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Table of contents

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Changing the nature of board engagement

Five tips for directors and CEOs striving to make the most of their limited time.

Bill Huyett and Rodney Zemmel

"Ask me for anything," Napoleon Bonaparte once remarked, "but time."[1] Board members today also lack that luxury. Directors remain under pressure from activist investors and other constituents, regulation is becoming more demanding, and businesses are growing more complex. McKinsey research suggests that the most effective directors are meeting these challenges by spending twice as many days a year on board activities as other directors do.[2]

As directors and management teams adapt, they're bumping into limits—both on the amount of time directors can be asked to spend before the role is no longer attractive and on the scope of the activities they can undertake before creating organizational noise or concerns among top executives about micromanagement. We recently discussed some of these tensions with board members and executives at Prium, a New York–based forum for CEOs.[3] The ideas that emerged, while far from definitive, provide constructive lessons for boardrooms. If there's one overriding theme, it's that boosting effectiveness isn't just about spending more time; it's also about changing the nature of the engagement between directors and the executive teams they work with.

Engaging between meetings

Maggie Wilderotter, chairman and CEO of Frontier Communications (and a member of the boards of P&G and Xerox) stresses that "it's not just about the meetings. It's about being able to touch base in between meetings and staying current." Such impromptu discussions strengthen a board's hand on the company's pulse. Keeping board members informed also minimizes the background time that slows up regular board meetings. And the communication works both ways. "I also want board members to elevate issues that they're seeing on the horizon that we should be thinking about," explains Wilderotter. "To me, it's really more of a two-way street." Directors and executive teams will need to work out what rhythm and frequency are right for them. Denise Ramos, president and CEO of ITT, notes that "conversations with board members every week or every two weeks may be too much." For boards seeking to boost their level of engagement between meetings, experimentation and course correction when things get out of balance are likely to be necessary.

Engaging with strategy as it's forming

Strategy is an area where the diverse experiences and pattern-recognition skills of experienced directors enable them to add significant value. But that's only possible if they're participating early in the formation of strategy and stress testing it along the way, as opposed to reviewing a strategy that's been fully formed by executives.[4] In Wilderotter's description, strategy needs to become "a collaborative process where different opinions can be put on the table" and "different options can be reviewed and discarded." This shifts the board's attitude from reactive to proactive and can infuse a degree of radicalism into the boardroom. Effective directors don't shy away from bold strategic questions, such as "What businesses should this company own?" and "What businesses should this company not own?" We were impressed by one board that even dared ask, "Should this company continue to exist?" In fact, that board concluded that the company should *not* continue to exist and effected a highly successful reorganization separating the firm into several freestanding enterprises.

Engaging on talent

Directors have long assumed responsibility for selecting and replacing CEOs, both in the normal course of business and in "hit by a bus" scenarios. Many also find it useful to track succession and promotion—for example, by holding annual reviews of a company's top 30 to 50 key executives. But to raise the bar, some boards are moving from simply observing talent to actively cultivating it. Case in point: directors who tap their networks to source new hires. Donald Gogel, the chairman and CEO of Clayton, Dubilier & Rice, explains that "our board members can operate like a highly effective search firm. There's nothing like recruiting an executive who worked for you for a long time, particularly in some functional areas where you know that he or she is both capable and a great fit." Other boards actively mentor high-performing executives; this allows those executives to draw upon the directors' experience and enables the board to evaluate in-house successors more fully.

Engaging the field

Another way to enhance board engagement is to assign directors specific operational areas on which to engage. Board members can assume roles in specific company initiatives, such as cybersecurity, clean technologies, and risk—becoming not only "the board's eyes and ears," notes Eduardo Mestre, senior adviser for Evercore Partners and a board director of Comcast and Avis Budget Group, "but really being a very active participant in the process." Jack Krol, chairman of Delphi Automotive and former chairman and CEO of DuPont, requires board members to visit at least one business site every 12 months. At the same time, directors should be mindful not to interfere with operational teams or to supplant managers. The goal is to target specific projects that are particularly appropriate for individual directors and to encourage participating board members to be, as one director says, "collaborative, not intrusive."

Engaging on the tough questions

We noted above the value of probing difficult strategic issues, but the importance of asking uncomfortable questions extends beyond strategy sessions to a wide range of issues. "You should have some directors—perhaps 20 percent of the board—who know the industry and can challenge any operating executive in that company on industry content," says Dennis Carey, a Korn Ferry vice chairman who has served on several boards. "But the problem is not too few people on boards who know their industries. The problem is too *many* people who know the industries, who are looking in the rearview mirror and assuming that what made money over the past 20 years will make money again." Michael Campbell, a former chairman, CEO, and president of Arch Chemicals, builds on this theme by adding that "every board member does not necessarily need to have industry experience. But they must have the courage in the boardroom to ask difficult questions."

Our McKinsey colleagues have noted in past articles that understanding how a company creates (and destroys) value makes it much easier to identify critical issues on the fly.[5] In fact, it is worth asking whether everyone in the boardroom does indeed understand how the company and each of its divisions make money. Gogel even suggests that "boards should have at least one person who has the responsibility to think like an activist investor. Many boards are caught unaware because no director is playing that role."

As boards raise and grapple with uncomfortable questions, it's important to connect the dots between issues—perhaps by tasking one director with serving in an "integrator" role. "We get into a boardroom," Wilderotter remarks, "and everybody's a peer. But having a specific capacity to bring disparate points together is critical to keeping a board functional versus having it be dysfunctional."

■ ■ ■

Ultimately, there are no shortcuts to building and maintaining well-attuned board and executive mechanics. Each of the measures requires hard work from the board members—and, sometimes, a CEO with thick skin. But a good director will provide the extra effort, and an effective CEO will make the most of an engaged board's limited time. ■

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1 John Strawson, *If by Chance: Military Turning Points that Changed History*, London: Macmillan, 2003.
2 Christian Casal and Christian Caspar, "Building a forward-looking board," *McKinsey Quarterly*, February 2014, mckinsey.com; Chinta Bhagat and Conor Kehoe, "High-performing boards: What's on their agenda?," *McKinsey Quarterly*, April 2014, mckinsey.com; "Improving board governance: McKinsey Global Survey results," August 2013, mckinsey.com.
3 McKinsey is a knowledge partner with Prium.
4 Casal and Caspar, "Building a forward-looking board."
5 Bhagat and Kehoe, "High-performing boards: What's on their agenda?"

A version of this article, "How the best board directors stay involved," was previously published by Harvard Business Review, *on hbr.org.*

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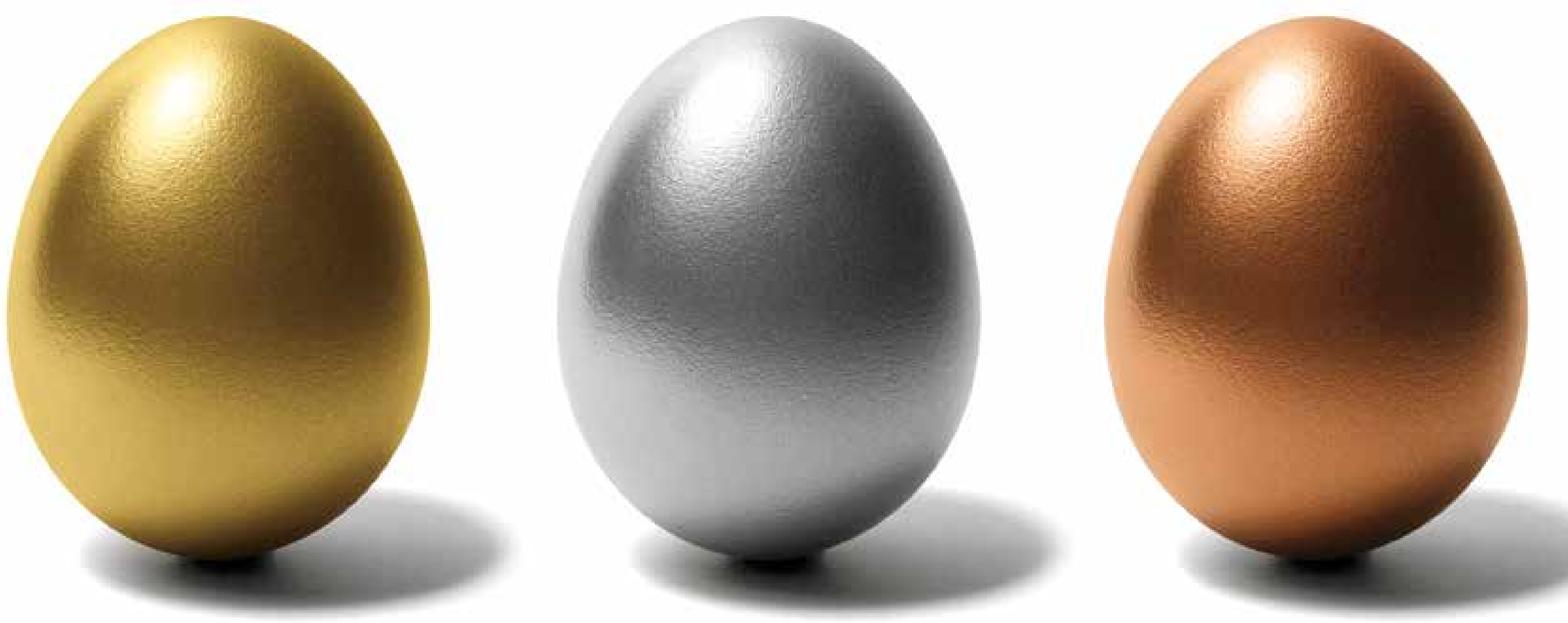

Why capital expenditures need more CFO attention

Companies in capital-intensive industries need to get more out of their capital budgets. CFOs can play a critical role.

Ashish Chandarana, Ryan Davies, and Niels Phaf

It's no secret that cost overruns and delays run rampant in large capital projects. Research points the finger at decision biases, which often play an important role in skewing the forecasting of costs and timing as projects are being planned. But a lack of internal discipline, in both the proposal and management stages of a project, further raises costs—both of individual projects and entire portfolios of investment.

It's a drain on the bottom line even when times are good, but it also leaves companies less prepared for capital constraints prompted by external events such as the recent swoon in oil prices. By our reckoning, for example, energy and petroleum companies have already had to trim between 20 and 50 percent off their current year's capital budget over last year. And when the capital budget consumes around two-thirds of cash flows, as it does in upstream oil and gas, cuts of that magnitude can force companies into painful trade-offs between cutting exploration, which imperils future growth, and reducing existing production at the risk of cash shortfalls and liquidity issues. Such decisions are especially difficult when projects can't be easily compared, when managers resist change to their budgets, and when efforts to review them are ad hoc.

Whether or not CFOs are the primary owners of the capital-expenditure process, they are major stakeholders, and in most cases they should play a bigger role. CFOs are well placed to ensure that the capital budget is consistent with an overall strategy for the use of cash, informed by their knowledge of both the capital requirements of current and future projects and balance-sheet and cash-flow constraints. The impact can be substantial, especially at companies managing hundreds of capital projects every year. Taking a more disciplined approach, one global energy company, for example, was able to trim more than $1 billion from a multibillion-dollar portfolio of more than 500 projects over the course of four years. Its experience, which we review below, is illustrative and highlights the need to create a standard, comparable model for projects; improve the business-case rigor of individual projects; and assemble a multidisciplinary team to bring independent challenge and support to managing the capital portfolio.

Create a standard, comparable model for projects

The global energy company mentioned above had a flagship business unit with a multibillion-dollar portfolio of capital investments, including more than 500 projects of all sizes, from $100,000 to $1 billion in capital expenditures. The process to develop and manage the company's vast portfolio of small capital projects—those below $5 million—was mostly left to operations and engineering. The CFO's office was responsible only for collating and distributing a master list of the hundreds of projects that the various project teams had proposed for funding. When times were good, cash was plentiful, and this approach was not questioned. However, managers realized the shortcomings in their approach when corporate executives asked them to cut costs.

The problem started in the proposal stage, when attempts to demonstrate the merits of a proposed project's underlying rationale and business case were patchy and lacked a standard methodology. Project teams that took pride in their engineering and technical excellence often proposed highly complex projects, which meant projects were often overly expensive by design. Few proposals were challenged, and most were approved as long as they appeared to be sufficiently robust to solve a real problem or could be justified on important dimensions of value or risk. This lack of standardization in project development, process, and accountability created an opacity in the portfolio that made it impossible to play a more constructive role in challenging proposals, comparing projects, or assessing the trade-offs of investing in one project over another without compromising operational integrity and sustainability.

To play that more constructive role, CFOs must implement a standard model for all projects that identifies the detailed sources of value in the business case and metrics that reflect that value for comparison with other projects. This includes setting standard rules and parameters for key outputs and assumptions on, for example, exchange rates, inflation, capital costs, and product prices. It's also essential to ensure that the standard model includes the parameters necessary to create a business case both for straightforward growth projects, where metrics like net present value and internal rates of return are easy to calculate, and also for maintenance and compliance projects, where such calculations are often more complex.

In the end, the energy company's project-development model required that each proposal demonstrate both expected direct benefits, in economic value added, and expected indirect benefits, in the value of prevented loss or mitigated risk over its life cycle. While this initially imposed a more extensive analytical burden on project teams, the effort always provided better and earlier clarity into the true value of each

Taking a more disciplined approach, one global energy company was able to trim more than $1 billion from a multibillion-dollar portfolio of more than 500 projects over the course of four years.

project and allowed for important early adjustments—in itself a key element of defining an optimal capital portfolio. In addition, project teams began to appreciate the need to develop their proposals more carefully and comprehensively up front, which paid dividends later on, as fewer projects were delayed at important decision gates.

The CFO's office should also build and govern an aggregated and dynamic view of all projects as a single portfolio. This is a critical yet often missing step that provides important insights for capital allocation. It allows managers to address fundamental questions about the likely returns of different portfolio configurations and the best mix of compliance and maintenance relative to growth projects. The goal is to drive as much transparency and internal comparability as possible across the project portfolio and connect it to critical sources of value, so that senior managers can make informed decisions as demands on capital shift—ideally acting preemptively, and, if not, then reacting quickly. Implementing such steps, the global energy company went from no portfolio view at all to a formal capital-review process. The CEO and other senior executives compared capital-expenditure-portfolio scenarios on a semiannual basis when they made funding decisions.

Improve the rigor of individual projects

While engineers play an irreplaceable role in capital projects, engineering organizations are often biased toward including costly and unnecessary features and refinements in capital projects—so-called gold plating—such as buying the latest models of equipment even when a refurbishment would do just as well. They also often resist changes to their original business case without prompting from above. Moreover, business-unit leaders see the capital budget as an opportunity to win allocation of as much money as possible with the expectation that they will later be able to spend as they see fit.

The finance organization can assert a level of rigor into the review of projects and scrutinize proposals for the kinds of arrangements that mask such problems. In one such arrangement in our energy-company example, business-unit managers often bundled together projects with poor financial viability, typically under general labels of sustaining capital or environmental, health, and safety risk. But since finance had a seat at the table for each stage-gate review of a project and was empowered to challenge both the business case and the technical case for the project, it was able to conduct a detailed review of each proposal, compelling project teams to single out discrete elements and justify those not directly related to the stated purpose of the bundle on their own merits.

Another such arrangement comes in the form of cost-avoidance projects. These do not enhance profitability but arguably prevent profitability from deteriorating. Too many of them can lead to a capital portfolio with a high headline level of returns without much improvement in the bottom line. An involved finance team can examine the wisdom of deferring the cost of, say, replacing a pump. It can compel project managers to quantify the magnitude and probability of the risk of the pump failing by asking questions such as how often pumps have historically failed. Is there a quicker fix, like having a spare readily available? Is the pump a bottleneck in the plant such that downtime would reduce overall production?

In cases like these, finance can bring a useful independence to what are often emotive issues. Environmental, health, and safety-compliance projects, for example, often include fierce arguments for immediate and total funding, without which, proponents argue, the company would surely face ruin or shutdown. In some cases this may be true; in other cases, the decision to fully fund such projects may be determined by regulation. Yet there are many examples where challenging the expectation of calamity leads to a joint realization that the speculated risk is not that high or that a cheaper solution is available. Enforcing this rigor is valuable for all projects above a certain threshold, particularly for megaprojects—those valued at more than $1 billion. These often run over time and budget and can single-handedly mar both the financial performance and reputation of a company for years.

Dedicate a multidisciplinary team to manage the capital portfolio

A close review and improvement of a large capital portfolio, sometimes called "scrubbing," requires more—and more reliable—resources and capabilities than the usual ad hoc approach provides. A dedicated team can help. In our energy-company example, once such an effort proved its value for the flagship business unit, the group's CFO built a dedicated capital-portfolio team to lead a similar process across the remaining business units. Since previous efforts by a team with only finance-related expertise had encountered objections that projects could not be changed for technical reasons, the new team included members with a full range of technical, financial, and procurement skills. The team was also designed with softer characteristics in mind, such as resilience, an ability to build relationships across different businesses and technical disciplines, and the kind of career-advancing opportunities that would attract the necessary talent.

In this example, the CFO also controlled the investment committee. While this needn't always be the case, the committee and process must have an owner independent from the businesses—such as the chief operating officer or a corporate-project organization—and finance should set the tone for rigor and at least have a voice on the quality of each project's business case. The CFO can also push businesses to raise their aspirations for how much can be cut, weighing productivity against canceling or deferring projects.

Finally, improving the postmortem process played an important role in boosting accountability. While an existing process reviewed safety and on-time and on-budget performance, the executive committee expanded its remit to review each project's overall business case at a predetermined interval after completion of the project (typically six months to three years) and whether it had delivered the expected value. The committee also put into place a rule holding each project's original sponsor accountable for its outcome, even if he or she changed roles. This improved perceptibly the level of focus and rigor in project business cases.

In the end, approximately 10 percent of proposed projects did not survive the scrubbing exercise. The team further lowered the cost of remaining projects by removing excess that often plagues highly engineering-centric project development. The sum of the two activities led to an approximately 22 percent reduction in capital-expenditure needs for the current year (about $300 million in savings for the year, realized within six months). Recognizing the size of the impact, the team was elevated to the CFO's office at the group level, with the mandate to review the entire group's capital-project portfolio. This team has since delivered a total realized capital-expenditure savings exceeding $1 billion to date, over a four-year period.

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Capital productivity is an important and often underused value lever in capital-intensive industries. The CFO who takes this to heart and knows where to plug in and how to push can make a big difference in boosting both return on invested capital and free cash flow. ■

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A hidden roadblock in public-infrastructure projects

Misplaced assumptions that governments always enjoy a cost-of-capital advantage over private players can kill projects on the drawing board. Reexamining the economics could move more deals ahead.

Alastair Green, Tim Koller, and Robert Palter

The world needs more infrastructure than governments can deliver. Long-term projections call for an estimated $57 trillion globally to build new and refurbish existing infrastructure between 2013 and 2030,[1] an amount that governments at any level are unlikely to fund. Yet private investors and companies too frequently fail to fill the gap—even when their coffers are full. As a result, we've seen specific projects not getting done—including efforts to privatize an interstate highway in the United States, build an airport in Southern Europe, develop a hospital in Scandinavia, and fund airport services in South America.

There are many reasons why such projects falter, but these four shared at least one: they all failed to attract suitable private-sector investors. Why? As we've heard from clients and learned from companies' informal decline-to-bid remarks, the returns from such projects are often too low relative to their cost of capital.

But if the assumptions about those projects' cost of capital are wrong, valuable deals may be abandoned at the drawing board for the wrong reasons. We often find this to be the case. Government managers at all levels often assume their own cost of capital to be much lower than that of the private sector, effectively lowering a project's expected returns. For example, if a bridge project is designed using assumptions of low government costs of capital, the toll on a bridge might only need to be $1—whereas private investors might need the toll to be $2 to cover their cost of capital—even when taking into account greater operating efficiencies that would lower private-sector costs.

The result is that many projects are never started. In fact, as long as returns from government infrastructure projects are structured around assumptions of a government's cost of capital, a lot of engineering and construction firms (and their capital partners in bidding consortia) tell us they just won't bid on them. It's also often one of the reasons stand-alone private-equity funds that invest in infrastructure don't invest in classic public–private partnerships.

A more thorough evaluation of the economics—especially around assumptions about lower government cost of capital—could move more infrastructure deals forward. With regard to both debt and equity, such assumptions are often misplaced—and often overlook the potential savings that private companies might offer to the often overstretched public purse.

Government capital can cost as much or more than corporate capital

Just as with any organization, a government's cost of capital includes both its cost of debt—borrowing money through bonds, for example—and its cost of equity, or funds from nondebt sources, such as the public treasury.

On the debt side, governments are limited by how much they can raise without precipitating a credit downgrade—which would increase their cost of debt or shut off their access to it entirely. A downgrade that still leaves a country's credit with an investment-grade rating may not be an utter disaster,[2] but a downgrade to lower levels can have a significant impact. In fact, the cost of a single sovereign-credit downgrade can raise the cost of borrowing for a country—as well as for its corporate borrowers—by an average of 0.5 to 1.5 percent because of the effect that a sovereign-rating downgrade has on local corporate borrowing.[3] Moreover, Standard & Poor's credit-rating formula for US local governments, for instance, places 10 percent of its overall weighting on indebtedness levels, so a jump in local or state government debt can greatly influence a downgrade.[4] Recently, countries such as Greece, Italy, Portugal, and Spain have seen increases to their interest rates attributed primarily to debt overloads. And many others around the world are grappling with high debt-to-GDP levels that may already be constraining their capacity for additional low-cost debt.

There are limits to the public treasury on the equity side too. Raising taxes or fees can be politically unpopular. Expanding the tax base—the number of taxpayers—is often a practical challenge in both developing and developed economies. And raising taxes to fund infrastructure can at least appear to run counter to efforts to attract companies with more attractive tax packages. Eleven US state governments each gave away more than $1 billion in commercial tax incentives in 2014 alone. EU countries gave away more than €23 trillion in tax incentives between 2009 and 2011, nearly 40 percent of total noncrisis private-sector support.

Moreover, when a government's cost of equity is added to its cost of debt, its overall cost of capital rises. And just as with private companies, its cost of equity is a function of the expected level of return—or level of benefits, in the government's case—that capital could receive from alternative investments with similar levels of risk. If public funds are redirected from another public goal—like education, defense, or scientific research—then the true cost of equity of public funds (measured by the economic return achievable in those other areas) can be quite high. For instance, if a particular IT system implementation is expected to

Misaligned incentives, such as a lack of penalties for a construction company that runs over schedule, can lead to major project breakdowns.

produce a 10 percent economic return over ten years, and the government seeks to redirect a portion of those funds to an infrastructure investment, the public equivalent of a cost of equity on that capital is at least 10 percent, since that reflects the alternative investment opportunity.[5]

To be sure, estimating the public cost of equity is challenging, since it could vary by geography, by time period, by social priorities. In addition, comparing the benefits from infrastructure projects, including user fees and related economic benefits, with those of social services, such as care for the elderly, invites a difficult assessment. But since the benefits of infrastructure projects are primarily economic, it is possible to approximate the government cost of equity from alternative economic investments, such as education or basic research. When a cost of equity at that level is added to the cost of debt, a government's cost of capital is often not as low, relative to the private sector, as many public managers typically surmise.

Cost of capital isn't the whole story

To weigh the potential advantages and disadvantages of public and private capital, public-infrastructure owners—which include, for example, ministries of finance, housing and development authorities, port authorities, municipal water-treatment companies, and transportation authorities that they work with—should develop a holistic picture of the advantages and disadvantages of each, taking into account both the differences in their cost of capital and other factors.

In particular, the impact of project-delivery effectiveness, such as minimizing budget overruns and missed deadlines, can often affect project cost more than the underlying cost of capital. From that perspective, involving private capital offers public-infrastructure owners potential advantages. For example, the private sector, on average, has a track record of completing projects more quickly—and projects can be designed so that companies bear the risk of cost and time overruns, which is an incentive to keep costs down.[6] Where the cost of private capital is higher, faster execution can offset those costs.

Private-sector involvement also poses possible disadvantages. For example, contracts may require amending or renegotiating in the event of significant overruns, especially when design specifications or project conditions change. Misaligned incentives, such as a lack of penalties for a construction company that runs over schedule, can lead to major project breakdowns. A lack of clarity around construction roles, responsibility for completing approvals, securing financing, or linking with other infrastructure initiatives can also result in significant delays. And the government's ability to redesign or cancel a project is greatly reduced once it has contracted with a private company. Moreover, private investors have a responsibility to their limited partners and shareholders to maximize their own return on projects. Public-procurement offices could find themselves overpaying for a project if they do not compare competing offers.

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There is no single financing solution for the gap between the $57 trillion of infrastructure the world needs and what governments can deliver. But public-sector managers should recognize that a government's cost of capital doesn't automatically give it an advantage over private funders. A closer look at the funding details could bring in private investors to deliver more, better public-infrastructure projects. ■

1 For the full McKinsey Global Institute report, see *Infrastructure productivity: How to save $1 trillion a year*, January 2013, on mckinsey.com.

2 Tom Lauricella, "Lessons of lower ratings," *Wall Street Journal*, July 30, 2011, wsj.com.

3 Heitor Almeida et al., *The Real Effects of Credit Ratings: The Sovereign Ceiling Channel*, September 15, 2014, ssrn.com.

4 *U.S. Local Governments: Methodology and Assumptions*, Standard & Poor's, RatingsDirect on the Global Credit Portal, March 6, 2014, standardandpoors.com.

5 According to McKinsey analysis, the typical cost of equity for a private-infrastructure developer is often 3 to 6 percent higher in developing countries than for otherwise comparable deals in countries in the Organisation for Economic Co-operation and Development.

6 *Case Studies of Transportation Public–Private Partnerships in the United States*, Federal Highway Administration, prepared by AECOM Consult for the US Department of Transportation, July 7, 2007, fhwa.dot.gov; Robert Puentes and Patrick Sabol, *Private Capital, Public Good: Drivers of Successful Infrastructure Public–Private Partnerships*, Brookings Institute, December 2014, brookings.edu.

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The strategist CFO: A conversation with ADP's Jan Siegmund

As the finance chief's remit has grown, companies have looked further afield to fill the role. Here's how a former chief strategy officer fits in.

Basel Kayyali and Ishaan Seth

Broader expectations of the role of the finance chief are leading to some unconventional CFOs—executives with deep experience outside the traditional finance, comptroller, and accounting career paths. This is especially so the more companies rely on the CFO to shape, refine, and implement their strategic plans. The best candidate for the role, as some of our colleagues have noted, reflects a balance among the demands of a company's strategy, the skills and abilities of the CEO and other senior managers, and the given individual's ability to drive change.[1]

So perhaps the logic was obvious three years ago, when ADP tapped its chief of strategy, Jan Siegmund, to step into the CFO role. A 15-year veteran of the data-processing company, which boasts $12 billion in annual revenues, Siegmund describes his chief-strategy-officer (CSO) tenure as marked by a series of changes that transformed ADP from a primarily national payroll-centric company to a global human-capital-management company. That experience has proved helpful for Siegmund as CFO, especially in his ongoing efforts to transform ADP's finance function.

We recently sat down with Siegmund in ADP's Roseland, New Jersey, headquarters to discuss his role as CFO, ADP's finance transformation, and the impact of technological innovation on the industry. (An abridged video of the conversation is available on mckinsey.com.)

McKinsey on Finance: *How did the transition from CSO to CFO come about?*

Jan Siegmund: I joined ADP around 15 years ago and spent more than a decade in a variety of strategy roles. It was about two-and-a-half years ago that our CEO, Carlos Rodriguez, approached me about taking on the role of CFO. It caught me by surprise, I have to admit, because it had not been core and center to my own career planning.

Throughout the discussions with him and the board, it became clear that ADP was seeking to interject more of a strategic view into the finance organization. ADP, as a company, has had a very strong foundation in finance, but the function was a little more operations and transaction oriented than it should be. Part of the idea and intent of transitioning me into the role of CFO was to add a component of driving change a bit more aggressively—not only for the finance organization itself but also for leveraging the role of the CFO to help the company accelerate its performance over time.

That was consistent with my career as a CSO, which focused on executing change programs for the company—whether facilitating and driving acquisitions or divestitures, instituting new product introductions, or building different skill sets across the organization. I think that experience helped me become the kind of action-oriented person needed in a large, classic function like finance.

McKinsey on Finance: *How did serving as chief strategy officer prepare you to be an effective CFO?*

Jan Siegmund: As a chief strategy officer, one has a unique opportunity to think about the enterprise in its completeness—to focus on the big-growth drivers and performance drivers for a company. That kind of prioritization is also crucial to being effective in the CFO role, where it's easy to lose the big picture of what's needed to drive the company's success in myriad daily transactions. For me, that was one of the biggest benefits of having a background in strategy: the ability to take apart complex problems, isolate core performance factors, and focus on those—and to set aside smaller issues that can eat into your day.

McKinsey on Finance: *What is it like coming into the CFO role without the technical background in areas such as accounting and treasury management?*

Jan Siegmund: As an unconventional CFO, you have to have a fair amount of respect for the function. There's a huge amount of learning to be done in the initial years to perform well. During my first 100 days, I invested a significant amount of time in learning and understanding—in particular the areas that had not been natural areas of focus for me, namely external reporting, compliance, audit, tax, and treasury functions.

Like most strategists, I like to think of myself as a lifelong learner—I like to understand and to dig deep into problems. Bringing that mind-set into the finance role helped me learn about the needs of our external-reporting functions, the compliance needs, tax needs, audit needs, and so on. Being open-minded and being an avid learner clearly helps a CFO with a nontraditional background. I also had a strong team that was very patient with me—that also helped. Is it a good idea for other companies to follow, in some ways, in ADP's shoes—to have CFOs without that kind of technical training? It would be hard to generalize. Every company is different. In ADP's case, we had a successful, highly functioning finance function that needed strategic direction—and it seemed I was a good fit for the role. But without that kind of context, a board would probably want to consider different profiles for the role, to meet the specific needs of its company.

McKinsey on Finance: *Going back to your unique background, do you think one person can fulfill both the strategy and comptrolling requirements of a large, multinational company? Is there a future where the two roles converge?*

Jan Siegmund: At ADP, the chief of strategy drives our corporate strategy, and the role is separate from the chief of finance. I'm a big proponent of that split and it serves us well. As a CSO, you need to have the time and resources to think about what affects a company's long-term trajectory without the demands of a broad set of daily operational responsibilities.

That's different from being a strategically focused and strategy-minded CFO; and the scope of the role has always oscillated as companies defined it in various forms. I don't see a general trend toward changing the core elements of being a CFO—compliance, external reporting, tax, and so forth. If anything, those things are getting more and more complex. What I do see is that many chief executives are searching for a CFO who can be a more strategically oriented business partner—who can help the senior management team make better use of the finance function's resources. The CFO today needs a balanced set of skills that combines a focus on long-term success with the ability to be a change agent for the organization.

McKinsey on Finance: *Let's talk about the finance transformation that you are leading at ADP. How did that come about?*

Jan Siegmund: ADP's finance organization has long been a strong, capable, and important part of its broader culture and its success. But over the past 30 years, it had grown rather complex, and we hadn't undertaken a fundamental review of

Jan Siegmund

Education

Holds a PhD in economics from Dresden University of Technology, an MA in economics from University of California, Santa Barbara, and an MS in industrial engineering from Karlsruhe Institute of Technology

Career highlights

ADP

(2012–present)
CFO

(2007–12)
President, value-added services

(2004–12)
Chief strategy officer

(2000–04)
Senior vice president, strategic development of brokerage services

(1999–2000)
Vice president, strategy

McKinsey & Company

(1993–99)
Consultant

Fast facts

Is a board member of the Lesbian, Gay, Bisexual & Transgender Community Center in New York City, where he lives with his husband, Ben; is a passionate cook and gardener

> "I don't see a general trend toward changing the core elements of being a CFO. If anything, those things are getting more and more complex. What I do see is that many chief executives are searching for a CFO who can be a more strategically oriented business partner."

its effectiveness. After my first 100 days of listening and learning, the senior team and I got together, and we decided that we had significant opportunities to change how finance would contribute to ADP. We launched, basically, a finance-transformation process that covered outsourcing our external-reporting function, optimizing our order-to-cash processes, as well as a real rethinking of our global financial-planning-and-analysis (FP&A) organization.

The biggest success I'm seeing is that reorganizing and rethinking how we want to deliver decision support and FP&A functionality will yield a lasting contribution for ADP. We started by establishing centers of excellence: how do we do revenue forecasting and planning, for example. We've built much better data and analytics capabilities in our offshoring location and have started rethinking the role of our field support with new definitions, new career paths for our associates, and different skill requirements. A side effect of this is that we will also save a considerable amount of money. ADP used to spend about 2 percent of its revenues on its finance function, and we were overinvested versus the benchmark. Our goal is to bring that down over the next year or two to around 1.2 to 1.3 percent of revenue.

McKinsey on Finance: *What challenges have you encountered while trying to transform the finance function at ADP?*

Jan Siegmund: I have led a number of larger change programs throughout my business career. One thing I've learned is that change programs in a finance organization are very complex. The functions we perform are often interlinked with a variety of work streams, and unwinding them to implement change while still maintaining a strong control environment and full compliance with the law can be challenging. Moreover, finance teams typically haven't experienced a lot of change processes on their own. I found my finance team a little hesitant, almost needing to muscle-build change processes while engaging in the process. The change readiness of the organization was a little lower than I expected. It took a lot of communication, team building, and aligning with a joined vision of the finance team to get the process going. But after we overcame the initial hesitation, we got good momentum. I would say we have completed phase one, and phase two is still to come.

McKinsey on Finance: *If you reflect back on your first couple of years as CFO, both in the finance transformation and how you transitioned into the role, what would you do differently?*

Jan Siegmund: Anyone appointed to a role like CFO of ADP will spend the first two years drinking from the proverbial fire hose. Getting into the job is an enormous task, and making the best use of time involves complex trade-offs. In my case, I invested a good amount of time in shareholder and investor communications, learning about the accounting and regulatory functions of the role, and establishing a good working relationship with our board and audit committee. Because those external pressures are demanding and take priority over internal pressures, I wish I could have invested more time building a more intimate relationship with the field organization, working directly with teams to understand their pressures—in finance in particular.

McKinsey on Finance: *What do you think about the pace of technological change that's going on in the industry?*

Jan Siegmund: It's incredibly exciting to be a part of the HR technology and service market because big technology trends, like mobility, globalization, and the movement to the cloud are all intimately affecting our business. Companies are more global, and employees expect HR solutions that have the functionality and ease of use of Facebook—and big data and cloud delivery are key factors in that.

Big data may be a perfect example. Many people know the ADP National Employment Reports and our ability to predict the growth of the national labor market very well. Now we're using the vast amount of HR and payroll data that we have in our systems to provide our clients specific, analytical support to better understand how their organizations can leverage their employees to be more effective and more engaged, to make better contributions to their business. Namely, we're providing a set of benchmarks that companies can use to analyze the effectiveness of their own HR organization—to leverage and better understand wage levels and benefit levels that they should provide compared with their competitors, or with participants in similar market segments. The application of big data at ADP will mean that services we already offer today will become even more valuable for our clients. We're excited about the opportunities that big data, as a trend, offers to us.

The cloud is also affecting us and our clients—it's a welcome technology trend that allows us to deliver our solutions to clients in an even faster and more cost-effective way. Today, about 75 percent of ADP's clients already process on the most modern SAS[2] solutions in the cloud. The excitement for us in ADP is about leveraging these global trends and accelerating and enhancing our own value proposition.

McKinsey on Finance: *Thinking back across your various roles, how important has storytelling been in the way you communicated about strategy and now about financial results?*

Jan Siegmund: One of my early observations as a new CFO meeting with shareholders and analysts was how helpful it was to have a background in strategy when telling the company's story. Most professional investors have a fairly good insight into the actual financials, but what they're missing is the context, understanding, and drivers of certain business decisions. So I spend much of my time in investor meetings telling the story of ADP rather than reconciling financial results that are already available in our reports. ■

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1 Ankur Agrawal, John Goldie, and Bill Huyett, "Today's CFO: Which profile best suits your company?," January 2013, mckinsey.com.

2 Statistical analysis system.

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Unearthing performance gains to boost bank value

Many performance improvements can raise bank valuations. The most powerful may not be the ones you'd expect.

Kapil Chandra and Zane Williams

At a time of fitful economic growth, banks around the world have lacked one of the most powerful engines for performance and valuation: robust GDP growth in their home economies. That leaves managers scrambling for other ways to improve, largely via cost cutting, growth initiatives, risk-weighted-asset reductions, and portfolio rebalancing. Each of these can have a significant impact on a bank's health, but they don't all add value equally. How should a savvy bank executive set priorities?

One way is to gauge the impact of different metrics on bank valuation. We tested more than 60 metrics that banks might use to measure their performance, specifically examining the impact of different levels of performance on the market-to-book ratios of more than 80 European and North American banks. At the highest level, we found that many things bank executives might expect to affect their valuation, such as market capitalization, asset size, loan quality, and business mix, actually had only marginal impact once you control for return on equity.

In general, home-country GDP growth and forecast revenue growth can have a real impact on the price-to-book ratio. But they pale in comparison to many measures that contribute to returns on equity (ROE). By measuring the impact of improving ROE by one percentage point through a single measure, while holding all others constant,[1] we found that changes in some components of ROE can drive bigger increases in valuation than others (Exhibit 1)—though it should be noted that the difficulty of doing so may vary substantially.

When considering which performance improvements to pursue, we found that the relationships between a bank's performance relative to peers and valuation varied substantially. Some improvements had consistent impact on market-to-book ratios, while others did so only if a bank was at the top of the industry or getting out of the bottom.

Improvements to some metrics boost valuation for all banks

Performance in two areas improved ROE regardless of a bank's ranking relative to peers. First, we found improving the size of the deposit base relative to assets to be a uniformly powerful metric; a bigger deposit base routinely results in a higher valuation. The data show that this is a very reliable driver of an improved market-to-book ratio.

A second powerful factor that drives bank valuations is the ratio of risk-weighted assets to total assets. A reduction in this ratio generates large and consistent benefits. What banks achieve here will have a much bigger impact on their valuation than any other action.

The clear implication is that banks should work continually to improve these ratios and periodically relaunch programs that deliver ongoing incremental improvements.

Improvements to other metrics boost valuation for the best and worst performers

Several performance improvements can have a substantial effect depending on current levels of performance.[2] The scale of the valuation gain they offer is minimal unless a bank is either very strong or very weak at them. Banks that fall at either end of the performance ranking can improve

Exhibit 1 **Improvements to some measures of ROE affect valuation more than others.**

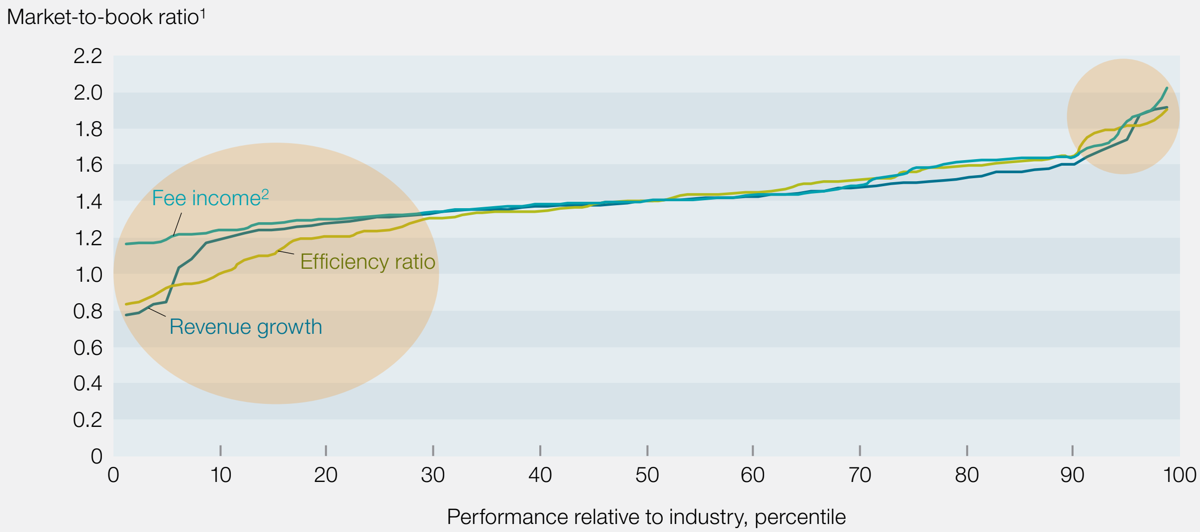
Improvement needed to increase ROE by 1 percentage point[1]	Improvement in valuation (market-to-book ratio)	Difficulty
Increase deposits by 27%[2]	0.36	High
Reduce risk-weighted assets by 11%	0.12	Low
Grow fee income by 28%	0.10	High
Reduce operating expenses by 4%	0.06	Moderate
Reduce equity capital by 11%	0.04	Low[3]
Reduce loan-loss provisions by 24%	0.03	Moderate

[1]While holding all other metrics constant, calculated for the average bank in the sample.
[2]Assumes deposits replace nondeposit liabilities at sample average deposit costs.
[3]Assuming capital remains at regulatory minimums.

Source: S&P Capital IQ; McKinsey analysis

Exhibit 2

Improvements to some measures benefit the best and worst performers.



[1]Curves show the market-to-book ratios our analysis predicted from changing 1 variable but keeping all other drivers at industry median.
[2]Non-net interest income.

Source: S&P Capital IQ; McKinsey analysis

their position relative to peers by focusing on three areas: fee income, revenue growth, and efficiency ratio (Exhibit 2).

The biggest gain to market-to-book valuation, even for banks in the top decile of performance, comes from finding ways to improve the ratio of fee income to total assets. Those that perform in the bottom third of rankings on this measure can also take advantage of an opportunity of similar scale. However, banks that fall in the area in between the top and bottom find little added valuation benefit from boosting relative performance incrementally. Although a bank CEO might aspire to top-decile status, it is likely that this would require a major shift in strategy and take substantial time to achieve.

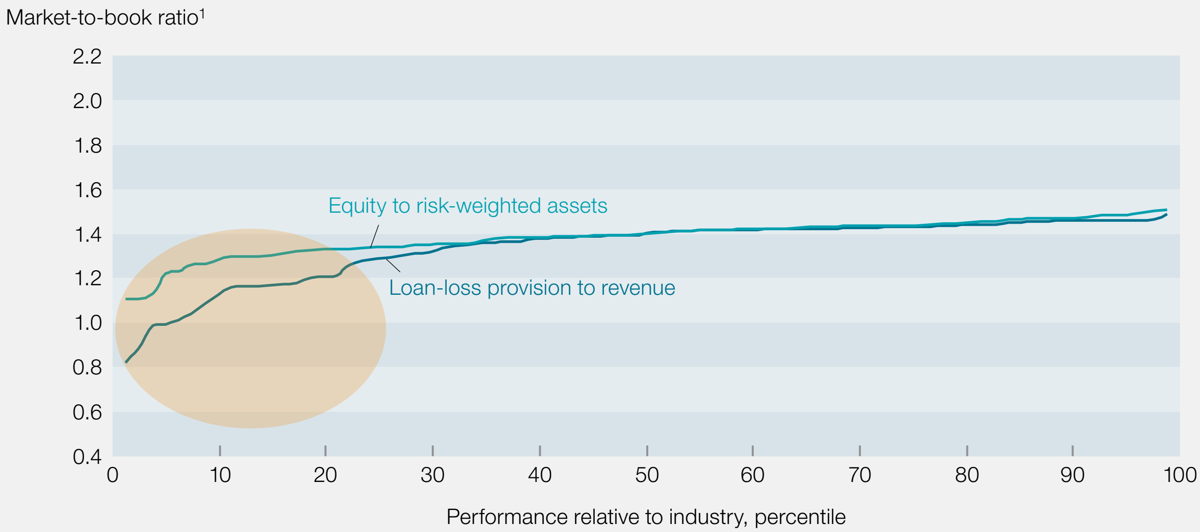
Relative improvement to peers in revenue growth can also boost the valuation of a top performer. But for most banks, as long as the growth forecast isn't negative, there isn't much benefit to be found here—unless revenue growth can be pushed above 8 percent.

Finally, top performers that improve the cost-to-income ratio, also known as the efficiency ratio, also see a boost to valuation. Here the data show a pronounced benefit from not being in the worst-performing 30 percent of banks. However, for those above that level, there isn't much of an impact until banks reach the top decile, where the efficiency ratio is below 50 percent.

Some improvements boost valuation only for laggards

Two other factors—the ratios of loan-loss provisions to revenue and equity to risk-weighted assets—only confer valuation advantages for banks if they currently lag well behind their peers

Exhibit 3 **Improvements to other measures primarily help only the worst performers.**



[1]Curves show the market-to-book ratios our analysis predicted from changing 1 variable but keeping all other drivers at industry median.
Source: S&P Capital IQ; McKinsey analysis

(Exhibit 3). Above-average or outstanding performance provides a marginal uplift to a bank's rating.

Banks only benefit from improving their loan-loss-provisions-to-revenue ratio when they're among the worst performers, that is, in the lowest decile. Once the loan-loss provision is less than 10 percent of revenue, further improvements may well be healthy for the bank's profit-and-loss statement, but the benefit with respect to the price-to-book valuation is minimal. The value from improving the ratio of equity to risk-weighted assets is similarly minimal once banks reach the average level of performance (with the ratio below about 12 percent). Further gains don't offer much potential to improve the market-to-book ratio.

■ ■ ■

Our findings apply to any bank, although some have more opportunity to take advantage—or more work to do in order to chalk up valuation gains. Market-based analysis can help them determine where to put their best efforts. ■

[1] The changes required to improve return on equity by this amount through a single measure are very large and could be difficult to do.
[2] The most powerful measure depends on the specific circumstances of individual banks.

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