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Building the right organization for mergers and acquisitions

Support for deal making should be organization-wide.

Rebecca Doherty, Cristina Ferrer, and Eileen Kelly Rinaudo

The internal organization that manages a company's M&A processes has always been a major contributor to the success of its deals. Today, as companies increasingly choose to manage their M&A processes internally, without the support of financial advisers,[1] it's all the more important to have the right team in place. This team must not only be skilled at screening acquisition targets, conducting due diligence, and integrating acquired businesses but also have the size, structure, and credibility to influence the rest of the company.

Admittedly, most of the best practices for designing an M&A organization are well known. But in our experience, many companies fail to put them into practice. M&A teams include members with unnecessary skills as often as they lack members with essential ones. Too little capacity is a common problem, but inflated teams frequently create issues as well. The effect on a company's ability to capture value from its deals is notable. According to our 2015 survey,[2] high-performing companies[3] are significantly more likely than low-performing ones to report that they have the necessary skills and capacity to support essential predeal activities. Moreover, nearly two-thirds of underperforming companies lack the capabilities to integrate their acquisitions (Exhibit 1).

What best determines the right size and capabilities for your M&A team? We'd highlight three factors: the demands of the M&A program you envision, the type of leadership role the team needs to play, and the relationship it should have with both the corporate center and with individual business units.

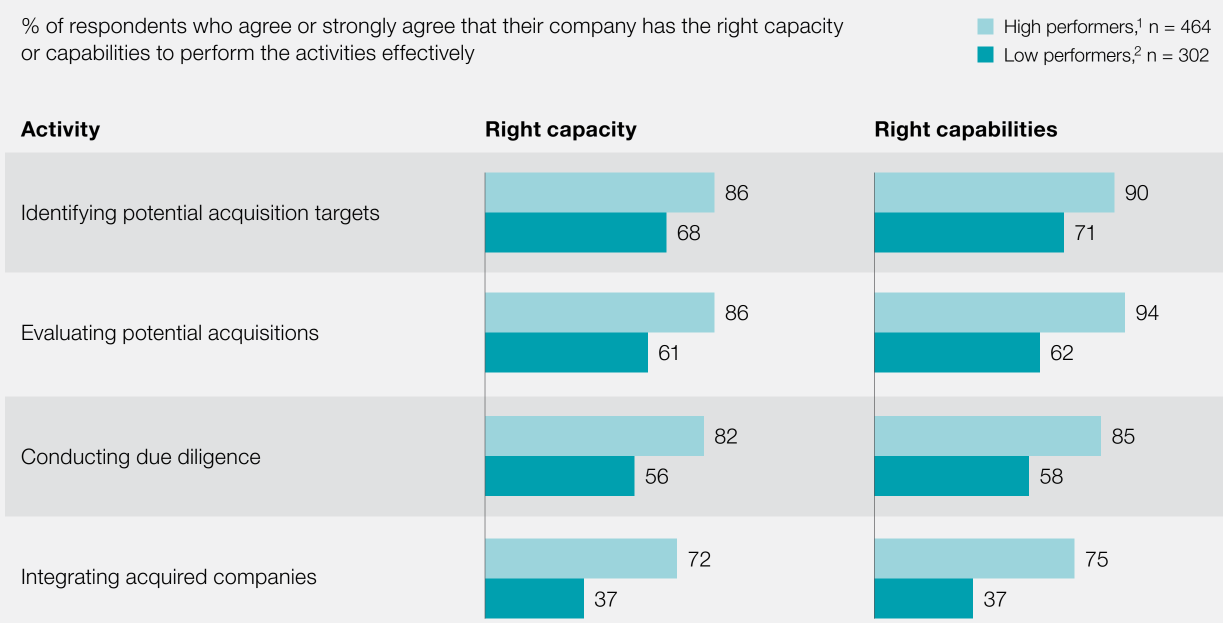
Meeting the demands of strategy

An M&A team can best support a company's deal-making objectives when those objectives flow naturally from a clearly defined corporate and M&A strategy. That strategy establishes the type and number of deals that will need to be closed. This, in turn, establishes a corresponding level of activity and skills needed for the pipeline of potential deals being screened, valued, negotiated, and closed. Companies in fragmented industries with high-volume M&A strategies, for example, will need to screen more deals. In our experience, companies that seek to close 5 to 15 deals a year may need to start out screening as many as 150.

What often happens, though, is that many companies size their M&A teams based only on the capacity and capabilities they expect to need for due diligence. That can lead to a team that is too narrowly focused, that is too tightly staffed, or that lacks essential capabilities to address all deal types or tasks. Because while due diligence is a central piece of the M&A process, it's not the whole story. Other pieces, such as how large the scan needs to be, the types of companies that need to be screened, and how those companies will be integrated, are equally important when designing the M&A organization.

Exhibit 1 **Companies often lack the organization needed to successfully execute M&A.**

% of respondents who agree or strongly agree that their company has the right capacity or capabilities to perform the activities effectively



[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.

It's just as problematic to deploy a team that's too large and that lacks clear roles and responsibilities or an appropriate breadth of skills. Take, for example, the experience of one global industrial company. When its executives embarked on an ambitious growth program, they quickly agreed that they'd need a bigger, more skilled M&A team to manage the number of deals they envisioned. So they doubled the size of the team, adding employees with experience in their core business areas, and tasked them with a target number of transactions per year. What managers misjudged was the variety of capabilities the team needed to source, evaluate, and integrate different types of deals. Two years later, the company had closed on a fraction of the deals it envisioned—largely due to problems exacerbated by the size of the team, including mismanagement, a lack of strategic focus, and unclear priorities. Many of the deals it had closed seemed to languish. And the M&A team had an 80 percent turnover rate.

A more holistic view of what's needed to execute an M&A program successfully can identify which skills a team needs, which it already has, and which might be acquired along the way with future deals. Much of this depends on the company's strategic approach to M&A. Consider the differences for companies using the main approaches to growth through M&A.

Transformational deals[4] don't require much sourcing effort because they tend to be self-evident and start from the top of the company. They do, however, require an experienced, discreet, and centrally organized M&A team with enough clout to understand and assume responsibility for the decisions it makes. These include, for example, defending the deal rationale, war-gaming the strategy, or even changing the fundamental financial structure of the company. Diligence, while led by this team, requires significant involvement from key functions and businesses. The team eventually grows considerably to handle postdeal integration. At that point, a large deal may need dozens or even hundreds of people from very different areas of the organization, including the M&A team, business units, and support functions, with at least half a dozen fully dedicated to the effort for a full year.

Acquiring *adjacent businesses*—in new industries or geographies, for example—tends to include a laborious sourcing process to identify appropriate candidates ahead of the due diligence. This often demands a dedicated team with expertise in the adjacent areas to define the attributes of a desirable acquisition target, whether by size, business model, competitive position, economics, or footprint. Integration efforts in this case can vary widely, depending on the degree of integration. Some adjacent acquisitions require larger, more complex integration teams because the value lies in the combination of the operations and activities of both businesses, such as those around R&D. Others require smaller integration teams, for example, when the only goal is to integrate support functions.

At the other end of the spectrum, *product and geographic tuck-ins*—small acquisitions that fit into a larger existing business—require in-depth knowledge of the product or geographic business. These are typically led by a business unit itself, often alongside the company's R&D or regional experts. In companies that do several tuck-ins a year, candidates are often on the radar well before an acquisition, and most of the predeal efforts are invested in maintaining valuable sources and developing relationships with potential targets. These companies often have fully dedicated integration managers to run an integration process that is more consistent between deals.

Additional external factors, such as industry fragmentation, major market shifts, and industry

The M&A approach a company takes ultimately depends on how it expects deal making to support specific strategic goals.

complexity, also affect the M&A approach and, ultimately, the skill sets needed within the M&A team. In more fragmented and diverse industries, more effort must be applied to sourcing and initial screening, as candidates might be difficult to identify and public information could be scarce. Team members will need broad experience and a deep understanding of the industry, as well as an ability to quickly review and evaluate opportunities. In turbulent industries where much deal making is under way, teams also need a thorough understanding of the market and the likely response of competitors. And in highly nuanced deals or complex industries, M&A teams should emphasize substantial experience and industry expertise over functional expertise.

In some cases, after considering these factors, companies will realize that they would benefit from a larger standing team to manage the complexity of their upcoming growth. In others, especially in more consolidated industries, where there are fewer strategic M&A opportunities, companies will realize that they're well served by a small M&A team that takes more of a project-driven approach.[5]

Deciding who should lead

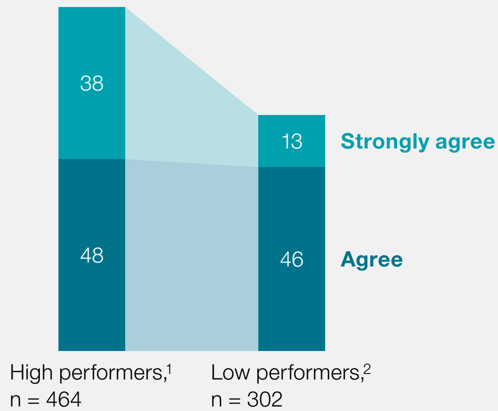
Strategic demands also affect who should lead a company's M&A program, depending on the nature of the business and the broader industry. In some companies, a corporate M&A unit takes responsibility for sourcing, evaluating, and executing deals connected with the corporate strategy, and the business units are called in to provide subject-matter expertise. This is especially true in financial institutions, where business units have relatively consistent strategic needs. In other companies, business units are responsible for sourcing, evaluating, and executing deals linked to the business-unit strategy, while the corporate M&A unit sets process and valuation standards. Highly diversified industrial groups tend to favor this approach, since it better suits the strategic needs of multiple groups.

Some, especially technology companies, also divide responsibility for M&A between corporate and business-unit leadership depending on the size and type of deal. The business units are responsible for sourcing and integrating deals related to the business-unit strategy, and they lead financial projections and synergy estimations. The corporate M&A unit leads the screening process and valuation. It pressure-tests business-unit assumptions—and also takes the lead on cross-business-unit deals or those that would enter a new adjacent business.

The approach a company takes ultimately depends on how it expects deal making to support specific strategic goals. One technology company, for example, aspires to double in size with a combination of larger deals in its relatively consolidated industry and significant M&A in adjacent spaces. Its corporate M&A group reflects that goal with the two main prongs of its organization: a team with fewer than five people, focused on large opportunities within its industry, and a second team, initially with just two individuals, focused on

Exhibit 2 **Corporate-strategy and M&A groups work better together in high-performing companies.**

% of respondents who agree or strongly agree that their corporate-strategy and M&A groups work well together



[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.

adjacent business opportunities. The business units themselves do not lead any M&A, though they provide subject-matter expertise during diligence and are heavily involved in and accountable for integration.

Coordinating internal working relationships

As companies confirm their strategy and the role of the corporate M&A team, they must also consider how it will interact with others needed to execute deals. In particular, managers must set clear and consistent expectations for the different organizational groups involved—including an explicit mandate for the M&A team, as well as roles and responsibilities for the corporate-strategy group, interested business units, and key support functions. In our experience, successful acquirers often go even further. They specify *how* different groups should interact, for example, by requiring quarterly meetings and by defining the inputs and outputs of those meetings.

Without this clarity, a business unit might, for instance, complain that the M&A team kills all its deals, while the M&A team complains that the business unit demands due diligence of unviable targets. Such tension and ambiguity can hinder the success of an M&A program. Consider the experience of one large healthcare company. Its highly skilled M&A team suffered from poorly defined roles, tense relationships with business units, and unclear strategic priorities, leading to frustration that undermined the team's effectiveness. The team lost nearly a third of its members every year for five years—an unexpectedly high turnover rate. Only a substantial push from the executive team to rework the mandate and redefine roles, followed by several months of campaigning with the business units and support teams, enabled the M&A team to reestablish relationships and reset expectations. The underlying organization did not change, but the effort substantially improved the team's performance and satisfaction.

The working relationship between the strategy group and the M&A team is especially important. High-performing strategy and M&A leaders work together to define how strategic priorities translate into a few targeted M&A themes. The M&A team then ensures that all deals are explicitly linked to those themes—confirming that link during the sourcing, evaluation, and diligence phases to make sure they're spending time on the right deals as more information becomes available. But given that only 38 percent of high performers in our survey (and 13 percent of low performers) strongly agree that the two groups work well together, it's clearly an area where most companies could improve (Exhibit 2).

Often, companies combine the two functions or link them within their reporting lines to encourage continual communication. This is particularly common in fast-moving industries such as high tech or pharmaceuticals. If they are not combined, it is important to orchestrate how the work of each group feeds into the other, such as how the M&A team's knowledge of what competitors are acquiring informs thinking on competitive strategy.

■ ■ ■

As companies look to improve how their M&A teams are organized, they must articulate their corporate and M&A strategy, determine how they want the projects to be managed, and enable productive and efficient relationships across the organization. ■

[1] Dana Mattioli, "An investment banker's worst nightmare," *Wall Street Journal*, May 10, 2016, wsj.com.

[2] Rebecca Doherty, Spring Liu, and Andy West, "How M&A practitioners enable their success: McKinsey Global Survey results," *McKinsey on Finance*, October 2015, McKinsey.com. The online survey on global M&A capabilities 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.

[3] "High performers" are defined as respondents to the global M&A capabilities survey who reported that their companies meet or surpass cost- and revenue-synergy targets in their transactions (n = 464). "Low performers" are defined as respondents who reported that their companies achieved neither cost- nor revenue-synergy targets in their transactions (n = 302).

[4] At McKinsey, we consider a deal transformational when it represents 30 percent or more of the acquirer's value, by revenues or market capitalization.

[5] Patrick Beitel and Werner Rehm, "M&A teams: When small is beautiful," *McKinsey on Finance*, January 2010, McKinsey.com.

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Strategic portfolio management: Divesting with a purpose

Tying portfolio decisions to a company's distinctive capabilities can help identify which businesses to divest.

Managers are becoming increasingly aware of the relationship between asset reallocation and value creation. They're also growing more attuned to the role of divestitures[1] as a tool for managing corporate portfolios. In our experience, deciding which businesses to sell and which to keep can make as much of a difference to a company's long-term value as which businesses it decides to acquire.

A structured, regular corporate-strategy process can help companies test which, if any, of their existing businesses have reached their sell-by date. The "best" owner of a business is whoever can generate the highest value from it.[2] And even if a parent company's distinctive capabilities stay the same, a business's needs change as it matures and the competitive landscape evolves.

For the past several years, McKinsey partner Ruth De Backer has co-led a McKinsey initiative on portfolio management and divestitures, working with leading players in the pharmaceutical, biotechnology, and medical-technology sectors. In her work, she's developed a particular interest in the application of the best-owner principle to portfolio decisions. We recently sat down with her to explore how the best-owner mind-set can help companies overcome barriers to profitable divesting.

McKinsey on Finance: *How does the best-owner principle help companies make objective, unbiased decisions about divestitures?*

Ruth De Backer: Companies need to ground portfolio-management decisions, including divestitures, in the attributes that make them a better owner of their businesses. Such attributes can include, for example, unique skills, governance, insight, or even connections to other businesses. They can also include access to talent, capital, or relationships.[3]

Tying divestitures to the better-owner principle means companies need to define explicit criteria for what good ownership looks like in each of their businesses. Some of those criteria should reflect a company's strategic intent. If a business unit helps a company meet its strategic goals, such as becoming an emerging-market player or developing a certain set of unique skills, then managers should rate it higher against their strategic criteria. Other criteria should reflect a company's capabilities. A company with a large integrated footprint and high operational efficiency is likely a better owner of products that help fill capacity and contribute to overall scale than companies without those attributes, so managers should rate such businesses higher on the capabilities criteria. And some criteria should reflect a company's current market position. For example, managers of a company with an enviable channel position or leading customer relationships and a great reputation across their portfolio can rate businesses against their ability to leverage the company's position across product lines.

Then managers can use those ratings to assess each of a company's businesses. The intent is to maintain the objectivity of the process, not to make every single business look good. So the scale needs to be consistent from business to business. For example, managers might agree that market position is 20 percent of each business's overall score, capability is 50 percent, and strategic intent is 30 percent. Naturally, the most attractive and valuable businesses will score very high. Those businesses where the company isn't a very good owner will score lower.

McKinsey on Finance: *How do the ratings help executives decide?*

Ruth De Backer: That rating process allows managers to have a more dispassionate conversation, because having gone through it, they'll already have nearly diagnosed why their company is or is not a good owner of certain businesses. And when the outcome is visibly a rational, objective, criteria-driven decision, it's much harder for business-unit managers to disagree. That accelerates divesting. Otherwise, it can take two or three years for some managers to accept that the issue is deeper than an unusually bad year or a difficult turnaround and that their businesses don't belong in a company's portfolio—and another couple of years to get the businesses out of the portfolio.

McKinsey on Finance: *Do the criteria differ from company to company?*

Ruth De Backer: At a high level, criteria are always about value-creation potential, natural ownership, and objectives drawn from the company's strategic plan. But the details may change from company to company, and the focus may change from industry to industry.

In the pharmaceutical industry, much of the value comes from innovation, technology, and intellectual property. So the criteria for a pharma company will be less focused on market position than on the products they offer and related capabilities. These include their intrinsic capabilities as market leaders that make them natural owners of those products over the long term, including a strong knowledge of therapeutic areas in your research-and-development department or existing relationships with physicians, opinion leaders, and start-ups. For example, the more related assets a diabetes company can offer, the easier it will be to get access to physicians who specialize in

‘A CEO who is primarily focused on growth and the size of the organization can be the biggest roadblock to divesting.’

diabetes—and often the better the reimbursement status for the company’s product portfolio. However, market position alone is not enough to have a lasting edge, because the relative positions of companies in the market shift based on the clinical benefits of their products. Many of the leading infectious-disease companies today weren’t leading the category ten years ago. When intellectual property or exclusivity runs out, as it does every 7 to 15 years, you get turnover even among the top companies.

Market position is more important for companies in the medical-equipment industry. The top cardiovascular companies ten years ago, Boston Scientific and Medtronic, are still the top companies today. For them, market position is a more important criterion because it means they can pull a lot of new products into their most important channels.

In industrial companies, scale benefits and operational capabilities are more important. Their ability to produce something at a lower cost is probably more important than it would be for the average pharma company, where the gross margin will be high even if they could be a couple hundred basis points more efficient.

McKinsey on Finance: *What are the common roadblocks to divesting?*

Ruth De Backer: A CEO who is primarily focused on growth and the size of the organization can be the biggest roadblock to divesting. In a company with a strong, numbers-driven CFO, the case to divest can be quite clear, objective, and grounded in data—but to make the actual decision, you need a CEO who is willing to act.

It’s also harder in decentralized companies. In such cases, divesting is often left to individual division managers, who may find it difficult to pivot from building a business to thinking about divesting it. In those cases, you obviously need strong strategy and corporate-development functions looking at the corporate portfolio. Otherwise, those are the companies where assets past their prime will linger the longest.

McKinsey on Finance: *How do executive incentives come into play?*

Ruth De Backer: The right incentives can help. If incentives are grounded in sales growth, for example, managers would be working against their own interests to sell a business with $2 billion in revenue. Unless the company were to set a new baseline for incentives after the sale, it would be hard to fill the revenue gap with anything else. A strong CFO and a strong corporate HR officer can help companies better understand how their incentives support corporate strategy—and can also explain them to investors.

McKinsey on Finance: *The evidence is clear that Wall Street reacts positively when companies make divestitures, even if those companies become smaller.*[4] *Why would there be a disconnect between the statistics and the way companies believe Wall Street will react?*

Ruth De Backer: On the face of it, executives get a lot of conflicting messages from Wall Street, often emphasizing growth. It takes a lot of courage to shrink, especially for executives who are unaware of the data showing that investors tend to applaud intelligent divestiture programs. Divesting is also counterintuitive to executives conditioned to highlight revenue and margin growth in quarterly earning calls. Given the pressure they face, explaining a divestiture-driven revenue decline or even a slowdown in revenue growth can be daunting.

McKinsey on Finance: *You might expect that from a division leader, but aren't the CFO and CEO more in touch with the way the market reacts to these things?*

Ruth De Backer: Many of them are. The more experience they have at divesting, the more they've seen the market's positive reaction firsthand, the more likely they are to do more and bigger spin-offs and divestitures. The more they do it, the more they take an interest in keeping the portfolio fresh. But companies with CEOs and CFOs who have no experience with shrinking, who frame performance in terms of revenue numbers rather than enterprise value, market capitalization, or shareholder value, find it very hard to divest.

McKinsey on Finance: *How much of that is related to their mind-set versus the way they are compensated or their relationship with their board?*

Ruth De Backer: All of the above. For instance, in one company in a high-margin industry, the chairman of the board is from an industry with low margins and low returns. The company was reluctant to sell anything that might dilute margins. The chairman argued that you can manage true low-margin businesses and make them attractive. And they generate lots of cash, even though a more focused, higher-growth, higher-margin business would have created more value. So boards can shape the dialogue. And if the board always talks about revenue growth, and your incentive system is based on revenue, then it's not surprising that you get CEOs who are very much focused on revenue numbers and growing the pie. The academic evidence is pretty clear that the single most important indicator of a CEO's compensation over a longer period of time is the size of his or her company.

McKinsey on Finance: *How can companies get the incentives right?*

Ruth De Backer: Getting the incentives right isn't easy, even for executives. I was working with a company that was really good at setting executive incentives based on the profile of its end markets and the profitability and the strategic objectives of each of the businesses. Executives told managers of the low-profitability, low-growth business in the portfolio not to worry about growth but to maximize their returns on invested capital and profitability instead. And in the end, they earned twice the bonus of managers of the portfolio's most profitable business, whose incentives were grounded in growth. Some people were unhappy and weren't shy about expressing their discontent, even though the incentives were actually aligned with creating shareholder value. Those kinds of incentive systems put a lot of pressure on companies because they're harder to live by year after year. It's one reason not to keep diverse divisions in the same portfolio, because most human-resources managers and most executives are uncomfortable when everyone's performance isn't measured against the same yardstick. Even when companies do manage to sustain diverse incentives year after year, it doesn't get easier. You don't want to disenfranchise the people who deliver the most value for the company in the long term. But you also don't want to undermine the people in a business that needs to be managed differently, to do what is right from a shareholder-value perspective. ■

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[1] The sale of part or all of a business can take the form of private transactions, including trade sales and joint ventures, or public transactions, including IPOs, carve-outs, spin-offs, split-offs, or tracking stock.

[2] Richard Dobbs, Bill Huyett, and Tim Koller, *Value: The Four Cornerstones of Corporate Finance*, first edition, Hoboken, NJ: John Wiley & Sons, 2011.

[3] Richard Dobbs, Bill Huyett, and Tim Koller, "Are you still the best owner of your assets?," *McKinsey Quarterly*, November 2009, McKinsey.com.

[4] See, for example, Audra L. Boone and J. Harold Mulherin, "Comparing acquisitions and divestitures," *Journal of Corporate Finance*, 2000, Volume 6, Number 2, pp. 117–39, pendientedemigracion.ucm.es; James A. Miles and James D. Rosenfeld, "The effect of voluntary spin-off announcements on shareholder wealth," *Journal of Finance*, 1983, Volume 38, Number 5, pp. 1597–606, onlinelibrary.wiley.com; Katherine Schipper and Abbie Smith, "A comparison of equity carve-outs and seasoned equity offerings: Share price effects and corporate restructuring," *Journal of Financial Economics*, January–February 1986, Volume 15, Numbers 1–2, pp. 153–86, sciencedirect.com; Katherine Schipper and Abbie Smith, "Effects of recontracting on shareholder wealth: The case of voluntary spin-offs," *Journal of Financial Economics*, December 1983, Volume 12, Number 4, pp. 437–67, sciencedirect.com; Jeffrey W. Allen and John J. McConnell, "Equity carve-outs and managerial discretion," *Journal of Finance*, February 1998, Volume 53, Number 1, pp. 163–86, onlinelibrary.wiley.com; and Roni Michaely and Wayne H. Shaw, "The choice of going public: Spin-offs vs. carve-outs," *Financial Management*, 1995, Volume 24, Number 3, pp. 5–21, semanticscholar.org.

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What private-equity strategy planners can teach public companies

Successful private-equity firms model practices that would benefit any multibusiness enterprise—as well as some that break the public-company mold.

Matt Fitzpatrick, Karl Kellner, and Ron Williams

In many respects, successful private-equity firms seem to defy economic logic. They acquire most of their businesses through some form of auction, where competitive bidding drives prices above what other potential buyers are willing to pay. Because they manage portfolios of discrete businesses, their acquisitions rarely reap substantial synergies. Their ability to survive, let alone thrive, depends on sustaining returns that attract limited partners to reinvest every few years. And unlike traditionally organized public companies, private-equity firms can't underperform for very long, because their track records directly affect their ability to tap into capital markets.

Yet a number of prominent private-equity firms have succeeded for decades, earning healthy returns for investors and founders alike. So it's not surprising that some public-company managers would look in that direction for new models to address their own myriad challenges—around aspects of governance, operations, and active ownership, among other things.[1] The way private-equity firms manage strategic planning, for example, offers lessons that might help public companies adapt to an environment marked by heightened shareholder pressure for performance and a fast-paced business cycle.

In our experience, successful private-equity firms excel at some practices that public companies should—but often don't. These include detaching themselves from the tyranny of quarterly-earnings guidance, deploying highly disciplined business-unit strategies, and developing a competitive advantage in M&A. We believe many public companies would benefit from applying a private equity–like approach more aggressively in these areas, even by going to lengths that might seem unorthodox.

Don't be tyrannized by the short term

Private equity's most powerful advantage may simply be that it is private. These firms can restructure and invest for the future while avoiding the glare of quarterly analysts' calls and the business media. They can also communicate more intimately with a much smaller investment community, so they don't broadcast their strategies and growth advantages to competitors. Our research shows that public-company managers can also gain shareholder support for long-term programs by communicating convincingly and making the right progress metrics clear to the investment community.

In the first 100 days after an acquisition, some successful private-equity firms collaborate with the new portfolio company during an intensive planning process. Over this period, management and the board develop a five- to seven-year plan, agreeing on new markets, channels, or products; assessing the capital needed to execute these initiatives; and developing an explicit set of new metrics and corresponding management incentives. In addition, they identify tactical near-term moves to build positive momentum from the deal's most readily apparent benefits.

Such efforts require a highly disciplined, rigorous emphasis on metrics that reflect longer-term value, like cash flow, rather than short-term value, like earnings per share (EPS). Many private-equity firms separate the financing of a business from its operating performance, which they get management teams to focus on by using cash flow–based measures, such as earnings before interest, taxes, depreciation, and amortization (EBITDA) and free cash flow. EPS reflects nonoperating factors (such as interest and tax expenses) that rely on a deal's structure, but EBITDA depends more on operating performance. Free cash flow also takes into account the capital expenditures and additional working capital required to generate profits; EPS does not.

During the 100-day planning process, private-equity firms are more active than public companies in considering the furthest horizons of strategic planning. Public companies often focus on nearer-term objectives, including existing baseline products and emerging product lines, though longer-term bets can help to create significant longer-term value. Typically, private-equity firms more actively identify and emphasize strategic planning's third horizon—including new markets and products—and diligently make tactical bets on it. For example, when private-equity firm Clayton, Dubilier & Rice (CD&R) acquired PharMEDium for $900 million, in 2014, it hadn't previously invested in outpatient care. But managers identified this as a major growth opportunity and made a calculated bet that paid off handsomely. CD&R ultimately sold the business for $2.6 billion.

Public companies could emulate much of this. Quarterly earnings can't be ignored, but long-term shareholder value depends heavily on the generation of free cash and on the third horizon of future-growth trajectories. Public companies should also explore the intensive 100-day planning process private-equity firms put in place after acquisitions, whether every other year or after the transition to a new leadership team.

Create disciplined business-unit strategies

A multibusiness company is the sum of its parts: if strategies for the underlying units aren't focused and robust, the overall picture won't be either. Success requires picking winners and backing them fully—something that often eludes public companies looking for the next new thing. Indeed, most of them pass only three out of ten tests of business-unit strategy.[2] Although financial theory suggests that capital should always be available for attractive investments, public companies that are constrained, for example, by their EPS commitments to Wall Street or by planned dividends often face intense competition for internal resources. Too often, they spread those resources thinly across business units. The right strategy means little if it isn't fully resourced.

Private-equity firms don't plan strategy around business units, but their investment theses for portfolio companies amount to the same thing. They provide a plan for investing across a portfolio of businesses, basing the allocation of capital on ROIC relative to risk, as well as explicit plans for creating incremental value in each business. Private-equity firms do focus less than public ones on the strategic fit of companies in their portfolios—a tech company in a portfolio of heavy-industry businesses wouldn't be a concern because the businesses are managed separately. But the portfolio-management objectives and disciplines ought to be similar. Both public companies and private-equity firms should evaluate a similar set of expansion options to assess market context, potential returns, and potential risks.

Private-equity firms develop, monitor, and act upon performance metrics built around an investment thesis. That's in sharp contrast with the one-size-fits-all metrics public companies often use to evaluate diverse business units—an approach that overlooks differences among them resulting from their position in the investment cycle, their prospective roles in the overall portfolio, and the different market and competitive contexts in which they operate. Although tailoring metrics to reflect these differences is hard work, it gives corporate management a much clearer picture of each unit's progress.

Public companies could go further. Unlike private-equity firms, for example, they traditionally manage the balance sheets of a business unit against the needs of the enterprise as a whole. But should they always do so? Instead of divesting a slow-growing but cash-generating legacy business unit, should they have it issue its own nonrecourse debt? This would save the tax and transaction costs of divestiture and potentially preserve additional upside. Would it make sense to bring outside capital into a high-risk emerging business unit—as Google X (now known as X) did for some of its nascent healthcare ventures? This approach would help investors to see the long-term value of such units, which would be more directly exposed to the discipline of the capital markets.

In addition, public companies could emulate the governance of private-equity firms at the business-unit level, where each portfolio company has its own board of directors. These boards are generally

Private-equity firms develop, monitor, and act upon performance metrics built around an investment thesis.

controlled at the firm level, but they are often supplemented by knowledgeable and senior outsiders with a meaningful equity stake. Since the board's activities focus on only one business unit, the board can effectively surface, grasp, and debate the critical strategic, organizational, and operational issues it faces. While creating true governance boards for business units isn't a realistic option for a public company, nothing prevents it from appointing advisory boards, with incentives based on the creation of value at the specific business units they oversee. In fact, freedom from formal governance responsibilities may make such boards more effective, allowing them to spend significant amounts of time on strategy and on developing management.

Finally, public companies could do more to compensate business-unit managers based on their own results. Compensation for private-equity fund managers typically reflects the results of the fund as a whole, but the pay of management teams at portfolio companies strictly reflects their own company's value creation. This means that portfolio-company executives in a lagging business can't hope to be carried along by strong results at the fund level. It also means that executives in high-performing portfolio companies won't be affected by the poor performance of entities over which they have no influence. This is a powerful motivator in both directions.

Could it make sense, for example, for multibusiness public companies to link incentive compensation for business-unit managers not to traditional stock options but rather to "phantom" stocks[3] that reflect changes in the intrinsic value of their business units? That would be counterproductive where businesses are highly interdependent, but in many cases at least some parts of a company operate more independently. And such an approach could generate the kind of entrepreneurial focus on value that private-equity firms get from the management teams of their portfolio companies. In the 1980s, Genzyme, for example, pioneered many tracking stocks for specific business units, and John Malone used them recently for those of conglomerate Liberty Media.

Develop M&A capabilities as a competitive advantage

Among public, nonbanking companies, those that routinely acquire and integrate clearly outperform their peers.[4] That fact should make unearthing, closing, and extracting value from attractive acquisitions a functional skill—like the effectiveness of the sales force, manufacturing, or R&D. Many public companies don't treat it that way, but the best private-equity firms do, building and institutionalizing M&A skills as a competitive advantage.

Public companies that do behave like successful private-equity firms engage in M&A according to a handful of explicit themes, supported by both organic and acquired assets to meet specific objectives. Achieving this competitive advantage calls for proactively identifying attractive strategic targets, often outside banker-led deal processes. It calls for managing a reputation as a bold, focused acquirer that can offer real mentorship and distinctive capabilities. And it calls for effective commercial and financial diligence based on the detailed information available to acquirers after signing letters of intent. Other requirements include reassessing synergy targets, adjusting them as appropriate to provide a margin of safety, and being highly disciplined about the price paid for acquisitions, to ensure accretion.[5] Most public companies seek to develop these skills, but many don't dedicate enough time or resources.

Making M&A a competitive advantage isn't limited to acquiring. Private-equity firms, like the most capable M&A teams at public companies, recognize that they are not permanently the best owners of particular assets. In fact, as empirical research finds, the largest 1,000 global companies that actively acquire and divest generate shareholder returns as much as 1.5 to 4.7 percentage points higher than those of companies focused primarily on acquisitions.[6] These high performers not only seek the best owner for an asset when the time is right but also actively manage their portfolio companies to make them an even more compelling fit with identified prospective buyers.

Public companies could adopt still more of a private-equity mind-set—for example, identifying and capitalizing more on the flexibility of options-based investing. Owning a portfolio company creates a plethora of options for private-equity firms. In addition to selling at a time of their own choosing, they can refinance, pay a special dividend, spin out or sell part of a company, or make bolt-on acquisitions. Private-equity firms identify these options and remain open to (and act on) them when appropriate. A traditional public company could encourage this mind-set through its annual strategic-planning process.

■ ■ ■

These strategic-planning principles are easier to articulate than to execute. Evolving their application to changing conditions is even more of a challenge. Yet private-equity firms that have sustained their success over decades built their businesses by both executing and evolving. Although public companies may find these principles provocative or even foreign, they offer valuable lessons in how to boost performance in an environment of fast-paced change. ■

1 See Viral Acharya, Conor Kehoe, and Michael Reyner, "The voice of experience: Public versus private equity," December 2008, McKinsey.com; Andrew Mullin and Alex Panas, "Private-equity operations: Inside the black box," December 2014, McKinsey.com; and Andreas Beroutsos, Andrew Freeman, and Conor Kehoe, "What public companies can learn from private equity," January 2007, McKinsey.com.

2 Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, January 2011, McKinsey.com.

3 Phantom stock is a form of compensation in which a company agrees to compensate employees in proportion to the market value of an equivalent number of shares in that company's actual stock.

4 Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," January 2012, McKinsey.com.

5 Cristina Ferrer, Robert Uhlaner, and Andy West, "M&A as competitive advantage," August 2013, McKinsey.com.

6 Sean O'Connell, Michael Park, and Jannick Thomsen, "Divestitures: How to invest for success," August 2015, McKinsey.com.

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How we did it: Implementing a private-equity strategic vision

A private-equity veteran describes his approach to strategy.

Ron Williams

Established organizations are mostly structured to do yesterday's work. To meet the changing needs of today's and tomorrow's customers, businesses must constantly reinvent their structure, human capital, processes, and technology.

In my experience, private-equity firms do this—and create value—by focusing on the medium and long term, as well as on the short term. Among the best of them, this emphasis on the classic three horizons of growth shows up in their vision, investment, governance, operations, talent, and capitalization. Over my career, I've worked to incorporate that basic mind-set into the culture at both Aetna and Clayton, Dubilier & Rice (CD&R). Here's how we did it.

Vision: Clearly articulate the five- to seven-year vision and plan for the company.

A successful long-term strategy requires historical or baseline products, emerging product lines, and future-growth trajectories. Public companies often focus on the first two, but the third is the hardest—even though it often has the biggest impact on long-term value creation. Private-equity firms explore this third horizon more actively and are diligent about identifying and making tactical bets against it.

I served as chairman at PharMEDium, a leader in customized pharmacy sterile compounding, after it was acquired by CD&R. We identified it as a major growth opportunity, and after extensive due diligence, we developed an investment thesis. The thesis focused on enhancing penetration of current customers, launching new products, and ramping up to serve a new customer segment: the outpatient market. Our thesis was well executed by an excellent CEO in 2013. Our $900 million investment paid off to the tune of $2.6 billion when we sold it just two years later, much sooner than expected. Public companies could make similar decisions, but managers there are often hesitant to take the short-term hit to their earnings-per-share (EPS) ratio. That limits their long-term growth investments to things they can offset by cutting costs. The lesson here for public executives is to consider making a set of focused, tactical bets on the long term, and then clearly communicate the value story to the market.

We took a similar approach during my tenure as CEO of Aetna, where we made long-term vision and the innovation cycle a key focus for our management team. This was partly because of industry regulation, which required that we write down every new product we created and file it with public agencies. That eventually allowed competitors to launch copycat products, so we had to innovate constantly to stay ahead of our peers. As a result, we emphasized a three-year planning horizon, devoting significant management attention to "white space" brainstorming on the likely evolution of the industry and ways to leverage technology to create new services and capabilities. Aetna's market cap over the period grew to $15.3 billion, from $4.7 billion.

Investment: Determine the significant capital and operating investments required to achieve the vision, independent of impact on near-term earnings.
Making substantial investments in growth over the long term can be hard for a public-company CEO. Given that the average tenure of a Fortune 500 CEO is under five years, the returns on long-term investments can easily accrue outside the EPS timeline as CEO.

Managers of private equity–backed companies are much more likely to invest in change early, particularly within the first one or two years of acquiring a portfolio company, if it will increase earnings or change the trajectory of the business at the time of exit. The new expenses from PharMEDium's investment in the outpatient market did not have to be covered by cuts elsewhere, as they might have in an EPS environment. Instead, the board and management agreed on the costs and benefits of investment and were comfortable sacrificing short-term earnings to a tactical bet that it would drive long-term value.

Governance: Ensure alignment and cooperation in the strategic-planning process among the chairman, board, CEO, and executive team.
Public boards tend to focus on key strategic and compliance questions, such as risk management, and members often come from a range of industries and backgrounds. A private-equity board, by contrast, will usually be filled with a combination of private-equity professionals and experienced former executives from the industry in which the company operates. A board chair may meet with a CEO several times a week, offering counsel on how to achieve the strategic plan, helping to assess and sponsor growth opportunities, and supervising key operational challenges. This level of board involvement and relevant experience makes it easier to reach alignment on vision, horizons, and investments.

Envision Healthcare is one good example of this. Soon after CD&R acquired Envision in 2011, the board and I approved the rollout of an ambitious revenue-growth expansion plan. Under the implementation of CEO Bill Sanger, the company eventually almost doubled its revenue to $5.45 billion, from $2.90 billion. Because of this successful growth, CD&R took Envision public two years later, in 2013. Board alignment has allowed the expansion plan to continue, with CD&R

returning a fivefold multiple of capital on its investment.

Operational improvement: Assess restructuring needs with a fresh eye.

The quarterly timing of earnings that matters so much in a public company doesn't matter in private equity, as long as earnings at exit meet or exceed the original investment. As a result, companies backed by private equity are much more willing to take a restructuring charge in the near term or to weather midterm earnings volatility. This, along with different approaches to governance, also allows private equity–backed companies to recover more quickly than public companies during periods of distress.

Restructuring a company in the public market is still feasible if managers clearly articulate a plan and the pathway to long-term value, similar to private equity's approach. For example, at Aetna in 2002, Jack Rowe and I set out to transform the business and improve performance. Knowing that this would take time, we made the decision to withdraw EPS guidance. This, we believed, would minimize distraction and focus the market on the turnaround story. I then did a listening tour with all our customers to understand their preferences and unmet needs. Those conversations led to the most fundamental component of the restructuring: refocusing the business on all fronts—from product development to sales and finance—to serve customers vertically, by industry segment, rather than horizontally, by geography. This required a significant redesign and streamlining of the organization, as well as extensive value-chain analysis to break apart each segment and assess potential profit pools. It was also crucial to the long-term growth that followed, as Aetna focused on developing new products, services, and capabilities for each customer segment. In addition, it formed the basis of a compelling value-creation story for our investors.

Talent management and incentives: Tie management-performance incentives to long-term shareholder equity returns, focusing on value at exit rather than near-term liquidity.

Public companies often tie executive compensation to shares or options. Executives receive grants annually that vest at a given level of performance or length of time—usually a year. Not surprisingly, this can encourage a focus on near-term earnings.

In contrast, private equity typically ties executive compensation to a five- to seven-year view. The entire executive team and board receive the standard cash compensation, but their incentives have little connection to near-term liquidity. They do receive one-time equity grants at the outset of a deal but must usually hold them for the duration of the holding of the company. That

Public-company management teams should explore tying compensation to longer-term performance metrics and liquidity milestones.

compensation structure enables them to focus on investing in and building toward value at the eventual sale or exit from a business. That, in turn, is a key element of private-equity success, because it encourages managers to act as owners, with a focus on cost efficiency, cash flow, and long-term value.

Public-company management teams should explore tying compensation to longer-term performance metrics and liquidity milestones. Aetna, for example, made several key changes to its compensation structure. First, the company created profit-and-loss statements for each of the end-to-end customer segments. Then it tied incentives not just to running the day-to-day business but also to a specific set of innovation metrics linked to expanding the products, services, and interactions with that customer segment.

Capitalization: Optimize the capital structure of the business, basing debt load on interest coverage and enterprise value rather than on EPS impact. In contrast to the public market's focus on post-interest EPS and retaining an investment-grade credit rating, private-equity firms often choose to utilize more leverage. This gives them increased flexibility with respect to, for example, more earnings potential for acquisitions, without equity dilution.

In fact, as McKinsey research shows, almost a third of the value created by private equity comes from the appreciation of market or sector value, plus financial leverage independent of company outperformance. For instance, CD&R purchased Envision Healthcare in 2011 for $3.2 billion, with $915 million of equity. In addition to the company's significant operational outperformance, its use of leverage multiplied its equity return. Today, Envision Healthcare has an enterprise value of $6.7 billion, with $3.8 billion of equity. ■

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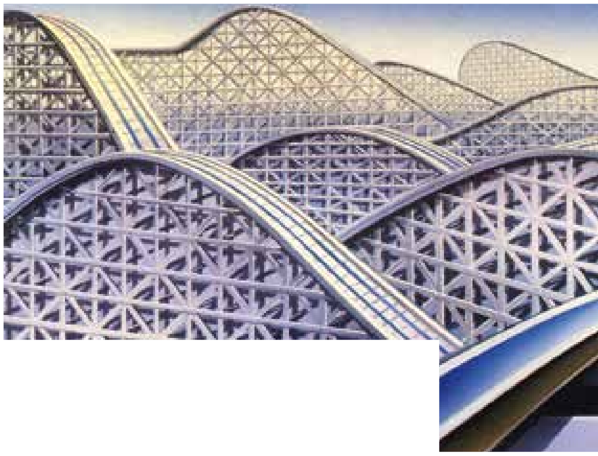

Fundamental Finance

Improving the investment patterns of cyclical companies

Companies that invest smartly when times are bad typically outperform peers.

Marc Goedhart and Jyotsna Goel

When profits are high and funding is readily available, it's easy for companies to invest in capital projects. But it's also unwise. Not only do companies that do so reinforce cyclicality in profit growth, they also forgo opportunities to invest at lower prices when profits are down.[1]

It's a hard cycle to break. Capital expenditures for the 500 largest US corporations over the past 45 years are highly correlated with prior-year profitability (exhibit). When corporate profits rise, capital expenditures typically go up as well in the following years. This relationship has been remarkably consistent over time—even in the recent years of quantitative easing—with a surprisingly strong correlation of 55 percent since 1972.

The findings correspond with our experience with companies in the energy, mining, transportation, and chemical sectors.[2] From a long-term perspective, they would be better off smoothing out their capital spending, building financial flexibility in good times so that they can spend more in bad. Companies that can time their capital spending and asset purchases to invest countercyclically typically outperform their peers. ■

[1] See Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, 2015, pp. 711–12.
[2] See, for example, Thomas Augat, Eric Bartels, and Florian Budde, "Multiple choice for the chemicals industry," *McKinsey on Finance*, Summer 2003, McKinsey.com.

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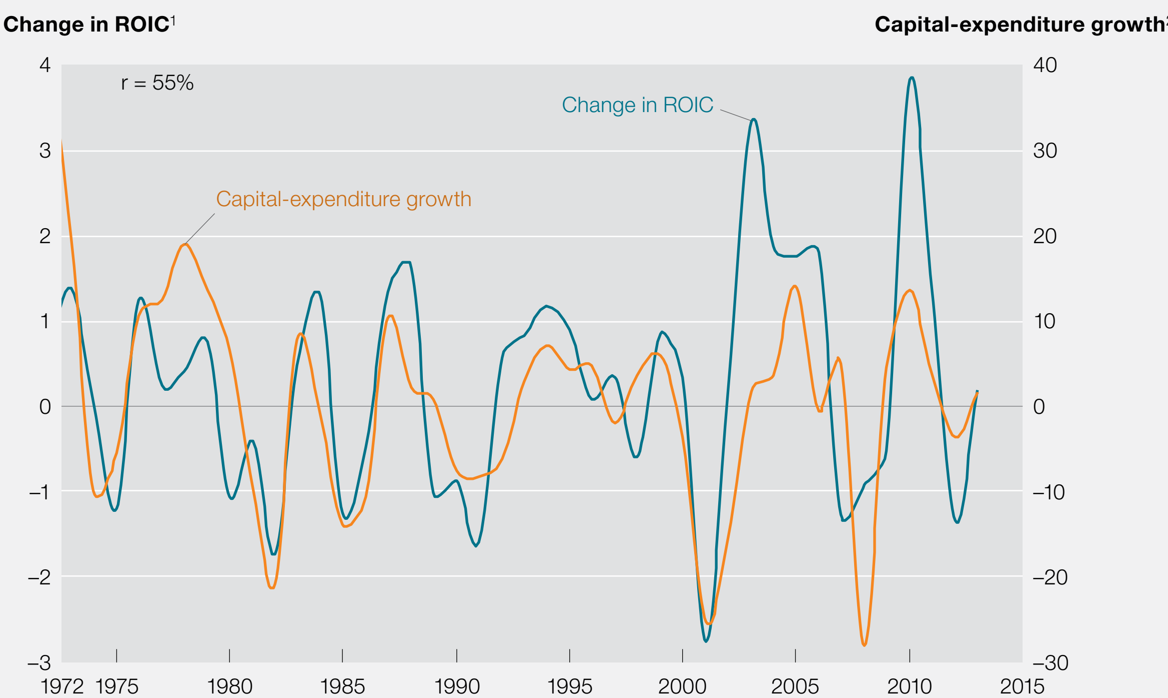
Exhibit **Capital investments are highly correlated with prior-year profitability.**

1972–2014, %



[1] Based on aggregate net operating profit less adjusted taxes divided by average invested capital, excluding goodwill.
[2] Based on gross capital-expenditure growth relative to annual changes in ROIC, normalized against long-term CAGR of 6%.

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