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Are share buybacks jeopardizing future growth?

Fears that US companies underinvest by paying too much back to shareholders are unfounded. Rather, the rise in buybacks reflects changes in the economy.

Tim Koller

Returning cash to shareholders is on the rise for large US-based companies. By McKinsey's calculations, share buybacks alone have increased to about 47 percent of the market's income since 2011, from about 23 percent in the early 1990s and less than 10 percent in the early 1980s.[1] Some investors and legislators have wondered whether that increase is tantamount to underinvestment in assets and projects that represent future growth.

It isn't. Distributions to shareholders overall, including both buybacks and dividends, are currently around 85 percent of income, about the same as in the early 1990s. Instead, the trend in shareholder distributions reflects a decades-long evolution in the way companies think strategically about dividends and buybacks—and, more broadly, mirrors the growing dominance of sectors that generate high returns with relatively little capital investment.

In fact, ever since the US Securities and Exchange Commission loosened its regulations on buybacks in 1982,[2] companies have been changing the way they distribute excess cash to shareholders. So while dividends accounted for more than 90 percent of aggregated distributions to shareholders[3] before 1982, today they account for less than half—the rest are buybacks (Exhibit 1). The shift makes good sense. Empirically, the value to shareholders is the same,[4] but buybacks afford companies more flexibility. Executives have learned that once they announce dividends, investors tend to expect that the dividends will continue in perpetuity unless a company falls into financial distress. By contrast, a company can easily add or suspend share buybacks without creating such expectations.

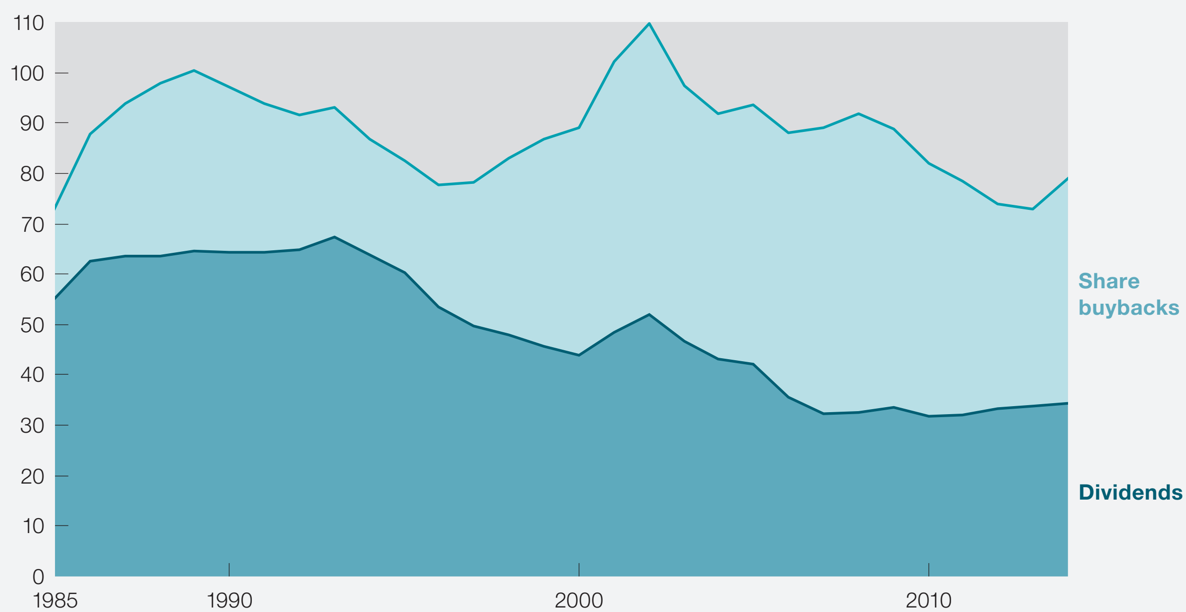
Regardless of the proportion of buybacks to dividends, there's little evidence that distributions to shareholders are what's holding back the economy. In fact, on an absolute basis, US-based companies have increased their global capital investments by an inflation-adjusted average of 3.4 percent annually for the past 25 years[5]—and their US investments by 2.7 percent.[6] That exceeds the average 2.4 percent growth of the US GDP. Furthermore, replacement rates have remained similar. Capital spending was 1.7 times depreciation from 2012 to 2014, compared with 1.6 times from 1989 to 1999.[7] The only apparent decline is in the level of capital expenditures relative to the cash flows that companies generate, which fell to 57 percent over the past three years, from about 75 percent in the 1990s.

That's not surprising, given how much the makeup of the US economy has shifted toward intellectual property–based businesses. Medical-device, pharmaceutical, and technology companies increased their share of corporate profits to 32 percent in 2014,

Exhibit 1

Overall distributions to shareholders have fluctuated cyclically since deregulation in the mid-1980s, though the ratio of buybacks to dividends has grown.

Distributions as % of adjusted net income, 5-year rolling average[1]



[1] For US nonfinancial companies with revenues greater than $500 million (adjusted for inflation).

Source: Corporate Performance Analysis Tool; McKinsey analysis from 13 percent in 1989. Since a company's rate of growth and returns on capital determine how much it needs to invest, these and other high-return enterprises can invest less capital and still achieve the same profit growth as companies with lower returns. Consider two companies growing at 5 percent a year. One earns a 20 percent return on capital, and the other earns 10 percent. The company earning a 20 percent return would need to invest only 25 percent of its profits each year to grow at 5 percent, while the company earning a 10 percent return would need to invest 50 percent of its profits. So a higher return on capital leads to higher cash flows available to disburse to shareholders at the same level of growth.

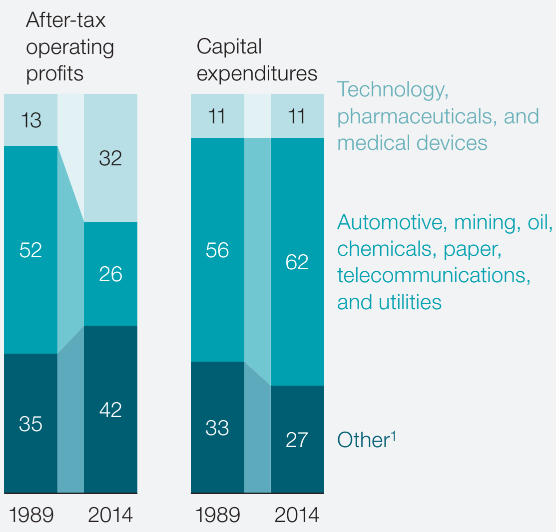
That is what's happened among US businesses as their aggregate return on capital has increased. Intellectual property–based businesses now account for 32 percent of corporate profits but only 11 percent of capital expenditures—around 15 to 30 percent of their cash flows. At the same time, businesses with low returns on capital, including automobiles, chemicals, mining, oil and gas, paper, telecommunications, and utilities, have seen their share of corporate profits decline to 26 percent in 2014, from 52 percent in 1989 (Exhibit 2). While accounting for only 26 percent of profits, these capital-intensive industries account for 62 percent of capital expenditures—amounting to 50 to 100 percent or more of their cash flows.

Here's another way to look at this: while capital spending has outpaced GDP growth by a small amount, investments in intellectual property—research and development—have increased much faster. In inflation-adjusted terms, investments in intellectual property have grown at more than double the rate of GDP growth, 5.4 percent a year versus 2.4 percent. In 2014, these investments amounted to $690 billion.

Exhibit 2

The composition of the US economy has shifted away from capital-intensive industries.

Share of total profits and capital expenditures for US-based companies, %



[1] Other includes capital goods, consumer staples, consumer discretionary, media, retail, and transportation.

Source: Corporate Performance Analysis Tool; McKinsey analysis

Certainly, some individual companies are probably spending too little on growth—just as others spend too much. But in aggregate, it's hard to make a broad case for underinvestment or to blame companies returning cash to shareholders for jeopardizing future growth. ■

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[1] For US nonfinancial companies with revenues greater than $500 million (adjusted for inflation). Income is before extraordinary items, goodwill write-downs, and amortization of intangibles associated with acquisitions.

[2] Rule 10b-18 of the US Securities and Exchange Commission "provides companies with a voluntary 'safe harbor' from liability for manipulation under the Securities Exchange Act of 1934."

[3] Among nonfinancial companies in the S&P 500.

[4] Bin Jiang and Tim Koller, "Paying back your shareholders," *McKinsey on Finance*, May 2011, mckinsey.com.

[5] US-based nonfinancial companies with more than $500 million in revenues. Using the aggregate GDP deflator, capital expenditures increased by 2.6 percent, versus 3.4 percent for the capital-expenditure deflator (as a result of lower inflation on capital items).

[6] National Income and Product Accounts Tables, US Department of Commerce Bureau of Economic Analysis, accessed August 2015, bea.gov.

[7] This is lower than it was in the 1970s and 1980s—decades affected by high inflation.

The author wishes to thank Darshit Mehta for his contributions to this article.

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A better way to understand internal rate of return

Investments can have the same internal rate of return for different reasons. A breakdown of this metric in private equity shows why it matters.

Marc Goedhart, Cindy Levy, and Paul Morgan

Executives, analysts, and investors often rely on internal-rate-of-return (IRR) calculations as one measure of a project's yield. Private-equity firms and oil and gas companies, among others, commonly use it as a shorthand benchmark to compare the relative attractiveness of diverse investments. Projects with the highest IRRs are considered the most attractive and are given a higher priority.

But not all IRRs are created equal. They're a complex mix of components that can affect both a project's value and its comparability to other projects. In addition to the portion of the metric that reflects momentum in the markets or the strength of the economy, other factors—including a project's strategic positioning, its business performance, and its level of debt and leverage—also contribute to its IRR. As a result, multiple projects can have the same IRRs for very different reasons. Disaggregating what actually propels them can help managers better assess a project's genuine value in light of its risk as well as its returns—and shape more realistic expectations among investors.

Since the headline performance of private equity, for example, is typically measured by the IRR of different funds, it's instructive to examine those funds' performance. What sometimes escapes scrutiny is how much of their performance is due to each of the factors that contribute to IRR above a baseline of what a business would generate without any improvements—including business performance and strategic repositioning but also debt and leveraging. Armed with those insights, investors are better able to compare funds more meaningfully than by merely looking at the bottom line.

Insights from disaggregating the IRR

Although IRR is the single most important performance benchmark for private-equity investments, disaggregating it and examining the factors above can provide an additional level of insight into the sources of performance. This can give investors in private-equity funds a deeper understanding when making general-partner investment decisions.

Baseline return. Part of an investment's IRR comes from the cash flow that the business was expected to generate without any improvements after acquisition. To ensure accurate allocation of the other drivers of IRR, it is necessary to calculate and report the contribution from this baseline of cash flows.

Consider a hypothetical investment in a business acquired at an equity value of $55 and divested two years later at a value of $100 (Exhibit 1). The business's operating cash flow in the year before acquisition was $10. At unchanged performance, the investment's cash return in year two, compounded at the unlevered IRR, would have been $23.30. In other words, the return from buying and holding the investment without further changes contributed ten percentage points of the 58 percent IRR. Strong performance on this measure could be an indicator of skill in acquiring companies at attractive terms.

Improvements to business performance. The best private-equity managers create value by rigorously improving business performance: growing the business, improving its margins, and/or increasing its capital efficiency.[1]

In the hypothetical investment, revenue growth and margin improvement generated additional earnings in years one and two, amounting to a compounded cash-flow return of $3.30. In addition, earnings improvement in year two translated into a capital gain of $20, bringing the cash return for business-performance improvements to $23.30 and its IRR contribution to ten percentage points. This is an important measure of a private-equity firm's capacity to not only choose attractive investments but also add to their value during the ownership period.

Strategic repositioning. Repositioning an investment strategically also offers an important source of value creation for private-equity managers. Increasing the opportunities for future growth and returns through, for example, investments in innovation, new-product launches, and market entries can be a powerful boost to the value of a business.

Consider, for example, the impact of the change in the ratio of enterprise value (EV) to earnings before interest, taxes, depreciation, and amortization (EBITDA) for our hypothetical investment. The business was acquired at an EV/EBITDA multiple of 10 and divested at a multiple of 12.5—which generated a cash return of $30. This translates into 13 percentage points of the project's 58 percent IRR. This measure could indicate a firm's ability to transform a portfolio company's strategy to capture future growth and return opportunities.

Effect of leverage. Private-equity investments typically rely on high amounts of debt funding—much higher than for otherwise comparable public companies. Understanding what part of an investment's IRR is driven by leverage is important as an element of assessing risk-adjusted returns.

In our hypothetical example, the acquisition was partly funded with debt—and debt also increased

Exhibit 1 **Disaggregating returns reveals how much of the internal rate of return is attributable to different sources.**

Investment financials	Year 0	Year 1	Year 2	
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	10.0	11.0	12.0	Constant revenues, no taxes, no capital expenditures
Enterprise value (EV)	100.0		150.0	Acquisition per end of year 0
Net debt	(45.0)		(50.0)	Without interest
Equity value	55.0		100.0	
EV/EBITDA	10.0		12.5	

Levered and unlevered internal rate of return (IRR)	Year 0	Year 1	Year 2	IRR
Operating cash flow		11.0	12.0	
Cash flow on exit/acquisition	(100.0)		150.0	
Unlevered cash flow	(100.0)	11.0	162.0	33%
Cash flow from debt	45.0	5.0	(50.0)	
Levered cash flow	55.0	16.0	112.0	58%

Decomposition of IRR from:		Year 0	Year 1	Year 2	Present value (PV) of year 2[1]	Fraction	Contribution to IRR[2]
Baseline	Cash flow		10.0	10.0	23.3	0.30	10%
Business performance	Cash flow		1.0	2.0	3.3	0.04	10%
	Capital gain[3]			20.0	20.0	0.26	
Strategic repositioning	Capital gain[4]			30.0	30.0	0.39	13%
Unlevered return			11.0	62.0	76.6	1.00	**33%**
Leverage[5]							25%
Levered return							**58%**

[1] Cash flows compounded at unlevered IRR to year 2.
[2] Calculated as each lever's PV (year 2)/total PV (year 2) × unlevered IRR.
[3] Calculated as [EBITDA (entry) – EBITDA (exit)] × EV multiple (entry).
[4] Calculated as [EV multiple (exit) – EV multiple (entry)] × EBITDA (exit).
[5] Calculated as residual between unlevered and levered return.

over the next two years. In that time frame, earnings increased by 20 percent and the company's EV-to-EBITDA ratio rose by more than two percentage points. The IRR of the acquisition, derived from the investment's cash flows, would be 58 percent.

How much does the company's debt affect its IRR? Adding back the cash flows for debt financing and interest payments allows us to estimate the company's cash flows as if the business had been acquired with equity and no debt. That results in an unlevered IRR of 33 percent—which means leverage from debt financing contributed 25 percentage points, about half of the investment's total levered IRR. Whether these returns represent value creation for investors on a risk-adjusted basis is questionable, since leverage also adds risk.

The disaggregation shown in Exhibit 1 can be expanded to include additional subcomponents of performance or to accommodate more complex funding and transaction structures.[2] Managers may, for example, find it useful to further disaggregate business performance to break out the effects of operating-cash-flow changes from revenue growth, margin expansion, and improvements in capital efficiency. They could also separate the effects of sector-wide changes in valuation from the portion of IRR attributed to strategic repositioning. Moreover, if our hypothetical investment had involved mergers, acquisitions, or large capital investments, further disaggregation could separate the cash flows related to those activities from the cash flows due to business-performance improvements—as well as strategic repositioning.

Comparing projects beyond the bottom line

The example above illustrates the basic principles of disaggregating IRR, which ideally should be done before any comparison of different investments. Consider, for example, two investments by a large private-equity fund, both of them businesses with more than €100 million in annual revenues (Exhibit 2). Each had generated healthy bottom-line returns for investors of 20 percent or more on an annualized basis. But the sources of the returns and the extent to which these represent true value creation differed widely between the businesses.

The investment in a retail-chain company had generated a towering 71 percent IRR, with more than three-quarters the result of a very aggressive debt structure—which also carried higher risk. On an unlevered basis and excluding sector and baseline contributions, the risk-adjusted return to investors was a much lower but still impressive 21 percent. By improving margins and the capital efficiency of the individual retail locations, management had contributed around 5 percent a year to IRR from business performance. A successful strategic transformation of the company formed the

Understanding the true sources of internal rates of return provides insight not only into the evaluation of individual investments but also into collections of investments.

biggest source of management contributions to IRR. Utilizing the company's real estate and infrastructure, management was able to launch additional customer services with more stable margins, which translated to a higher-valuation multiple on exit and drove 17 percent annual IRR.

Exhibit 2 **Sources of returns can differ widely among businesses.**

Internal rate of return (IRR),[1] %

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

Exhibit 3

Disaggregating internal rates of return for a portfolio of projects can reveal a fund's strength.

5-year annualized returns,[1] %

≤0% <2% <5% <10% ≥10%

	Retail (1)	Retail (2)	Retail (3)	Power (1)	Power (2)	Real estate	Power (3)	Tech (1)	Tech (2)
Organic growth	1	(1)	0	3	(1)	1	(16)	0	(9)
Margin increase	2	(4)	1	2	0	2	14	0	4
Efficiency improvement	2	6	7	N/A	(1)	(2)	N/A	3	11
Business performance	**5**	**1**	**7**	**5**	**(2)**	**1**	**(2)**	**2**	**6**
Capital investment	4	(1)	N/A	N/A	N/A	N/A	6	4	(6)
M&A	N/A	12	7	6	3	0	9	2	14
Strategic repositioning	13	2	7	4	3	1	4	0	(1)
Transformation strategy	**17**	**13**	**14**	**9**	**5**	**1**	**19**	**6**	**7**
Sector	0	(1)	13	1	(1)	0	0	0	(15)
Baseline	5	14	(2)	1	6	4	(10)	1	5
Unlevered internal rate of return (IRR)	**27**	**27**	**32**	**16**	**8**	**6**	**7**	**9**	**4**
Leverage	44	14	4	7	5	3	0	(4)	(2)
Levered IRR	**71**	**41**	**36**	**23**	**13**	**9**	**7**	**5**	**2**

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

In contrast, the equipment-rental business turned out to be one where management made more of a difference when it came to business performance and strategic transformation, which, when combined, contributed 32 percent to the business's IRR. Most of this was due to higher growth and improved margins in its core industrial-equipment segments, combined with significant divestments of its consumer-rental business. Unfortunately, nearly 14 percentage points of the overall IRR was wiped out as the credit crisis reduced opportunities across the sector for future growth and profitability. With leverage adding ten percentage points, the IRR for investors ended up at 34 percent.

Understanding the true sources of IRR provides insight not only into the evaluation of individual investments but also into collections of invest-

ments, such as within a single private-equity fund or within an investment portfolio of many different private-equity funds. Such an analysis revealed that one fund, for example, was most successful in transforming acquired businesses through rigorous divestment of noncore activities and resetting strategic priorities (Exhibit 3). As with many private-equity funds, leverage was the second-most-important driver of investor returns.
From a fund-investor point of view, a high level of dependence on financial leverage for results raises questions, such as whether a firm's performance will be robust across economic scenarios—or whether it has a track record of successful interventions when high leverage becomes problematic for its portfolio companies. By contrast, reliance on business improvements is inherently more likely to be robust across scenarios.

Investors can conduct a similar analysis to identify which funds in their portfolios contribute the most to their returns and why. For example, separating leverage components reveals which funds boost their IRR by aggressive debt funding and are therefore more exposed to changes in underlying business results. Understanding where broader sector revaluations have driven IRR can help investors understand which funds rely on sector bets rather than improvements in business performance or strategy. Investors can also assess how well a general partner's stated strategy matches its results. A firm touting its ability to add value from operational improvements should get substantial portions of its IRR from managerial changes and strategic repositioning, while a firm more focused on its financial-engineering skills might be expected to benefit more from the leverage effect.[3]

■ ■ ■

IRR calculations can be useful when fully understood. Disaggregating the effect of IRR's various components can help managers and investors alike more accurately assess past results and contribute to future investment decisions. ■

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[1] Joachim Heel and Conor Kehoe, "Why some private-equity firms do better than others," *McKinsey Quarterly*, February 2005, mckinsey.com.
[2] We have, for example, developed a decomposition approach to an investment's so-called cash multiple rather than its internal rate of return.
[3] Assuming that the higher-valuation multiple is entirely driven by repositioning the business—and not by sector-wide appreciation.

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Profiling the modern CFO: A panel discussion

Seasoned finance chiefs explore revamping business models and coping with new competitors, currency risks, and changing capital structures.

At McKinsey's annual Chief Financial Officer Forum, in London this June, CFO and chief operating officer Samih Elhage of Nokia Networks, Manik ("Nik") Jhangiani of Coca-Cola Enterprises, and former Alstom CFO Nicolas Tissot took up some of the challenges facing today's finance chiefs. Over the course of an hour, the panelists explored the pricing threat posed by a new breed of low-cost competitors now rising in emerging markets, the risks from the resurgent volatility of currency markets, and the brave new world of cheap debt financing and its implications for capital structures.

The discussion, moderated by *Financial Times* Lex column editor Robert Armstrong, shapes a profile of the skills and tactics that define the modern CFO. The edited highlights below begin with the question of whether CFOs should make challenging the existing business model part of their role.

Nik Jhangiani: A business never gets to the point where it has the ideal model. The world is changing so fast around us. Even in a business that you think is stable and predictable, the operating model needs to continue to evolve, just given what technology is doing. At Coca-Cola Enterprises, we don't conclude, at a single point in time, that the business model needs to change—that's something we challenge ourselves on through our long-range-planning process every year.

For example, we have probably the largest sales force in Europe of any packaged-goods company, and I almost *have* to challenge that. Is it really bringing us the value today that it did five years ago? How many people want a salesperson calling on their stores or outlets helping them to place an order and to merchandise when so much more can happen through call centers and technology? You definitely don't want to lose the human touch and the relationships, but you do want to allow your sales force to be more efficient, effective, and focused on what the customers view as an added value.

This is something you, as CFO, need to challenge almost every day—to ask if your company's business model is fit for purpose today and, more important, if it is fit for purpose for the future. What do we need to change, without suddenly having to make a wholesale change tomorrow? It needs to be constantly adapted.

Robert Armstrong: *When you realize that a major change has to be made, how do you deal with your executive board?*

Nicolas Tissot: Among the members of executive committees, CFOs are probably best positioned to challenge the businesses. They are independent from operations. And they are the only ones, apart from the CEO, who have a comprehensive vision of the company. The role of a CFO who goes beyond being a bean counter is clearly not only to be a business partner but also to be a business challenger. This is not the easiest part of the job, but it is definitely a part of the modern CFO role.

Samih Elhage: In a fast-moving industry like Nokia's, technology life cycles are becoming much shorter. In our case, the transformational aspect of the business is becoming a way of life. We can't say, definitively, that this is really my process; this is my business; this is how I sell; this is how I buy. We can say that we're in a continuous-improvement process—and the process itself has to evolve.

This isn't about squeezing the budget to reduce costs. It's about significantly changing the company's processes and mode of operation. In many cases, you have to change the way you sell certain products and the way you charge particular customers. And, in some cases, you have to exit specific areas of the business. When I first came to Nokia, we were operating in ten different segments. Since then, we've made

Manik ("Nik") Jhangiani

Education

Holds a bachelor's degree in accounting and economics from Rutgers University

Career highlights

Coca-Cola Enterprises
(2013–present)
Senior vice president and CFO

(2012–13)
CFO, Europe

Bharti Enterprises
(2009–12)
Group CFO

Coca-Cola HBC
(2000–09)
Group CFO

Fast facts

Married, with 2 children

Lives in Central London

incisive and, I think, courageous changes, divesting eight of these businesses to focus intensely on the two that would give us the operating performance we were looking for.

Competitive dynamics and pricing

Robert Armstrong: *Let's talk a little about competitive dynamics. Samih, you are in a unique position there. How do you manage the company when you are constantly under pressure from large, low-cost emerging-market competitors?*

Samih Elhage: Well, competition is undeniably an important element in our day-to-day operations because of its implications for our cost structure and for pricing. But we resist being driven reactively by the actions of competitors. We have a strong pricing strategy and controls to ensure that prices are being set at the right level—one that ensures our customers are getting value for money and that we are able to fund investment in R&D and healthy performance for our stakeholders. And, in a competitive environment, our cost structure, which is extremely lean, gives us the means to fight when fighting is what's required.

Robert Armstrong: *Let's explore that pricing theme a bit. Nik, how does pricing feed into the finances of Coca-Cola Enterprises?*

Nik Jhangiani: It is a huge element. Fortunately, in the past couple of years, we've benefited from

Nicolas Tissot

Education

Holds an MBA from École des hautes études commerciales (HEC) and graduated from École nationale d'administration

Career highlights

Alstom

(2015)
Adviser to the group chairman and CEO

(2010–14)
CFO and executive-committee member

Suez/GDF Suez/ENGIE

(2008–10)
Deputy CEO, global gas and liquefied natural gas

(2005–08)
CFO and executive-committee member, Electrabel

(2003–05)
CFO and executive vice president, Energy International

(1999–2003)
Head of group financial planning and control

French Ministry of Economy, Finance, and Industry

(1995–99)
Inspecteur des Finances, the senior audit and consulting body of the ministry

Fast facts

Married, with 4 children

Member of the French-American Foundation (and former FAF Young Leader) and the Société d'Economie Politique

Independent director at Euroclear Settlement of Euronext-zone Securities the more benign commodities environment. As recently as four or five years ago, inflation was high, and we had to find a way to pass that on to our customers and our consumers. Today, some markets in Europe are actually facing deflation, and customers and consumers are looking at that, too. What we're not able to achieve through pricing, we have to do by reducing costs—finding better ways to be efficient at what we do.

The answer isn't always about the absolute price the market will bear. Sometimes, it's much more about what you can do from an overall revenue-growth perspective. In addition to cutting costs and increasing prices, how do you get the right mix of products to generate more transactions? How might you change your packaging strategy to increase revenue growth? For example, would consumers want—and pay a slight premium for—a smaller or differentiated or more premium package?

Nicolas Tissot: In heavy industries, the pricing environment is always driven by the business cycle. For several years, we've been in a crisis that also has some structural components. So we've had to adapt structurally to the emergence of new competitors from places with a lower cost base. We also need to adjust to the interest of our clients in our services, as well as our technology. The CFO is instrumental, for example, in launching performance and restructuring plans, setting up partnerships, allocating R&D money, and reorienting manufacturing investment.

On pricing, we need to adapt rapidly or we'll lose every sale. At one time, deals targeted a level of profitability that fully rewarded our investments. But when there is overcapacity in the market and when—to break even—competitors fight to keep factories running, sometimes you end up settling for the second-best price. At Alstom, the CFO, who personally approves every

Samih Elhage

Education

Holds a bachelor's degree in electrical engineering and in economics from the University of Ottawa, as well as a master's degree in electrical engineering from École Polytechnique de Montréal

Career highlights

Nokia Networks

(2013–present)
Executive vice president and CFO

(2013–present)
Chief operating officer, Nokia Solutions and Networks

Nortel

(2009–10)
President, carrier voice over Internet Protocol (VoIP) and applications solutions

(2008)
Vice president and general manager, carrier VoIP and applications solutions

(2007–08)
Vice president, corporate business operations

Fast facts

Married, with 2 children

Pastimes include world music, traveling, walking, and golf bid above €50 million, has to take into account those specific periods and relax the margin targets appropriately.

Foreign-currency risk

Robert Armstrong: *Currency risk has returned to the corporate world's attention over the past year, with the strong dollar and the fluctuations of other currencies. How do you manage the risks?*

Samih Elhage: I start with how we should achieve our performance goals and then ask how we cope with the challenges of all external aspects, including currency fluctuations. In our business, we depend mainly on four currencies—the euro, the US dollar, the Japanese yen, and the Chinese yuan. We usually get our performance plan approved by the board in Q4 and make any changes at the beginning of the year. From there, I ask teams to develop their performance plans reflecting the impact of currencies. Their underlying business objectives have to be achieved from an operating-profit perspective, and that comes down to cash.

If the effect of currency shifts helps the top line, that's assumed to be in addition to the team's performance goals. If currency shifts affect costs negatively, the team has to find some way of compensating for that.

Is that challenging? Absolutely. It adds to the pressure on teams to meet their goals. Are we making progress? Yes, we are. But costs associated with hedging have to be included in the accounting statements, and they have cash implications. Our teams know that they just have to make the numbers add up.

Nik Jhangiani: The countries in which Coca-Cola Enterprises operates give us a fairly natural hedge—because our revenues and a great deal of our cost base are local. In fact, we produce 90-plus percent of our products within a given market. It's difficult and expensive to transport water. Producing locally gives us another natural hedge.

The issue is more with our commodity exposures, which could be in different currencies. That's where we make sure that we're covering risk through transaction exposures, for which we hold teams accountable—having hedging policies in place and ensuring that all our transaction exposures are covered, at least on a rolling 12-month basis (with lower levels of coverage going out 36 months). Teams are responsible for making sure that currency risks are covered through pricing and cost structures and so on.

Our hedging strategy is very clear. We're not looking to beat the market. We are just trying to increase certainty around our cost structure. We do not hedge for translational currency conversion or exposure. When we communicate with the market, we actually give guidance and provide our performance data both on a currency-neutral basis and then with the impact of currencies. The transaction part is built into the information we provide.

You can't keep changing what you do in volatile times, as that volatility will always be out there. At times, translation or currency conversion works and has some benefits, and at times it doesn't. You have to try to ride through that cycle without being reactive and changing things, unless you see something that isn't working over the long term.

Nicolas Tissot: We see our business as being a supplier of industrial equipment and associated services, not playing games with the fluctuations of currencies. As soon as an order is firmed up, we have a full analysis of the currency flows. Then that exposure is systematically hedged over the horizon available in the market, with a rolling foreign-exchange strategy. We have pretty significant activity in that respect. To avoid paying too much in fees to the banks, we use an electronic platform. The banks own the platform, and it is competitive for any foreign-exchange trade that we handle to hedge our exposure.

Capital structure

Robert Armstrong: *One of the ironic consequences of the financial crisis is that debt financing is cheap and easy to get unless you're a bank. It's so cheap, why have any equity at all? How do you make capital-structure decisions in this context?*

Nicolas Tissot: Regarding debt financing, over the past few years there have been times when we've needed to think fast, act fast, and be opportunistic. There are imperfections in the market, and many of us have seized the opportunities they create. But at the same time, you always have to keep the long-term view in mind.

Alstom is in a very cyclical industry, and sometimes you can lose sight of your position in the cycle. When things are good, there's a risk of leveraging too much; when the hard times come back, you burn a lot of cash and quickly deteriorate your financial structure and therefore your rating, which leaves you little if no access to debt markets. We manage our financial structure—the structure of the balance sheet—with that in mind. At the peak of the cycle, we want to have almost no leverage, while at the trough we accept more.

Samih Elhage: At Nokia, our capital-structure decisions are guided by the principle that we should always do our best to give back to shareholders. In the past two years, as we purchased Siemens's share of Nokia Siemens Networks and sold the device business to Microsoft, we put in place a program to improve our capital structure and to return €5 billion to shareholders over three years.

Why have equity at all? Our philosophy is that there should be a balance. You should go to the market when you must, but you also need a very strong capital structure to defend the business and to drive the right investment at the right time.

Nik Jhangiani: We sold the US business back to the Coca-Cola Company in 2010 and formed the new Coca-Cola Enterprises. That included much of the debt we had, as well. We continue to generate a great deal of free cash flow, but at the same time we also realized that we were very underleveraged and didn't have the most efficient balance sheet. So we set a leverage target of two and a half to three times net debt to EBITDA, compared with where we were before the sale, which was closer to one to one and a half times net debt to EBITDA. It could have been lower, but we picked a level that we saw as the right starting point for the journey we wanted to make. We would slowly lever up toward that level, so this wasn't a big one-shot bang, and we wanted to make sure we had enough dry powder for potential activities.

The leveraging up, along with the free cash flow that we continue to generate and a strong focus on that cash-conversion rate, gives us a solid pool of free cash flow. In the absence of M&A, the best way to use it was to return it to shareholders. Over the last four years, from the formation of the new Coca-Cola Enterprises through the end of 2014, we have returned approximately $8 billion to shareholders. ■

Building a better partnership between finance and strategy

The growing strategic role of CFOs may create tension with top strategists. That's a missed opportunity for teaming up to improve company performance.

Ankur Agrawal, Emma Gibbs, and Jean-Hugues Monier

Two-thirds of all executives agree that the best way for CFOs to ensure their company's success would be to spend more time on strategy.[1] Indeed, it is increasingly common for CFOs to be taking on more strategic decision making. Companies value the hard data and empirical mind-set that a finance chief can lend to strategic planning, especially around forecasting trends, building strategic capabilities, or managing government and regulatory relationships.[2]

Yet as CFOs map out what can be a wide range of strategic responsibilities, they may encounter challenges and even turf wars from some traditional strategy leaders, such as chief strategy officers (CSOs) and business-unit heads. These seldom boil over into public view, but we often see signs of tension where the two roles increasingly overlap.

Such friction is destructive—and a missed opportunity. Working together, CFOs and CSOs have the stature to challenge biases and influence how the top team makes decisions to improve a company's performance. In many cases, a CSO may be better placed to take on certain roles typically managed by the CFO, such as owning the resource-allocation map or the M&A process. Many CFOs are the first among equals on a company's board of directors and can assist CSOs with improving board productivity on strategy. Having explicit conversations about expectations and the division of such roles will improve the dynamics of strategic decision making—by ensuring a better link between a company's capital allocation and its strategic priorities, by better informing a search for growth, and by better balancing a company's strategy for long-term growth with its short-term strategy for earnings and investors.

Better linking capital allocation to strategic priorities

Research by our colleagues finds that, on average, companies allocate 90 percent or more of their resources to the same projects and activities year after year, regardless of changes in the environment or their strategies.[3] Dynamic companies that reallocate resources more actively deliver better, less volatile annual returns to shareholders, on average, than their more dormant counterparts[4]—particularly during economic downturns.[5]

CSOs and CFOs each bring insights to create a better link between resource allocation and strategy in the corporate-strategy-development process. This means, among other things, creating a distinct corporate- or portfolio-strategy process (rather than just aggregating business-unit plans); encouraging more frequent conversations among small groups of senior leaders on an ongoing basis, rather than annually or every three to five years; and ensuring that the corporate-strategy and budgeting processes are fully integrated with capital-allocation processes (including M&A and divestment). This integrated view of strategic direction and resulting allocation of corporate resources demands close collaboration between finance and strategy.

In the case of one North American healthcare company, the CSO set up a planning council that included the CFO to discuss strategic issues, growth opportunities, and funding needs. For each of the promising opportunities—which carried the imprimatur of both the CFO and the CSO—the council appointed a strategic leader. Each leader was tasked with creating a deliberate dialogue with existing business leaders and cultivating their support for more than a dozen related initiatives well in advance of the annual allocation process. As a result, the council was able to aggressively challenge the expenses attributed to running the business and set aside a defined amount for growing the business instead. This result clearly was achieved due to the foresight and trusted collaboration of the CFO, the CSO, and their teams.

CSOs can also track how critical resources such as growth investments and talented R&D teams are used. This allows managers to assess whether resources are allocated to support strategy—or whether each year's capital allocations unduly influence the next.

Finally, CSOs can pay close attention to the way strategic decisions are made, for example, by managing the executive team's strategic agenda and prompting debate on competing options and scenarios to account for inherent sources of bias. Often this means bringing external data into the room to help reanchor discussions away from assumptions based on prior decisions. The CSO at a consumer-products company, for example,

Working together, CFOs and CSOs have the stature to challenge biases and influence how the top team makes decisions to improve a company's performance.

used this approach to good effect when managers found themselves facing a major disruption in a core market. The CSO shepherded the executive team through a series of strategic decisions that allocated resources away from traditional cash cows. Instead, she shifted attention and resources into a disruptive technology identified by the company's widely accepted strategy review as the future of the business. To guide the discussion, she clearly laid out the level of resources needed to fund the agreed-upon strategy, reminded the executive team of the rationale for the change of direction, and carefully positioned each decision to reduce the likelihood of bias.

Looking outside the company for insights into growth

CFOs agree that companies need to step up their game in a wide range of growth-related activities, particularly driving organic growth, expanding into new markets, and pursuing M&A. Recent McKinsey research shows that more than 60 percent of growth comes from riding on favorable tailwinds—that is, doing business in markets that are growing well and where companies enjoy a competitive advantage.[6] However, a 2010 survey found that less than 15 percent of executives consider such macroeconomic trends when they develop strategy, and only 5 percent take their competitors' strategies into account.[7] Moreover, less than a quarter even look at their own internal financial projections and portfolio performance. Little wonder that companies and their CFOs struggle to find growth; they're looking at a mirror and not a window.

CSOs are well placed to help correct this. Many CSOs own the organization's trend-forecasting and competitor-analysis function. Good trend forecasting involves creating proprietary insight into trends, discontinuities, and potential shocks to find growth opportunities and manage business risk. Similarly, good competitor analysis involves gathering competitive intelligence, closely tracking the behavior of competitors, monitoring their potential responses to a company's strategic moves, and evaluating their sources of competitive advantage. All are necessary to understand how a company creates value—the foundation of the strategic decisions that best balance a corporate portfolio for risk and return. Armed with such insights, CFOs and CSOs together are better placed to go beyond a CFO's traditional strengths in managing the portfolio, navigating it toward growth opportunities, setting objectives for organic growth, and planning a strategy for M&A.

The experience of a CFO and CSO at one industrial conglomerate is illustrative. The newly appointed CSO developed a proprietary view of what contributed to each business's growth and injected that insight into corporate-strategy discussions. Underlying factors included, for example, projections down to the level of how much new commercial floor space would be built in Latin American cities—a central variable in forecasting demand for the company's most advantaged products, such as electrical wiring. The CFO, in turn, provided data and analytical rigor in assessing the business case for each product. In particular, the CFO created a database that empirically evaluated pricing relative to demand and the number of competitors in each submarket. With information at this level of detail, the executive team could see which businesses in the company's portfolio were the best positioned to capture pockets of growth. Not only were they better able to set targets for organic growth, which the CFO now uses to manage performance, but they also used the information to develop a clear acquisition and divestment strategy.

Taking a long-term strategic view to offset short-termism

A key challenge at any company is balancing the long-term growth strategy against the demands of increasingly vocal short-term investors. Working together, a strategist's deep understanding of regulation, innovation, and microeconomic industry trends complements a CFO's understanding of cost and revenue, capital allocation, and stakeholder issues. Together, they can put forth options that improve both a company's short-term earnings and its longer-term growth in a way that is compelling to management, boards, and investors.

To facilitate collaboration, one company explicitly rotates strategy and finance professionals between the two teams. Formal structures, such as the strategic-planning team, include people from both—strategic planning has two from each—so that they start the budgeting process hand in hand. That enables both sides to see how resources align with the long- and short-term strategies as they make long-term resource allocations, evaluate make-or-buy decisions, and challenge the business case.

■ ■ ■

Working together, finance chiefs and strategy leaders can complement each other, helping the CEO, the board, and the rest of the executive team face the challenges of creating growth over the long term in the face of so many short-term challenges. ■

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How M&A practitioners enable their success

Companies that are best at transactions approach M&A differently—but there's room for improvement across the board.

Rebecca Doherty, Spring Liu, and Andy West

In McKinsey's latest survey on M&A practices and capabilities, most respondents report that their companies regularly examine the portfolio for new opportunities—and many do so at least once a year.[1] But if the blistering M&A pace of the past several years continues, as most respondents expect, then these responses also suggest that an annual review of portfolios may not be enough.

As of this writing, the value of M&A in 2015 is on track to rival last year's, when deal-value announcements totaled about $3.4 trillion[2]—levels not seen since 2008. That level of activity raises the stakes for companies reexamining their own business portfolios, as the shifting competitive landscape creates new opportunities—and threats. It may also explain why respondents who perceive their companies to be more successful at M&A are also significantly more likely to report looking for opportunities more often. Whether companies are successful because they look for opportunities more often or the other way around, we can't say. But the correlation, combined with the fast pace of M&A activity in general, does suggest that more frequent portfolio reviews may be better.

These are among the findings of our newest M&A survey, which asked executives about underlying trends, what M&A capabilities their companies do (and don't) have, and the effectiveness of their companies' M&A programs relative to competitors.

When we looked at what makes a company good at M&A, the results indicated that while it's important to perform well at every step of the M&A process, the "high performers" differentiate themselves from others by evaluating their portfolios more often, moving faster through their due-diligence and execution processes, and building stronger capabilities for integration. According to the results, though, even the highest-performing companies could benefit from giving their M&A teams more effective incentives and from proactively connecting and building relationships with their potential targets.

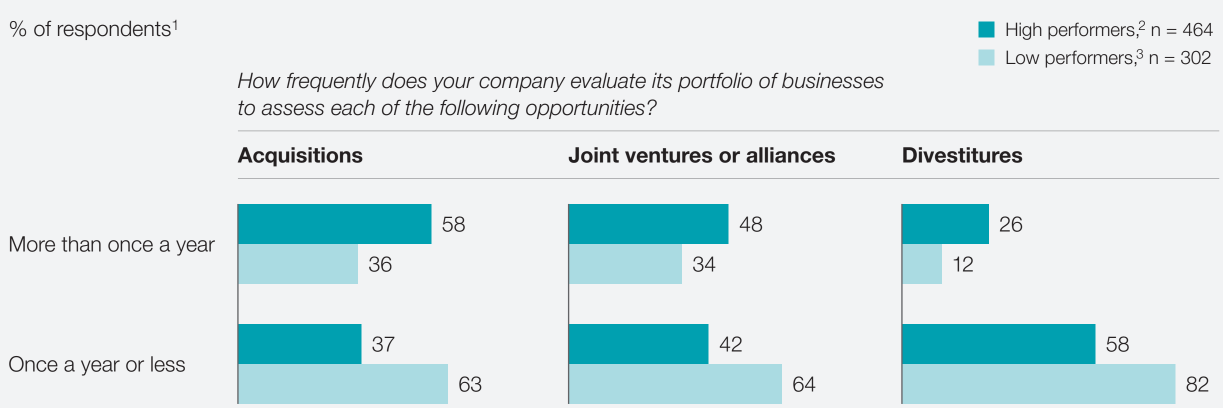
Will the pace of M&A continue?

Among respondents whose companies considered acquisition targets in the past year, just over two-thirds report completing at least one deal. Of those that tried but failed to complete an acquisition, 52 percent indicated that their companies engaged with at least one potential target but, ultimately, did not close the deal.

Most executives expect the next year to bring as many or more deals as the past one. It's too soon to tell whether market volatility in the late summer will affect M&A over the longer term, but as of May 2015, two-thirds of respondents expect the pace of activity over the subsequent 12 months to continue or increase—and nearly three-quarters expect these deals will be the same size or larger. Interestingly, those who anticipate a larger number of deals also expect their value to increase—and those who expect to do fewer deals expect their value to decline. Looking further ahead, respondents expect little change to their companies' rationales for deals in the next five years, and the most frequently cited reasons all relate to growth: expanding offerings, entering new geographies, and acquiring new assets.

Exhibit 1

Companies that outperform their peers are more likely to evaluate strategic options more than once a year.



[1] Respondents who answered "don't know" are not shown, so figures may not sum to 100%.
[2] Respondents who say the transactions their companies have completed in the past 5 years have either met or surpassed targets for both cost and revenue synergies.
[3] Respondents who say the transactions their companies have completed in the past 5 years have achieved neither their cost- nor their revenue-synergy targets.

More specifically, respondents from high-tech and telecommunications companies are significantly more likely than those in every other industry to expect an increasing number of deals, though they were not more likely to expect larger ones. Consumer-company executives tend to expect fewer deals in the next year than their B2B peers.[3]

What high performers do differently

To better understand companies' M&A performance overall and where the best-performing companies differentiate themselves most from their peers, we identified a group of high performers. Respondents in this group characterize their companies' performance as having met or surpassed targets for both cost and revenue synergies in their transactions of the past five years. The low performers, by contrast, are respondents who report that their companies have achieved neither the cost- nor the revenue-synergy targets in their transactions.

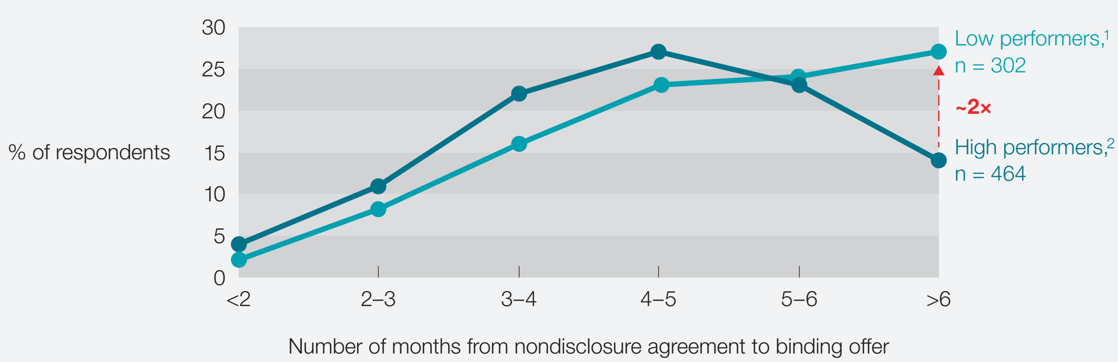
The survey results indicate a few areas where the high performers do things differently. For example, these respondents are much more likely than the low performers to report that their companies evaluate their portfolios for acquisition, joint-venture, *and* divestiture opportunities multiple times per year, as opposed to once every one or two years. The inverse is also true: low performers are significantly more likely to say their companies look for opportunities once a year or less (Exhibit 1). Notably, the frequency with which companies (both high and low performers) evaluate their portfolios for divestiture opportunities is significantly less than it is for acquisitions or joint ventures.

On average, high- and low-performing companies tend to move through their due-diligence and deal-execution processes at about the same speed—up to a point. However, among companies where respondents report taking six months or more, the pattern diverges. More than one-quarter of low-

Exhibit 2

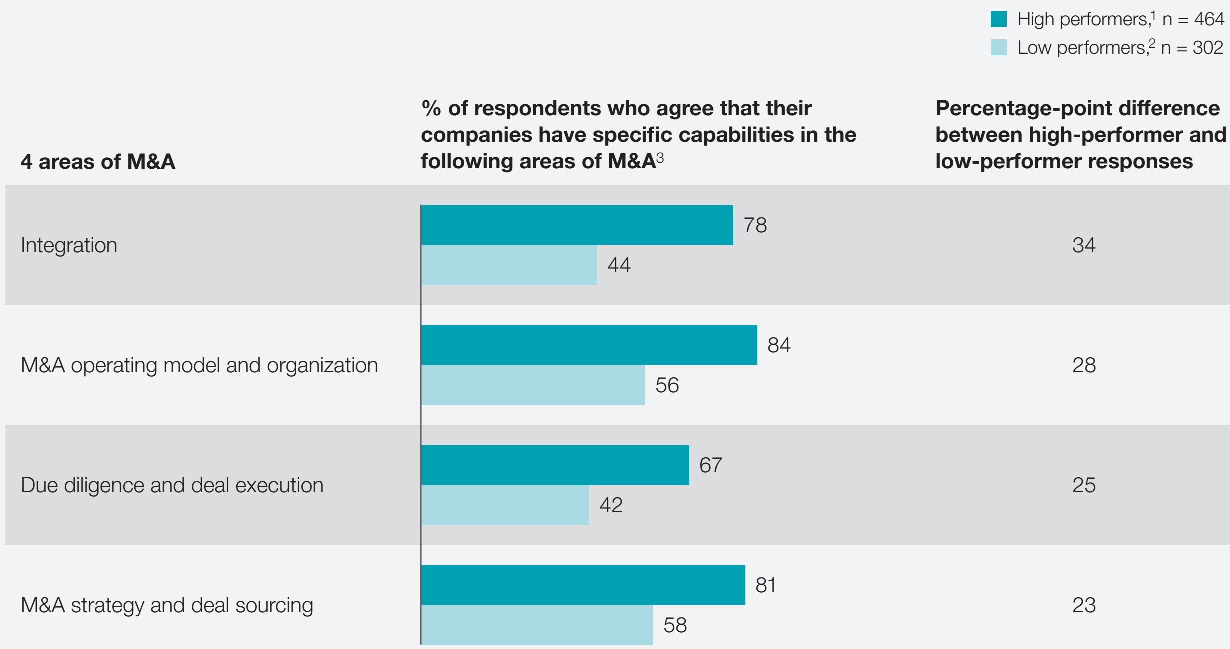
According to respondents, high performers move faster than low performers through deal execution.

Time spent by respondents' companies on diligence and deal execution



[1] Respondents who say the transactions their companies have completed in the past 5 years have achieved neither their cost- nor their revenue-synergy targets.
[2] Respondents who say the transactions their companies have completed in the past 5 years have either met or surpassed targets for both cost and revenue synergies.

Exhibit 3 **High-performing M&A companies are most differentiated from low performers in their integration capabilities.**



[1] Respondents who say the transactions their companies have completed in the past 5 years have either met or surpassed targets for both cost and revenue synergies.
[2] Respondents who say the transactions their companies have completed in the past 5 years have achieved neither their cost- nor their revenue-synergy targets.
[3] Includes "strongly agree" and "agree" responses.

performer executives say their companies take longer than six months to move from a nondisclosure agreement to a binding offer, nearly double the share of high performers that say they spend the same amount of time (Exhibit 2).

Finally, the high performers stand apart on the strength of their integration processes. We asked executives about their companies' capabilities across the four areas of M&A, and those from the high-performing companies report proficiency in all four more often than their peers at low-performing companies do. But their skills are most differentiated in integration (Exhibit 3). Interestingly, the two integration capabilities with the largest percentage-point differences between high and low performers are also the two capabilities where, overall, respondents report the least proficiency: effectively managing cultural differences across organizations and setting synergy targets.

What all companies could do better

For all their best practices and the strength of their capabilities, even the high performers have room to improve. When it comes to incentives, the results suggest that many companies focus on earn-outs and retention packages for key talent in acquired companies—but often overlook their own M&A teams. Because there are often different owners throughout a company's M&A process, it can be particularly tricky to put proper incentives in place for each one. So, incentives must balance the promotion of post-integration success with the successful execution of an individual's role.

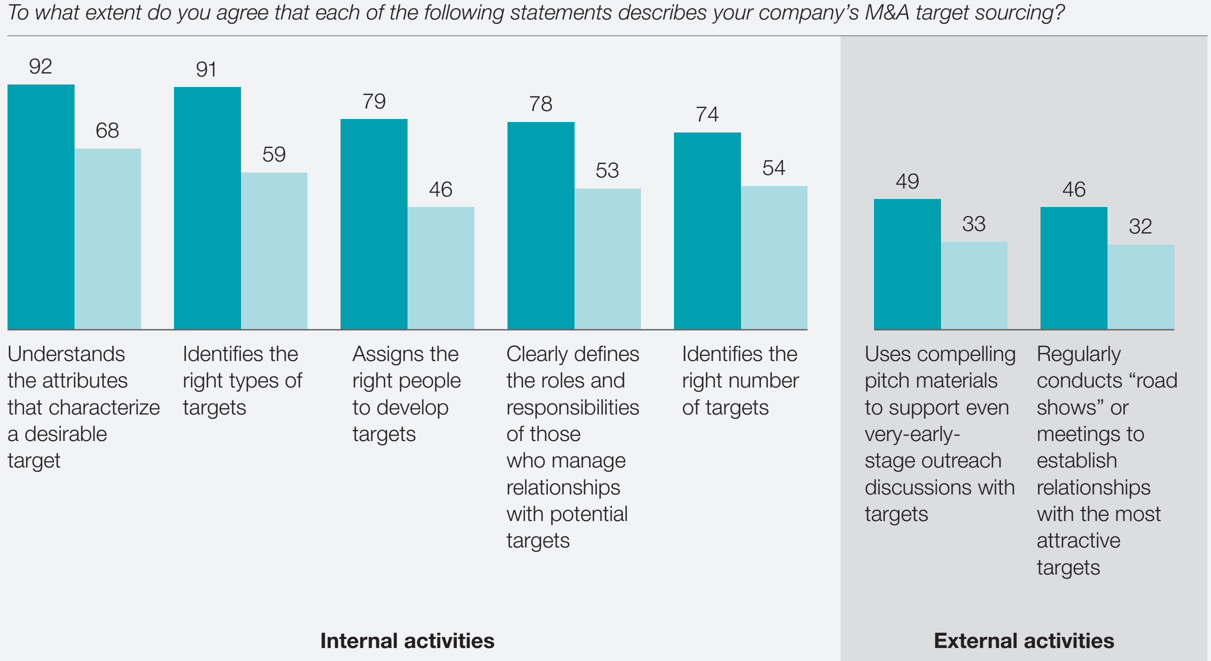
In practice, few executives report that their companies do this well. Less than half of all respondents indicate that the incentives of those involved in a given M&A transaction are closely aligned with the benefits the company extracts from it. Even among the high performers, only 57 percent agree that their companies are getting this right. For those that balance their incentives well, the potential for strong overall performance is striking: 93 percent of respondents who strongly agree that their companies' incentives are aligned with their strategic goals are high performers, versus only 23 percent of respondents who strongly disagree.

Exhibit 4 **When it comes to sourcing M&A targets proactively, companies get many internal tasks right but then fall behind on external outreach.**

% of respondents who agree or strongly agree

High performers,[1] n = 464 Low performers,[2] n = 302

To what extent do you agree that each of the following statements describes your company's M&A target sourcing?



[1] Respondents who say the transactions their companies have completed in the past 5 years have either met or surpassed targets for both cost and revenue synergies.
[2] Respondents who say the transactions their companies have completed in the past 5 years have achieved neither their cost- nor their revenue-synergy targets.

Although the high performers have particularly strong internal processes to identify potential targets, they—and their lower-performing peers—are least effective at connecting and building relationships with these targets (Exhibit 4). For example, not even half of respondents at the high-performing companies (and just under one-third at the low performers) say their companies regularly conduct "road shows" or meetings to establish relationships with the most attractive companies. Executives at both the high- and low-performing companies report similar results for using compelling pitch materials to support even very-early-stage outreach discussions with targets.

Looking ahead

- *Conduct frequent portfolio reviews.* Companies that systematically evaluate their portfolios for acquisition, joint-venture, *and* divestiture opportunities set themselves up to execute their corporate strategies more effectively. In many strategies, the inorganic component is critical, and getting that piece right begins with building a sound business case to define which businesses a company wants—and does not want—in its portfolio.

- *Invest in building M&A capabilities.* Companies that can build capabilities that support inorganic growth can enjoy a sustainable competitive advantage. This includes capabilities that are applicable to the earlier stages of M&A—such as efficient and effective due diligence and external outreach as part of proactive sourcing—as well as the core capabilities required to integrate a company.

- *Pay attention to governance and incentives.* In our experience, many companies will focus on earn-outs and retention packages for acquired companies but will overlook ensuring that their own M&A teams have the right setup, governance, and incentives. These are the necessary foundations upon which distinctive M&A capabilities are built. ■

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1 The online survey was in the field from May 19 to May 29, 2015, and garnered 1,841 responses from C-level and senior executives representing the full range of regions, industries, company sizes, and functional specialties. Of these executives, 85 percent say they are knowledgeable about their companies' M&A activity and answered the full survey.

2 According to Dealogic, as of August 11, 2015, the total announced global deal value surpassed $3 trillion for the year.

3 There were no significant differences in expected size or frequency of deals across geographies, or by company ownership or size.

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