team is appropriate, one major benefit is its ability, through its unrestricted access to the confidential data of all parties, to give executives greater clarity about the potential value of consolidation long before the companies make formal commitments or disclose sensitive information to one another. A clean team often helps companies to negotiate their agreements more quickly as well, by setting aside the inevitable “win-lose” negotiation items—where one party benefits more than the other—until the very end and focusing instead on the “win-win” elements. Indeed, analyses by a clean team that served the steel companies Arbed, Aceralia, and Usinor provided “the justification for the merger,” says Guy Dollé, chairman and CEO of the merged company, now called Arcelor. “When the negotiations became difficult,” he adds, the team's analysis “brought us back to reality.”

Setting the rules

As a neutral party, a pre-deal clean team has access to privileged information from all sides and can therefore conduct an early assessment of a deal's business rationale, develop an integrated business plan for the new entity, and ultimately support

EXHIBIT

Keeping information confidential

the formal negotiation process. Since companies share confidential information only through the clean team, this approach also reduces the risk of sharing too much of it and of rushing into formal negotiations too early (exhibit). To achieve these goals—

and to keep a potential deal fully reversible, with no harm to the parties involved, until the transaction closes—the clean team must operate under strict, mutually agreed-upon rules (see sidebar, “Clean-team management: The rules of the game”).

Clean-team management: The rules of the game

Successfully implementing a clean team requires meticulous preparation. In particular, the negotiating companies must have an unambiguous shared understanding of all the conditions under which the clean team will work—and of what happens to the members if a transaction isn’t concluded. Most important, a clean team must be structured so that it doesn’t favor the interests of any one party over the others.

A clean team doesn’t share confidential information with the companies involved in negotiations but rather uses it only to develop recommendations and assessments that can be shared with all. It keeps a detailed log specifying which information has been shared with whom and when. If questions arise about what can be shared, the clean team always secures the consent of the parties or their legal teams.

At the outset, the parties should specify the team’s intended end products as clearly as possible. Details (such as data aggregation and analytical methodologies, definitions, assumptions, and decision-making rules) should be resolved within the clean team’s governance structure—typically, a committee of executives from each negotiating party. All parties must accept a confidentiality and indemnification agreement that spells out the expected levels of disclosure, such as the handling of data or the past connections of outside advisers with the companies involved in the transaction.

As in any other M&A setting that involves a data room with confidential information, the parties must agree on clean-room guidelines and on a code of conduct subject to local regulation. Only clean-team members may enter the room. Documents must be stored in a locked cabinet and a list kept detailing what information about the

These strict rules allow a clean team to help companies verify their business plans and assess the likely extent of synergies by making it possible for the team to have free access to sensitive data (such as customer lists and raw-materials and production costs) that companies can't or don't want to share, because of regulatory or competitive considerations. Instead of sharing sensitive information directly, the companies provide it to the clean team, which consolidates the analyses into figures and reports that can be presented without risk to the top management of all parties.

The advantage of adhering to the rules can't be overstated. This point is most critical when companies focus on win-win issues, where an objective solution can be identified that is in the best interest of all parties. In the case of a joint venture involving two logistics companies, for example, the clean team helped them agree, very early in their discussions, on a common, objective set of principles

for setting transfer prices—an issue that otherwise could have become contentious during later negotiations, perhaps even scuttling the deal. Once these common principles were settled explicitly, no major differences of opinion on this subject arose later on, and the deal's champions on both sides remained in alignment.

Resolving such issues in the early stages of a deal by ensuring overall adherence to agreed-upon rules and harmonizing the assumptions behind the business plans of the various parties are two fundamental aspects of the clean team's role.

An adaptive approach

Typically, a clean team can support three phases of pre-deal discussions. Given the typical pressures and complexity of M&A transactions, the best approach is to use a single team throughout all three. In the first phase, the clean team helps the two (or more) parties to investigate the transaction in its early stages (for instance,

companies has been stored in which places. Making copies must be forbidden.

Managers and executives from the parties to the transaction must be involved in the process. But a preannouncement clean team can't include their own employees, who would by definition threaten its neutrality, which is essential at the preannouncement stage. By contrast, a clean team that supports integration efforts from the announcement to the closing may include employees of the negotiating companies—often recent retirees, people about to retire, or those who can be assigned to different business units should the deal fall through.

The parties must also agree about what would happen to the team (both their own employees and the outside advisers) if the deal were to fall through. Typically,

individual members of a clean team can't work for any of the parties, at least in the business or function related to the team's work, for a specified time period—often two years.

A preannouncement clean team doesn't get involved with the win-lose elements of negotiations, such as splitting the value of synergies between the parties. Instead, the team flags these issues and returns them to the deal's steering committee for direct negotiations by the parties. This is typically less of an issue for integration clean teams, since the parties have an interest in maximizing the value of the newly combined company or joint venture.

Finally, to ensure full impartiality the parties involved should share equally the cost of outside advisers working on a clean team.

A clean team works with both parties to establish contractually enforceable rules that protect sensitive information, ensure impartial treatment, and maintain a focused and transparent process

following exploratory talks at the CEO level). At this point, the team focuses on assessing the high-level strategic rationale, drawing on sensitive information from the parties involved. If the clean team's analysis helps the companies to confirm that the deal's business rationale makes sense, the process continues as it would in any other M&A transaction—typically, with executives signing a nonbinding letter of intent. In the second phase, the clean team continues to build the detailed business case in preparation for the final negotiations. In the third phase, when negotiations inevitably turn to the deal's more contentious elements, the clean team becomes less prominent but remains active as a neutral facilitator, answering specific questions about the details of the business case.

Confirming the business rationale

In the absence of a clean team, the business rationale for a deal is often scoped out only in informal discussions between the CEOs and a handful of other senior executives. In our experience, they often have little time to investigate the specifics. The risks of this approach are that momentum may slow because no executive has sole responsibility for pushing the deal through to completion or that, conversely, the partners may rush into final negotiations too quickly. In any event, the records from this crucial first stage are often vague and incomplete, which may waste valuable time later on if issues must be reexamined. Sometimes, serious problems that turn into deal breakers emerge late in the process. At worst, such a deal might simply evaporate.

By appointing a clean team, companies make the analysis more thorough and

ensure that they commit enough resources to explore the merits of a potential deal early on. Thus they ensure that its business rationale gets evaluated adequately and that they understand the critical issues while they are still in a cooperative phase of discussion. Also, the appointment of a clean team makes the process of investigating a potential deal more formal. Typically, greater formality encourages champions to emerge naturally on both sides, even during this early stage, and gives them a vested interest in moving the deal to completion once its merits have been confirmed.

In the case of the two logistics companies, the clean team's access to all of their confidential data made it possible to compute the deal's cost and revenue synergies with a high degree of detail and accuracy. The clean team was also able to confirm for the prospective partners that their respective business plans were based on similar expectations about the impact of restructuring.

Keeping the focus on an integrated business plan

In conventional merger or alliance talks, companies typically appoint a joint team to negotiate an integrated business plan. In our experience, such a team often spends a great deal of time reaching agreement on procedural issues, such as the business plan's format, the alignment of valuation assumptions (such as depreciation policies), and even the future positions of individual managers. These secondary issues inevitably sidetrack the negotiations from a focus on developing a solid business plan for the integrated entity.

A clean team, by contrast, works with both parties to establish contractually enforceable rules from the outset not only

to protect sensitive information and ensure equal, impartial treatment of the companies involved but also to maintain a focused and transparent process. Such rules and processes prevent managers on all sides from pursuing their personal agendas, so the members of the clean team can quickly agree on or dispose of secondary issues. Sticking tightly to the rules builds trust in the process and in the clean team and makes it possible for both the team and the companies involved to focus on harmonizing the assumptions behind its analysis and on building a solid integrated business plan.

After two midsize European banks had spent almost a year conducting negotiations on a wide-ranging cooperative agreement, for example, the talks broke down over disagreements about the structure of the complex deal and the banks' respective valuations. Frustrated about the time, the money, and the energy that would have been spent in vain if the deal collapsed, the two institutions appointed a clean team to help get their discussions back on track. Under the leadership of a joint steering committee, the clean team helped executives on both sides to set aside some of the more complex aspects of the deal structure and instead to concentrate on an analysis of the merits and implications of the business case. Supported by the clean team, the two companies reached agreement in principle within three months. The deal closed fully about six months later.

Supporting negotiations

While win-win issues lie at the core of any effort to develop an integrated business plan, win-lose issues take center stage in the third and final phase of negotiations. One classic example is the problem of dividing the value of the synergies identified

and valued during the first and second phases among the merging companies. Resolving this issue is a matter solely for negotiations between the interested parties. As a neutral intermediary, the clean team cannot take a stance.

During this phase, the role of the clean team thus changes from facilitating discussions based on the results of its analyses to supporting the negotiations. The team will have completed most of the background work of justifying the rationale of the transaction, building the business case for it, and identifying its synergies. Now the team usually works on responding to questions that come up in the negotiations—for example, the deal's value if putative growth rates or margins rise or fall.

Typically, investment banks or other counselors support the companies during this phase, whether or not a clean team is in place. But without a clean team's objective record of agreements and parameters, every aspect of the deal may be subject to lengthy discussion. A clean team can therefore still add value in a supporting role, if only by ensuring that the parties don't reopen issues on which they have previously agreed.

Common structuring tools, such as the negotiation grid the logistics companies mentioned previously used in their effort to form a joint venture, help a clean team to ensure that negotiations remain focused, timely, and on track. All of the parameters (about 50, in this case) driving the valuations of the respective companies were assessed, and for each parameter the clean team helped to forge a consensus on whether an identical value was required for both parties (for example, an identical cost of capital to value the business plans of both but different multiples to value

their subsidiaries). The team then indicated the parameter's impact (low, medium, high) on both parties, thus ensuring that precious time wasn't lost on minor issues that had little impact on value. The members of the team, who attended the negotiating sessions only to take notes and to ensure that the parties had a common understanding of its analyses, scrupulously sent back to the negotiators any questions it couldn't answer by using the results of its analyses in a way that was consistent with the previously agreed-upon rules of engagement.

A clean team delivers the greatest possible value if it can take a deal all the way through to this final stage. By then, the team will have become the deal's memory and conscience, thus ensuring—together with the champions on either side—that the negotiations reach closure.

Clean teams can be as effective in preannouncement discussions of an M&A deal as they often are in preparing companies to integrate after the deal closes (see the next article, "Smoothing post-merger integration"). Indeed, when used in the very earliest stages of discussion, such teams increase the likelihood of closing valuable deals and help companies to strike better and stronger agreements—or, alternatively, to conclude early in the process that a deal's business rationale doesn't stand up to scrutiny. **MoF**

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Smoothing postmerger **integration**

It takes less time than you think for a clean team to make valuable contributions to the integration of businesses.

**Nicolas J. Albizzati,
Scott A. Christofferson, and
Diane L. Sias**

In any merger, acquisition, or joint venture, the sooner managers integrate their companies the faster they capture the expected synergies. So in the hectic days and weeks after a deal is announced, CFOs face a daunting list of responsibilities, such as managing the deal's financial aspects, justifying the strategy to investors, negotiating with regulatory authorities, and ensuring compliance with the regulations that come into force once a deal is announced. And CFOs must manage all this while essentially flying blind, without access to legally restricted data.

In our experience, establishing a clean team to support integration efforts before a deal closes can help speed up the completion of critical tasks and improve the chances of capturing the merger's synergies. Working under confidentiality agreements, such a team has unrestricted access to data from each of the companies involved—data legally off limits to the companies' employees until the deal closes. After compiling and analyzing this information, the team can quickly deliver aggregated findings that help decision makers plan the structure and operations of the merged entity even before the deal has closed.

Given such virtues, it's surprising that executives don't set up integration clean teams more frequently. Many CFOs tell us

they worry that there won't be enough time for a clean team to accomplish anything before a deal closes. Some of them express concern that sharing confidential data will expose their companies to undue risk should the deal fall through—or that the impact of the clean team won't justify the expense of assembling it.

Such misplaced concerns often lead to costly delays. We believe that a well-structured clean team almost always makes it possible to capture a merger's value more quickly and can reduce the risk of failure. Such teams address myriad issues that are well within the limits of the regulations—and can help to resolve them well within the period between the announcement and the close of a deal.

Indeed, we find that managers consistently underestimate how much time may be involved at this stage, which for the 455 largest mergers in 2004 lasted an average of nearly three months (Exhibit 1).¹ That is plenty of time for a clean team not only to conduct analyses and make decisions that expedite postclosing integration but also to prepare the merged company to be fully operational from day one. Thus the team's work helps capture more of the merger's synergies before competitors have a chance to react.

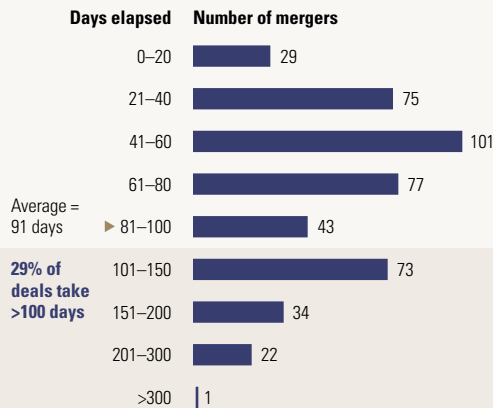
Moreover, clean teams can add value to merger integration efforts in incremental chunks—at first, quite small ones. Executives who anticipate having as little as a month between the announcement and the close of a merger should be able to assemble the most basic kind of clean team, which undertakes the critical work of gathering and harmonizing data and can serve as the foundation for a more elaborate team if time permits. And with a small team in place, the parties to a deal can avoid

¹The top 455 mergers, by transaction value, announced in 2004, excluding withdrawn, pending, rumored, and intended deals as well as deals announced and closed on the same day.

EXHIBIT I

A time-consuming process

Mergers and days elapsed between merger announcement and effective completion date¹



¹Top 455 mergers by transaction value announced from Jan 19 to Dec 31, 2004; excludes withdrawn, pending, rumored, and intended deals; excludes deals in which deal announcement and closure occurred on same day.

Source: Thomson

having to play an expensive catch-up game after it closes.

Three types of integration clean teams

In theory, clean teams can handle a broad range of pre-integration analyses and planning if sensitive, proprietary, or legally restricted data would otherwise inhibit collaboration until after the close. In practice, what these teams do varies considerably, depending on time constraints, the level of public information typically available in an industry, and any preexisting relationships between the companies. When time is as short as one or two months, a smaller and more targeted clean team—sometimes comprising only a few third-party advisers who limit themselves to gathering and organizing data—is preferable. If the period between the announcement and the close is longer,

it's useful to have a larger clean team that takes a more active role in facilitating, and even designing and planning, the integration of the merging companies. And while all clean teams operate under the same assumptions of confidentiality (see sidebar, "Clean-team management: The rules of the game," on page 6), different models provide for the flexibility needed to meet the demands of individual situations.

Library clean teams

When the time between the announcement and the close of a deal is expected to be short, the most basic type of clean team, serving a library function, may well be beneficial. Such a team can be deployed quickly and meet its objectives in a matter of weeks. Its primary work—gathering and harmonizing data—is almost certain to be useful in preparing businesses to integrate. In addition, its records will help to give regulators precise answers to questions about divestitures or grandfathered products and services. In 2003, some 40 percent of US deals involved second-stage requests from regulators for information, and nearly 4 percent ultimately faced a legal challenge, so many deals are delayed considerably beyond the target closing date. Given such scrutiny, the ability to avoid risky and expensive guesswork is attractive. Furthermore, once the library team has completed its initial task, it can add analyses and functions that help it evolve into new roles as time permits.

A successful library clean team should be able to do three things. First, the team and the decision makers ought to determine which data will be needed to integrate the companies once the transaction has closed. The data will vary, depending on the synergies expected from the merger. The team should also be able to gather and harmonize the data—organizing the

information into accessible formats so it can be compared and aggregated easily. Finally, the team should be able to brief the decision makers after the close about what the data mean and to point out problems in harmonizing the data between companies.

In general, it is relatively easy to decide which data are needed to make decisions. Harmonizing the data—a bigger challenge—has the side benefit of bringing into stark relief any differences in the way the two businesses define and use them. The key is to get started; a library clean team's efforts can easily be pushed further if time permits.

One packaged-goods company, which was pursuing a hostile takeover of a competitor, began working even before it was clear that the takeover would go through. The company created an informal clean team during the time between announcing its intentions and reaching the legal threshold of ownership for compulsory acquisition. This team was charged with deciding what technology would be used to validate the company's outside-in synergy estimates and with creating a series of data templates for the target company to complete immediately after the close. As a result, the same data in the same format would be readily available from both companies.

The informal team of the acquiring company then populated the templates with its own data and created detailed glossaries so that it would be very clear what data the team was seeking. Once it became obvious that the acquisition was inevitable, shortly before the close, managers from the acquired company joined the effort in a formal clean team. Thus, the integration managers understood their real targets, without any need for a time-consuming and error-prone manual reconciliation of

financial-reporting and synergy-tracking systems. It took less than two weeks to gather the data and only a month after the close to validate the deal's synergies.

Facilitator clean teams

If executives expect at least six weeks to elapse between the announcement and the close of a deal, the merging companies should consider expanding the team's role from librarian to facilitator. A facilitator clean team's work goes a couple of critical steps beyond that of a library clean team. Once the data have been gathered and harmonized, the facilitator team and the merging parties reach an agreement about the specific analyses, assumptions, and decision-making rules needed to determine how the expected synergies will be captured. The team then supports both companies as they develop recommendations and draft action plans.

Before a deal's close, the team can typically divulge only high-level information, such as the value and timing of anticipated synergies or the total number of displaced employees from each company. After the closing, the team reviews its work with the new management, which can either implement the recommendations immediately or modify them. A facilitator clean team typically doesn't include staff from either company, so if the transaction falls through no valued employee must be displaced.

Consider a merger between two IT hardware manufacturers, where three months elapsed between the announcement and the close. The clean team was small, with only five members, all third-party advisers. Its task was focused: to review the merged companies' supply base, so that when the transaction closed the executives and staff of the newly consolidated purchasing function would be able to

review the team's recommendations and supporting analysis and begin negotiations almost immediately.

By the time the deal closed, the clean team not only had analyzed the prices and terms of the current contracts (as well as the supply market dynamics) for the most important commodities but had also recommended specific tactics for purchasing them. In addition, it provided a detailed, consolidated spending database reconciling differences in the data definitions of the two companies; validated opportunities to save money by combining their purchasing volumes, using price arbitrage, and cutting the total cost of ownership; and drafted detailed plans (including the negotiating strategy) for each key commodity. In the end, the team's support enabled the companies to accelerate their integration effort by at least two months, so they could move more quickly to capture cost-saving synergies that executives valued at \$400 million a year.

Designer-planner clean teams

Designer-planner clean teams are the hardest for CFOs to deploy: they require the most resources, the largest budget, and the greatest number of people from both organizations. Such teams therefore also involve some risk if deals don't go through. While they can complete their work successfully in only two to three months (if companies feel comfortable about the risks), we have seen them take as long as six. Despite the investment and the risks, they can capture more of a merger's synergies more quickly after the close than can the other kinds of clean teams.

At this level, the team starts the real work of planning the integration of two companies—for example, by valuing assets and modeling scenarios to support

negotiations with regulators as well as analyzing budgets and financial plans to confirm and further develop the merger's synergy and growth targets. Its other roles include reviewing the companies' business plans to identify key short-term issues that must be resolved urgently after the merger wins regulatory approval, auditing the terms of suppliers and customers to identify the source and scale of opportunities or problems, and developing postmerger strategies in sensitive areas such as pricing and channels.

A designer-planner clean team set up by two financial institutions was developed over the six months between the announcement and the close. It eventually expanded to include a total of 600 staff members from both organizations—most of the people who would staff the combined business unit after the merger. To meet the goal of hitting the unit's full synergy run rate a mere five months after the close, the team built an information system that not only allowed the two institutions' communications and support systems to interact as soon as the deal closed but also let executives transfer assets to their new home quickly. In addition, the team made all systems infrastructure and applications choices and supported the process for selecting the merged unit's leadership.

When management decides to establish a designer-planner clean team, it is critical to provide for the right kind of interaction between the clean team, on the one hand, and the integration team, the line manager accountable for execution, or both, on the other. This approach ensures that line managers don't hesitate before executing recommendations or delay the integration effort by studying them, which would reduce or even eliminate the value of the whole investment in the

EXHIBIT 2

When to enlist an integration clean team			
Factor	Clean team adds value		Comment
Expected time to close	Sooner	Later	No value in launching a clean team if close is imminent
Importance of data-related synergies to merger aspirations	Low	High	Synergies in areas such as purchasing and sales cannot be planned without access to confidential information
Level of confidential information	Low	High	If the industry has much publicly available information, clean teams may deliver less value
Current relationship between the companies	Distant	Close	If joint ventures or promotions are in place, information may already be available to both parties
Level of geographic overlap of businesses	Low	High	Distinct geographies reduce likelihood that clean teams are needed
Level of product overlap of businesses	Low	High	Where there is no product overlap, sharing information is a commercial decision
Expectation of deal being approved by regulators and shareholders	Moderate	High	If approval is certain, clean teams may not be necessary; if the deal is at serious risk, companies may prefer to wait altogether
Need for delivery of synergies immediately after close	Low	High	Synergies in certain areas (eg, purchasing) must be addressed aggressively right after close; clean teams can accelerate process

clean team. In a recent merger in the chemical sector, a clean team was set up to segment customers by profitability. Biweekly interactions between the clean team and the integration team ensured the proper alignment, focus, and direction.

Deciding to use a clean team

Of course, in some situations the use of integration clean teams doesn't make sense. If the value of projected synergies from a merger is small, for example, the clean team's effort may not be worth the expense. A company may also have good business reasons for not sharing its sensitive information too openly—for example, when sharing technical specifics such as patents, R&D project portfolios, formulas, or oil exploration locations would create too much of a risk to its business if a deal were

to fall through. And clean teams are just impractical when the closing is imminent, in auction situations, and in most hostile takeovers, among other occasions.

The trick for executives heading up a merger is to balance the costs and risks of establishing a clean team, including the cost of outside advisers and the risk of including employees, against the risk of delaying integration planning until the deal closes and the cost of delaying the day when synergies can be captured. In such cases, it may help to analyze some of the basic opportunities and risks (Exhibit 2). Overall, though, companies may have more time to set up a clean team and may gain more in eventual synergies than most of them realize. Not surprisingly, however, managers often resist a CFO's efforts

to support these teams. Such managers claim that they need all of their time and resources just to manage the company's current workforce and don't have the management bandwidth, the people, or the budget to staff a clean team. Their resistance may be well intended, but it can cost a company dearly during the integration process.

First, without the answers a clean team can provide, the uncertainties (and hence the risk to ongoing business) will continue long past the final closure of the transaction. Second, while it is true that management must review the clean team's output and that some staff members will get involved in providing data and in undertaking analyses, this work will have to be done eventually anyway; delaying

it merely makes the peak workload after the close even worse. And the budget for a clean team is generally immaterial compared with the overall cost of getting the deal done and of the integration effort—a cost that can be as high as two times the value of the expected synergies. Finally, clean teams can have the added benefit of allowing the partners in a future merger to work together in an unbiased way that creates the trust necessary for success going forward. **MoF**

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Comparing performance when **invested capital** is low

Return on capital is the benchmark for comparing performance between businesses. But new math is needed when a company's capital intensity is low.

**Mikel Dodd and
Werner Rehm**

Executives and investors have reliable tools for measuring performance in capital-intensive sectors such as manufacturing, retailing, and consumer goods. In general, the math is simple: when managers generate returns on invested capital (ROIC) above their cost of capital, they create value. That formula makes it relatively easy to compare the creation of value among business units or between companies.

But what if the invested-capital side of the equation approaches zero, as it increasingly does among companies that use outsourcing and alliances and thus reduce the capital intensity of parts of their businesses? Other businesses, such as software development and services, also have inherently low capital requirements or take advantage of atypical working-capital dynamics, including prepayment by customers for licenses and payment by suppliers for inventory. Even traditional businesses are shedding capital: the median level of invested capital for US industrial companies dropped from around 50 percent of revenues in the early 1970s to just above 30 percent in 2004.¹

When a company's or a unit's business model doesn't call for substantial capital or even involves negative operating capital, the ROIC is usually extremely large (whether positive or negative), very sensitive

to small changes in capital, and highly volatile and thus often inappropriate as a tool for comparing the performance of business units or companies. What's more, executives who continue to use ROIC as their main point of comparison are likely to measure and manage performance unproductively. They might hesitate to invest additional resources in low-capital businesses (Exhibit 1) or, still worse, ignore capital altogether and focus on margins alone as the primary performance metric.

A more useful way to measure performance is to divide annual economic profit by revenue.² Grounded in the same logic as conventional ROIC and growth measures,³ this metric gives executives a clearer picture of absolute and relative value creation among companies, irrespective of a particular company's or business unit's absolute level of invested capital, which can distort more traditional metrics if it is very low or negative. As a result, executives are better able to evaluate the relative financial performance of businesses with different capital-investment strategies and to make sound judgments about where and how to spend investment dollars.

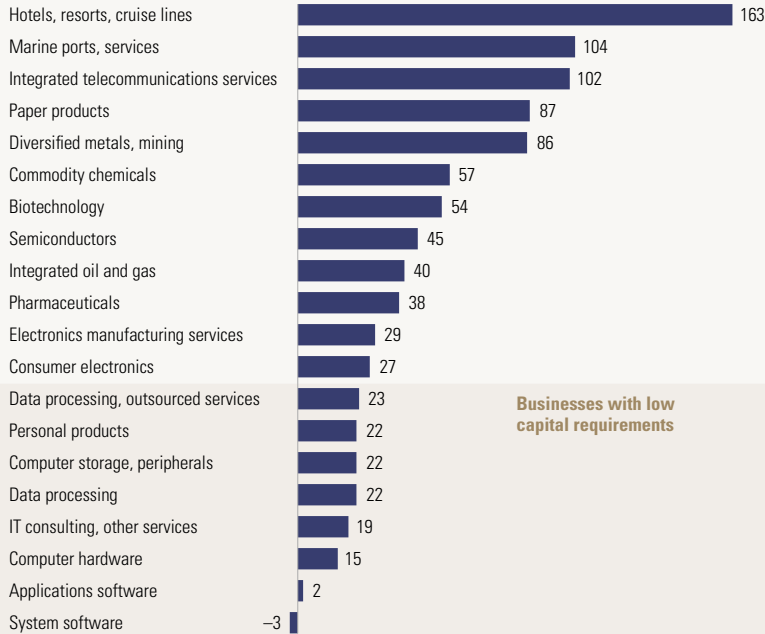
In application, this approach will vary from business to business, depending on what is defined as volume and margin. In a people business, such as accounting, the margin would likely best be broken down into the number of accountants multiplied by the economic profit per accountant. In a software business, however, it would be better calculated as the number of copies of software sold times the economic profit per copy of software; in this case, deriving the margin from the number of employees wouldn't make sense. But in all cases, this approach can provide a more nuanced understanding of performance across

¹This statistic is based on a McKinsey analysis of more than 600 companies with sales greater than \$100 million. The classification of a company as an industrial one is based on the Compustat CIGS classification system, jointly launched by Standard & Poor's and Morgan Stanley Capital International (MSCI) in 1999.

²Economic profit is typically defined as a company's posttax operating profit minus a capital charge, calculated as the company's weighted average cost of capital (WACC) multiplied by the operating invested capital. See Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fourth edition, Hoboken, New Jersey: John Wiley & Sons, 2005, pp. 182–8, for more information about calculating ROIC and economic profit.

³The present value of economic profit plus invested capital yields the same enterprise value as formulas based on ROIC and growth and discounted-cash-flow models.

EXHIBIT I

Capital requirements vary across businessesMedian invested capital as % of revenue, for selected industries¹¹FY 2004 year-end data for companies with >\$100 million in revenue.

Source: Thomson; McKinsey analysis

businesses or companies with divergent levels of capital intensity.

Same company, different economics

A large European industrial conglomerate provides an example of the difficulties of using ROIC to compare business units with different levels of capital intensity. The company's executive board decided to take advantage of a trend in traditional industries toward adopting the next generation of process automation software and services by launching a business unit that exclusively offered software solutions based on standard off-the-shelf hardware. The new business naturally had a low level of invested capital, since its assets were essentially people and no manufacturing was involved. The willingness of customers

to pay in advance for software development moved the level of operating invested capital below zero.

But while the move made strategic sense, operational reviews among the conglomerate's business units became meaningless. Executives insisted on comparing them only on the basis of ROIC and growth performance, which meant that much time was spent arguing about the negative ROIC of the new business and whether it created or destroyed value and was on track to become a profitable undertaking. Nobody could assess the performance of the software business against that of the conglomerate's traditional businesses. Discussions about the allocation of resources became heated—in particular because the growing software business needed to hire staff while older units were cutting back.

Since business models within a single industry may diverge, similar problems bedevil many executives trying to compare overall corporate performance. A US high-tech manufacturer that pursued an aggressive facility-outsourcing strategy combined with a just-in-time inventory system eventually drove its invested capital below zero. As a result, the company's ROIC was negative and therefore meaningless. A direct competitor also acted to improve its efficiency but kept its manufacturing assets in house. This decision left it with significantly higher levels of invested capital but also with higher margins. It thus had a substantial positive—and meaningful—ROIC, which made apples-to-apples comparisons between the two companies impossible. Furthermore, the ROIC of the first company fluctuated wildly, as minor changes in its invested capital sharply altered the results of the ROIC calculations.

EXHIBIT 2

Eliminating distortions in measuring value**1 Differences in return on invested capital (ROIC) become meaningless**

Business unit	Revenue, \$ million	Invested capital, \$ million	Profit margin, %	ROIC, ¹ %
Software	1,000	-10	7	-700
Services	1,000	10	7	700
Traditional	1,000	400	12	30

2 Economic profit per revenue is a better measure for value creation

Business unit	Growth, %	Value, ² \$ million	Economic profit as % of revenue
Software	6	1,765	7.1
Services	6	1,735	6.9
Traditional	4.5	2,267	8.4

¹ Calculated as revenue × margins ÷ invested capital.

² Assumes perpetuity growth and weighted average cost of capital (WACC) = 10% for software and services business units, 9% for traditional business unit.

Board members and investors of this first company frequently wondered if it was outperforming its competitor and wanted to know how management was judging the performance of its strategy and business model. In frustration, the company's executives and board increasingly focused on margins as their key operating metric. But the appropriate level of margins for their low-capital strategy was difficult to judge. They recognized that a business whose capital intensity was low as a result of outsourcing should have lower margins than one that retained its manufacturing assets and thus substantial capital, but they struggled to determine how low a level was reasonable.

A different measure

To understand how a metric based on economic profit and revenue can eliminate such distortions in measuring value, consider a hypothetical company with three business units, each with \$1 billion

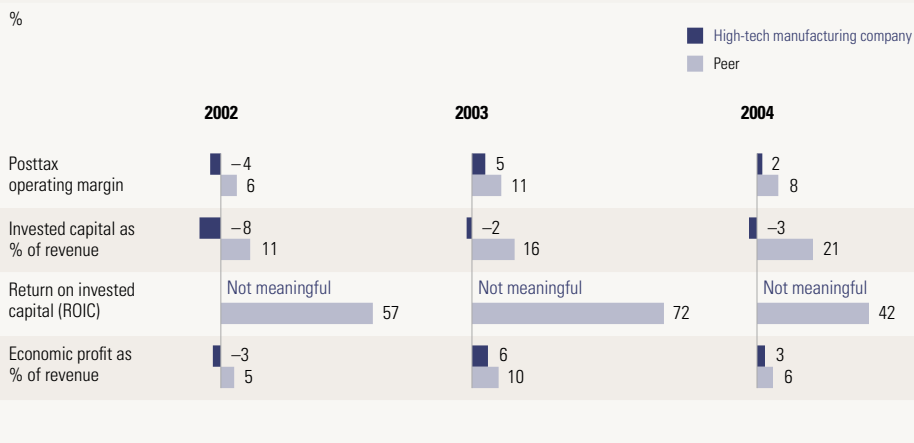
in revenue (Exhibit 2, part 1). Two newer business units—a software business and a services business—have very low or negative invested capital. The company's more asset-heavy traditional business can extract a profit margin of 12 percent (compared with 7 percent for the other units) because it doesn't outsource any parts of the value chain and has an established, captive customer base that faces high switching costs. It is growing more slowly, however—by 4.5 percent a year, compared with 6 percent for the new businesses.

Using these data, the return on capital for the software business is a negative 700 percent while the ROIC of the services business is a positive 700 percent, even though the actual difference in the invested capital of the two units is only 2 percent of revenue. The traditional business has a 30 percent ROIC. A conventional evaluation of performance would compare the two newer businesses on the basis of their margins (because their capital is so small as to be deemed meaningless) and scold the traditional business for its high capital intensity.

That kind of approach can lead to serious misjudgments of the value created by the three units and to the misallocation of resources among them—as indicated by the fact that the traditional business has the highest value of the group, even though it has the lowest growth rate (Exhibit 2, part 2). How can this result be reconciled with the observed returns on capital in order to compare the true fundamental performance of the three units? It turns out that in this case, ROIC tracks the creation of value much less accurately than does economic profit divided by revenue. According to that measure, the economic performance of the three units is remarkably similar. All are creating value in

EXHIBIT 3

Making meaningful comparisons



performance of the US high-tech manufacturer with that of its direct competitor (Exhibit 3). Owing to the high-tech company's negative invested capital (a result of the outsourcing strategy), ROIC comparisons were meaningless. Margin comparisons were also tricky; a company that outsources would be expected to have lower margins than one that holds on to all parts of the value chain. But an analysis using economic profit divided by revenue made it clear that the outsourcing strategy as implemented wasn't as successful as had been hoped; the high-tech company was still generating less value per unit of revenue than its competitor.

absolute terms (all the ratios are positive), and they are creating value at a similar rate, with the traditional business slightly ahead.

Equally important, economic profit divided by revenue avoids the pitfalls of ROICs that are extremely high or meaningless as a result of very low or negative invested capital. Economic profit, in contrast, is positive for companies with negative invested capital and positive posttax operating margins, so it creates a meaningful measure. It is also less sensitive to changes in invested capital. If the services business mentioned previously doubled its capital to \$20 million, its ROIC would be halved. But its economic profit would change only slightly and economic profit divided by revenue hardly at all (to 6.8 percent, from 6.9 percent), thus more accurately reflecting how small an effect this shift in capital would have on the value of the business.⁴

⁴Economic profit in the example falls by WACC times the change in capital, or \$1 million. The value of the business falls to \$1.720 billion, from \$1.735 billion, on this change.

Using the same approach, consider again attempts to compare the operating

Executives of the large European industrial conglomerate mentioned previously ultimately decided to use economic profit, combined with value targets based on economic-profit-discounting models, as its measure for success. While this approach required a significant investment in training, the change reflected management's goal of a consistent measure for value creation across capital-light and capital-heavy units.

Returns on capital will always be an essential metric for managers. Yet in businesses with low levels of invested capital, replacing ROIC with economic profit divided by revenue will make internal and peer comparisons much more meaningful. **MoF**

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What global executives **think** about growth and risk

As globalization creates new markets and competitors, hopes contend with fears.

**Steven D. Carden,
Lenny T. Mendonca, and
Tim Shavers**

A recent McKinsey Global Survey of Business Executives tells a two-sided story of growth and risk. On the one hand, rising affluence in developing economies and the increasingly fast pace of technological innovation present new opportunities for growth. Yet these same forces are driving the emergence of low-cost business systems that make global markets increasingly competitive, thus accelerating the rate at which companies lose their leadership positions. The survey quizzed some 9,300 business leaders around the world on the most important trends influencing the global economy in the next five years, with a particular focus on growth and the constraints to it.¹

Eighty-one percent of the executives surveyed think that increasing affluence and growing demand for goods in developing economies will be important during the next five years. Some 70 percent believe that these factors will buoy the profitability of their own companies. Technological innovation and the corresponding proliferation of new technologies emerged as an equally critical trend, which 81 percent of the executives consider important and 71 percent see as a significant driver of profitability.

The survey also highlights key differences of opinion. While most executives view the rise of low-cost business systems in

developing economies as an important trend, the respondents are divided over the impact these systems will have on the profitability of their own companies; the answer depends on which side of the cost divide they occupy. Likewise, while many company leaders think that the aging of the developed world—and the resulting decline in its workforce—will be an important economic factor, they disagree about the consequences: those in consumer-facing industries see opportunity, but those in labor-intensive ones see risk.

On the whole, global business leaders are bullish about the impact of key trends on profitability. Of the ten trends we studied, seven garnered more positive than negative responses—some by a wide margin (Exhibit 1): for example, 71 percent of the respondents expect technological innovation to have a positive impact on profits, while only 5 percent expect it to have a negative impact. The trends perceived as threats to global business are growing geopolitical instability, increasing risks to the supply of natural resources, and mounting environmental hazards. Many of the executives in the survey think that these three will have a negative impact on profitability.

In addition, the survey explored the actions that executives intend to take in response to the trends. How will the respondents expand the businesses they manage? What markets are they seeking? What constraints are most likely to limit growth? And what capabilities do companies require to prosper given the trends at work in the global economy?

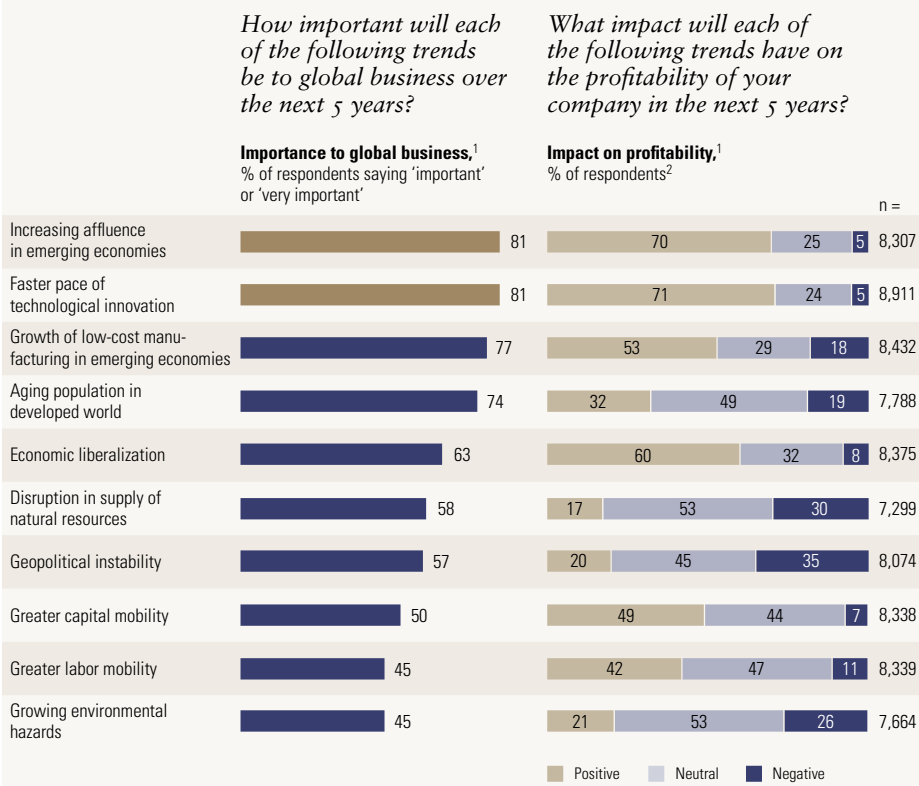
Sources of growth

When asked about the geographical sources of growth, executives point to both the developed and the developing world. Some

¹The respondents live in more than 130 countries and represent a wide swath of geographies and industries as well as a broad mix of large, midsize, and small companies. Approximately half of the respondents are “C-level” executives—board members or major decision makers in their businesses, including 274 CFOs and finance-related executives.

EXHIBIT I

Ten trends to watch



¹All data weighted by GDP of constituent countries to adjust for differences in response rates from various regions.

²Excludes respondents who answered "not applicable."

Source: Mar 2005 McKinsey Quarterly survey of 9,346 global business executives

27 percent believe that the relatively slow-growing but vast market of the United States will account for the bulk of future expansion. China, a close second, was the choice of one-quarter of the executives—little surprise given that country's meteoric rate of expansion. The United Kingdom came in third, at 7 percent, but no other country registered above 5 percent.

Interestingly, the key factor differentiating the United States and China as the market of choice appears to be company size. Of the respondents from companies with revenues of less than \$250 million, 30 percent choose the United States as the key growth market. Larger players, by contrast, anticipate more growth in China:

41 percent of the companies with more than \$5 billion in revenues expect it to be their biggest growth market. This focus on China reflects the substantial investments that many large companies have made there already. Perhaps less obvious, it also shows the growing realization that demographic trends are slowing growth in the developed world and forcing growth-hungry companies to look elsewhere.

As for the growth prospects of sectors, the executives say that health care has the greatest top-line potential in the next five years, with energy- and natural-resource-related industries coming in second. Information technology and telecommunications are tied for a distant third.

Optimism about the health care sector's growth prospects may reflect an increasing awareness of demographic trends affecting the developed world—in particular, the fact that older households will control an increasing share of total spending and will devote a growing proportion of their income and accumulated wealth to health care. This view of the health care sector's future probably results from other factors as well, including its historical growth and profitability, rapid innovation in health care technologies, and the brisk expansion of basic health care services in the developing world. Indeed, respondents from developing markets pick health care as the third most important growth sector, behind energy and telecommunications.

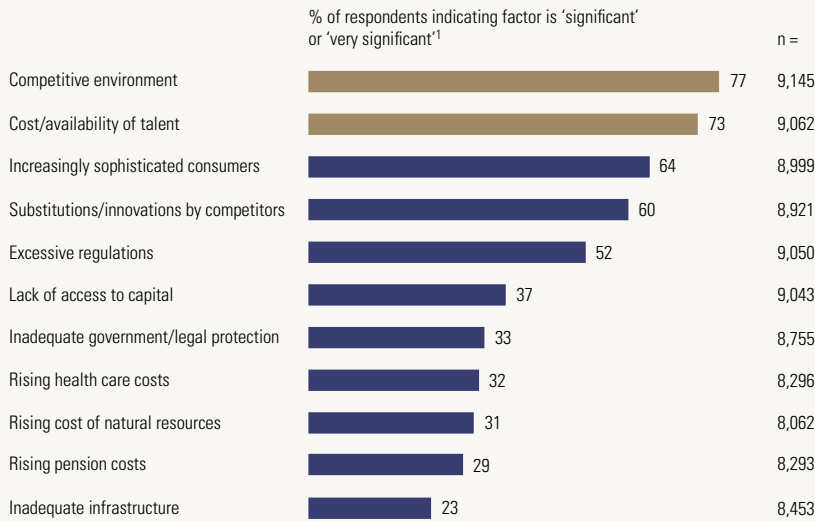
Constraints on growth

When asked about constraints on growth, the executives say that the shifting nature of their markets—the competitors and the consumers alike—will create the biggest challenges. Seventy-seven percent believe that intense competition will be an important constraint on the growth of

EXHIBIT 2

The constraints on growth

How significant a constraint on the growth of your company will each of the following be during the next 5 years?



¹ All data weighted by GDP of constituent countries to adjust for differences in response rates from various regions; excludes respondents who answered "not applicable."

Source: Mar 2005 *McKinsey Quarterly* survey of 9,346 global business executives

their companies. Sixty-four percent cite the challenges of satisfying an increasingly sophisticated consumer market. Sixty percent worry that competitors will introduce new products that could displace theirs. Large companies, which may be less confident of their ability to innovate and to stay ahead of rivals, fear the growing competitiveness and sophistication of their markets more than smaller companies do.

Another constraint preoccupying the executives is the high cost and low availability of talent; 73 percent consider this problem a key limitation on growth (Exhibit 2). Interestingly, even executives in labor-rich China and India are quite concerned about talent, with 71 percent and 81 percent, respectively, seeing it as a constraint—a response that may reflect the inherent challenges

of managing rapid growth. As China and India rise to global stature, local companies with relatively little experience managing large-scale organizations suddenly face the difficulties of handling a vast, newly employed workforce.

The constraints on growth that seem most serious to the executives vary widely by region—not surprising, given the vast differences among local business environments. North American executives are more concerned than their counterparts elsewhere about rising health care costs. Indian executives see a lack of infrastructure as a key limitation. Executives across developing economies worry about the rising cost of natural resources—a concern that probably reflects both an increasing demand for energy and the greater manufacturing orientation of these economies relative to those in the developed world.

Executives from different industries also disagree about the relative importance of various constraints. Financial-services executives see a hostile regulatory environment as a potentially key problem. Respondents from heavy industry, reacting to the recent double-digit price hikes across most commodity categories as Asian demand strains global supply, are significantly more concerned about the rising cost of natural resources.

Other potential concerns barely register with the respondents. European executives, for example, are among the least worried about rising health care costs, despite the region's rapidly aging population and the potential strain it places on national health care systems. US executives express relatively muted concern for the risks posed by environmental hazards, notwithstanding the global, if uneven, tendency to worry about and regulate them more vigorously.

EXHIBIT 3

How companies plan to grow

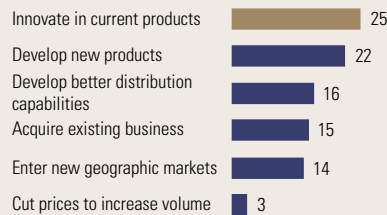
Which one of the following capabilities will be most important to the growth of your business over the next 5 years?¹

% of respondents²



Given the competitive landscape, what is the most important action your company could take to grow over the next 5 years?¹

% of respondents³



¹All data weighted by GDP of constituent countries to adjust for differences in response rates from various regions.

²Figures do not sum to 100%, because of rounding.

³Figures do not sum to 100%, because respondents who answered "other" are not shown.

Source: Mar 2005 McKinsey Quarterly survey of 9,346 global business executives

These responses and others like them suggest a tendency to assume that current local conditions will persist. This assumption creates potential blind spots about what trends are likely, over time, to upset the status quo.

Methods for growth

When the executives were asked how they plan to promote growth in the current environment, they overwhelmingly pointed to innovation, which some 43 percent describe as the capability their companies most need in order to grow. Asked what specific action is most necessary to achieve growth, one-quarter said innovation within current product lines and 22 percent said the development of new ones (Exhibit 3). Interestingly, financial-services executives, while seeing innovation as important, also regard better distribution as crucial, probably in response to the challenge of trying to deliver financial products in new and growing markets.

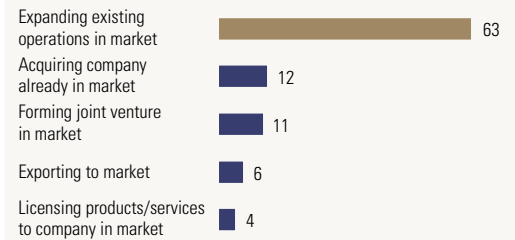
A majority of the respondents think that their companies will grow organically;

EXHIBIT 4

An organic approach

Which one of these steps will be the most important in achieving growth in your company's sales during the next 5 years?


% of respondents¹



¹All data weighted by GDP of constituent countries to adjust for differences in response rates from various regions; respondents who answered "other" are not shown.

Source: Mar 2005 McKinsey Quarterly survey of 9,346 global business executives

63 percent say that they plan to meet their goals in their most important growth markets by expanding existing operations. Only 12 percent and 11 percent, respectively, say that acquisitions and joint ventures are their most important growth strategies (Exhibit 4).

Coupled with the emergence of developing economies such as China and India, the pace of technological innovation creates a paradox of growth and risk for today's global executives. The way companies cope with the double-edged sword of low-cost business systems that make markets increasingly competitive will do much to determine which companies prosper—and falter—in a rapidly globalizing world. 

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