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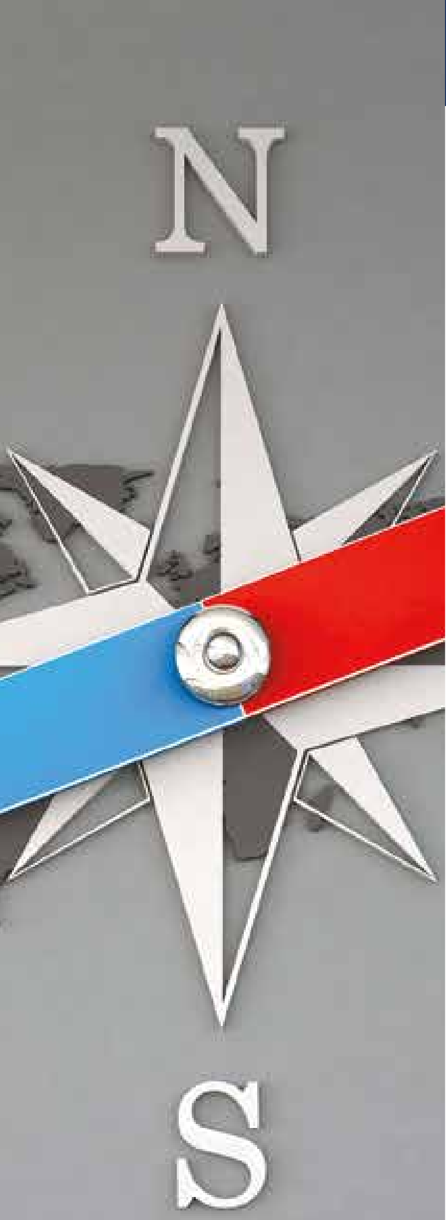

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The benefits of thinking like an activist investor

Whether or not your company is in the crosshairs of activists, assembling a team to take a good, hard look at your performance can deliver benefits.

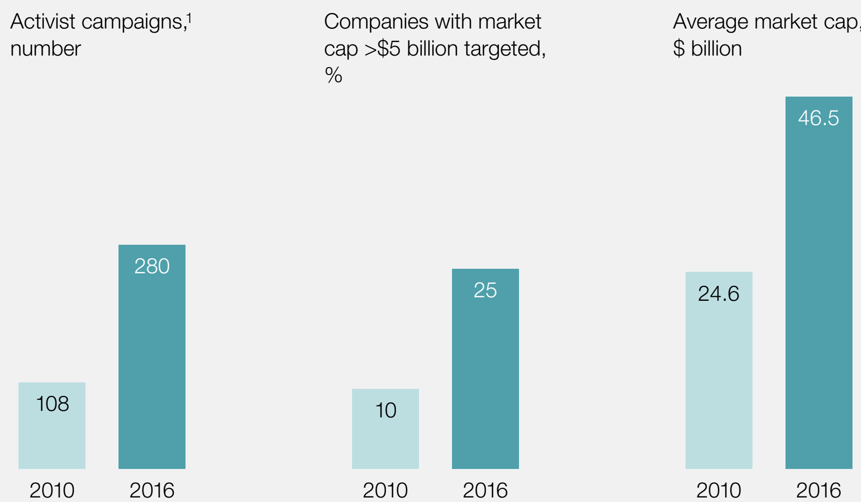
Joseph Cyriac, Snezhana Otto, and David Wells

The rapid growth and influence of activist investors has many executives nervously looking over their shoulders. Even large companies are increasingly vulnerable (Exhibit 1). But there is a benefit to be had for those managers with the courage to take as hard a look at their own company's performance as a performance-minded outsider might. The objective isn't necessarily for managers to do what activists would do—activists' performance is mixed, after all (Exhibit 2). Instead, the goal is for managers to examine their own strategy, governance, and operations with an eye to unearthing opportunities to improve performance.

Doing so, of course, requires acknowledging vulnerability. Managers, like all good leaders, are often successful because once they've made a strategic decision, they commit themselves psychologically to following through. Even those who invite dissent to challenge unconscious bias expect dissenters to fall in line once a decision is made. And in the absence of an occasional external point of view, that singular commitment can blind executives and board directors to opportunities as their company, the industry, and the economy around them change.

Shining light on those blind spots also requires more than just a typical strategy review. In our experience, that's where an activist role play can help. Managers give participants in such exercises (often called a "red team") deliberate

Exhibit 1 **Activist campaigns against large US companies are on the rise.**



[1] Excludes short sellers and gadfly investors. US companies only.

Source: Activist Insight; Capital IQ; McKinsey analysis

Exhibit 2 **Activism's track record on value creation is mixed.**

[1] N = 252 unique campaigns since 2007 across 151 companies trading on US exchanges that had 3-year TRS data available as of Mar 15, 2017, and market cap at campaign of more than $10 billion and revenues of more than $1 billion. Excludes activist short campaigns. Excess performance calculated vs S&P sector index.

Source: Activist Insight; Capital IQ; McKinsey analysis license to challenge their thinking across the board, including strategy, performance, governance, and even compensation, with no holds barred. That's the kind of exercise that many activists do when targeting prospective companies. For those who successfully emulate activist thinking, the opportunity can be striking: top-quartile activist campaigns are associated with sustained excess total returns to shareholders of more than 9 percent even three years out. It can also better prepare managers, who seldom prevail in disputes with activists (Exhibit 3), to better respond to their overtures.

Deploying an activist role play

The activist mind-set is, at its heart, a hypersensitive focus on shareholder value creation. Learning to think that way is usually only possible if senior managers agree to subject themselves to a role play that bulldozes through established patterns of thinking and deliberately looks for gaps and missed opportunities. The goal is to emulate the most constructive sort of activists who propose fundamental changes to improve long-term performance—typically supporting their case with sophisticated outside-in analyses of strategic and operational performance.

Done well, an activist role-play approach is substantially more provocative than a standard strategy review. The tone can be aggressive, even confrontational. In one pharmaceutical company, the red team's efforts sparked a much more drastic portfolio conversation than the usual incremental shifting of resources among therapeutic areas. Where there was a highly heterogeneous portfolio, adopting the activist's perspective drove consideration of much more drastic portfolio actions for parts of the portfolio that were not a natural fit. This approach helped compel executives to take an outside perspective and be a catalyst for overdue changes.

The setup matters. In our experience, the activist role play can liberate management thinking by creating an environment where all options are on the table and there are no sacred cows. It is one thing to read a report that suggests some changes to the operating model, and it is quite another to be the CEO in the hot seat and be questioned on performance, competence, board composition, and compensation. Moreover, while many CEOs may believe that everyone in their organization is empowered to speak out openly and freely, it's frequently the case that, at some point during a role play, one of the CEO's direct reports will sheepishly raise a hand and recall the time that his opinion on an important item was unceremoniously quashed.

Exhibit 3

Across sectors, management wins in less than a third of activist campaigns.

Results of activist campaigns against companies with market cap >$5 billion,[1] %

[1] N = 272 campaigns of companies with market cap of more than $5 billion, excluding gadfly investors and short sellers.

Source: Activist Insight; Capital IQ; McKinsey analysis

Focusing on strategy, performance, and governance

Mock activist role plays needn't cover the entire landscape of a company's business. It's possible to anticipate where the activists who care about long-term value creation will focus their attention. That can give companies a good idea of where to deploy this approach to examine performance through the external lens of an activist.

Portfolio strategy and capital allocation. It can be hard for companies to admit that a business unit in their portfolio would be better owned by another business, or that a turnaround isn't, as many managers like to think, "just two quarters away." In our experience, this isn't a sign of empire building as much as it is an indication that management teams honestly believe that they are a business unit's best owner. To them, asking them to divest a business is akin to asking a parent which of the children would be better parented by someone else?

But activists have no such misgivings. An activist will take a hard look at the synergies among a company's different businesses—excluding general and administrative synergies in corporate overhead, since another owner of similar scale could reap the same benefits. They will challenge the ability of the owner to manage well all businesses in a diverse portfolio. And for activists, past performance doesn't guarantee that a business stays in the portfolio; they will consider any unit that does not meet performance criteria as a candidate for restructuring, divesting, or harvesting.

At times, portfolio strategy may be right, but that may not be apparent to investors. One bank placed a significant premium on reporting the performance of each of its business units as if they were stand-alone businesses. While this approach aimed for transparency and business-unit accountability, investors saw it differently. The message they received was that these businesses were independent of one another and that the parent was effectively a conglomerate. By taking a skeptical outside-in perspective, managers realized they needed to change their communications with investors to highlight the value of cross-selling and other operational synergies among businesses.

Assuming that the right portfolio strategy and communication is in place, an activist would also evaluate whether capital was allocated to the most attractive parts of a company's portfolio. The skeptical view in an activist role play can highlight which businesses should be considered a growth and investment opportunity—or an efficiency and harvesting opportunity. It can also evaluate whether the company sufficiently redeploys resources to the businesses it intends to keep—new growth platforms or businesses with a clear competitive advantage in the market. Take, for example, the experience of one basic-materials company. By applying an activist's hypersensitive shareholder-value-creation perspective, managers realized that a legacy vertical-integration play had led the company to subsidize a unit that would have been loss making as a stand-alone entity. As a result, they diverted growth capital away from this unit and toward a unit further downstream that could generate more free cash flow.

Financial strategy. Among the most visible targets of activist demands are financial strategies that don't appear to be friendly to investors. Activists will evaluate a company's leverage or debt-to-equity ratios by benchmarking to likely market peers. They'll ask hard questions about tax efficiency and whether a business has too much or too little debt. And they'll weigh a company's deployment of excess cash—whether it could be invested or returned to shareholders.

The activist lens can compel managers to take a different perspective on how a company conducts its benchmarking.

Activist role plays should raise the same questions. Consider the example of one large, high-performing technology company. Managers and the board of directors firmly believed that they should be investing for growth—as they had done since the company was founded decades earlier. Indeed, the company had never paid a dividend or done a large share-repurchase program. However, the company had grown to a market value of more than $30 billion and was enormously profitable. It took a hard push by the red team to make managers see that their commitment to the narrative behind the company's success had to change.

Operating performance. A savvy activist will use outside-in assumptions to benchmark each business segment in a company's portfolio against best-in-class peers, as well as the combined enterprise.

The activist lens can compel managers to take a different perspective on how a company conducts its benchmarking. For example, one large pharmaceutical company was accustomed to benchmarking performance against its peers. However, when it looked at individual business units in the role play, it uncovered a different story and highlighted a number of issues in the cost structure of different parts of the portfolio. It was also clear that in certain areas, such as consumer marketing, the company was underspending, and there was too much R&D spend on business units that would not yield the same return on investment. That challenged the company's legacy of spreading savings targets equally across all the business units, which was at the heart of the company's operating mind-set.

Similarly, adopting an activist perspective can help set a higher bar for operating improvements. At one consumer-retail company, for example, managers took an activist perspective on operational benchmarking to review their performance goals. From the outside in, they realized, an activist would likely see incremental changes as insufficient. They then used that insight to build a case for change with expectations of doubling their margin improvement and improving working-capital efficiency by 50 percent. Companies could go even further. With a more radical margin aspiration and case for change, a company taking the activist perspective may contemplate going beyond industry benchmarks and applying a zero-based budgeting approach to fundamentally rethink parts of its cost base.

Governance. Activists will take a hard look at company boards to evaluate whether they constitute strong, competent oversight on behalf of shareholders relative to entrenched insiders. Companies will need to ensure board members have relevant, specific expertise. Ideally, boards would include both industry veterans familiar with what has historically determined success and functional experts from other industries that are ahead—in digital delivery, for example. Such functional experts can bring a perspective on the trends that will shape the industry's future. It is also critical that this expertise is communicated to shareholders.

Companies will also need to signal strong governance of the board of directors over management through the following measures:

- *Pressure-testing corporate strategy from an outsider's point of view.* Boards of directors often only think about the activist perspective reactively, after an activist has become involved. But considering an activist's mind-set proactively can also help directors to review their strategy more rigorously—and leave them better prepared to respond to activists when they show up. The board of one large healthcare company has found the outside-in activist role play so valuable in this regard that it involves the board in an activist role play as part of its annual strategy-refresh process.

- *Linking executive compensation to long-term value creation relative to the company's sector.* Compensation provisions can have the effect of encouraging executives to focus on near-term profits at the expense of long-term growth. An activist role play can help board directors compare compensation metrics with those of market peers to ensure that management compensation is aligned to performance that leads to growth, higher margins, and returns on capital. Where appropriate, they may also want to build in clawbacks to discourage short-term moves. That way, activists won't be able to argue that managers are being rewarded more than their peers for lower performance.

Thinking through these issues can help provide new insights into how to maximize business performance, and, in turn, deter activists. The process will also help companies develop a response should activists come knocking. By incorporating value-creating ideas into its plans and effectively communicating them to long-term shareholders, companies may find that even the most astute activists will be hard pressed to dazzle other shareholders with a better proposal.

■ ■ ■

Thinking like an activist can help managers improve their own performance before they attract activist attention. It can also give them the confidence to push back if activists attempt to intervene. ■

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Stress testing for nonfinancial companies

Assessing a company's vulnerability to risk makes otherwise theoretical discussions of strategy more real.

Conor Kehoe, Cindy Levy, and Matt Stone

In the decade since the global financial crisis, financial companies have honed their ability to measure risk in a way that nonfinancial companies have not. Granted, nonfinancial executives haven't faced the same existential crisis. And they've seldom come under the same kinds of investor and regulatory pressure. But the result is that they haven't absorbed many of the lessons on risk management learned by the financial sector.

We believe that nonfinancial companies, too, would benefit from a more aggressive look at the risks they face. Among the most important steps they could take, for example, would be to quantify risks in the context of broader scenarios, and not just as discrete sensitivities. They should calculate the effect of more extreme one-off events, such as a cybersecurity attack, in addition to continuous risks, like GDP. They should model risk-mitigation strategies as well as the risks themselves. And they should sustain a conversation about risk that is explicitly tied to strategic planning, capital allocation, and other business decisions.

We recently tested our thinking qualitatively in interviews with the CFOs, company secretaries, and controllers of 11 leading nonfinancial companies in the United Kingdom. Having just completed their first full reporting year under a new policy requiring companies to assess their longer-term viability,[1] these nonfinancial company executives offered insight into the value a structured risk-measurement exercise can bring to a company's decision making. As one UK executive reflected, seeing what certain risks could really mean for the value of their operations gives the whole intellectual exercise more currency.

Gauge scenarios, not just individual sensitivities

Companies often maintain a list of the main risks that managers believe they face, which they report as their "risk register" in annual reports. These include discrete operational events, such as major industrial accidents, cyberattacks, or employee malfeasance. If they take the next step to quantify those risks, many simply turn to that list and model them, often for the first time, onto their financial outlook. That's a good start, as it gives managers some insight into how sensitive the company's financial health is to changes around individual risks, which many companies don't do. But measuring individual risks discretely does little to illuminate a more complex landscape of interrelated risks that often move together in the real world. That requires the further step of coherently clustering risks together into scenarios.

Scenarios are more appropriate because they help managers consider the effects of a variety of severe but plausible situations without seeming farfetched. They can also accommodate interaction effects among sensitivities. One manufacturer in our group reported modeling 18 different scenarios after eliminating many more that it felt did not meet the plausibility criteria. The comprehensiveness of the exercise equipped the board with a clear perspective on the company's resilience and a number of management actions in time for the Brexit referendum months later. And finally, integrated scenarios also ensure that companies do not miss or underestimate the correlations between their different business activities and individual risk types, thereby underestimating group-level vulnerability.

Consider extreme and one-off events, not just everyday risks

We frequently encounter companies willing to model broader, everyday market variables, such as GDP or inflation, or more specific variables, such as the rate of formation of new companies. But we seldom find companies willing to model more extreme variables (see sidebar, "Stress testing for an energy utility company") or one-off events, such as a cyberattack or a natural disaster. The data to measure the effects of the former are fairly easy to come by, some argue, while reliable data on the latter are not. Others believe that their employees would sufficiently rally together to counter such events. As one UK executive told us, "We did not try to model events of nature and operational issues. All hands would be to the pump in the organization anyway, to deal with that particular situation, given its gravity. The complete random nature of seeking to put in a number—we think that is too difficult."

One-off events can also be more correlated with market downturns than companies expect. For example, the pressure on income after a recession can translate into aggressive business practices that lead to one-off risk events—by undermining product or employee safety or leading to ethics violations. Governments may add to the pressure with a more aggressive tax and regulatory stance. Many companies will model the economic downturn, but they often don't model one-off events like changes in tax policy.

Some companies do find ways around the challenge of quantifying one-off events—often turning to the lessons of history to drive the analysis. One IT company, for example, used the experience of other companies that suffered a cyberattack to quantify the potential impact on its business. Press and financial reports often provide the kinds of relevant details needed, such as an increase in customer churn rates or declines in revenues.

Stress testing for an energy utility company

Sven Heiligtag, Susanne Maurenbrecher, and Niklas Niemann

At most companies, scenario analysis looks for the *likely* development of core risk factors over time. When managers consider a range of scenarios, they tend to "chop the tails off the distribution" and zero in on those that most resemble their current experience. Extreme scenarios are deemed a waste of time because "they won't happen" or, if they do, "all bets are off."

That approach can work well in an era of gradual change. But, at times like the present, the sum of low-probability events quickly adds up to a high probability that one of them will actually happen. And it is the potential for extreme risks, not the everyday ones, and the prospect of chaotic change overnight that keeps many executives up at night. Stress testing requires companies to be bold as they imagine extreme scenarios; almost nothing is too strange or ridiculous to consider.

To illustrate, we modeled the potential impact of five extreme scenarios on a hypothetical energy utility, specifically examining their effects on the profits and losses, balance sheet, and cash flow for each of several business segments: generation, renewables, trading, distribution, and retail. After modeling the effects of a scenario separately for each business, we combined them to show the effect on the enterprise (exhibit).

The financial implications would be considerable across the scenarios, though none would necessarily bankrupt the company. Significant profit and liquidity risks appear, especially in the generation and retail businesses. In the absence of successful countermeasures, all five scenarios lead to negative recurring earnings before interest and taxes, revealing major risks for the sustainability of the current business portfolio. Furthermore, the scenarios suggest a 10 to 60 percent drop in equity and a 5 to 40 percent increase in net debt—which might trigger liquidity concerns.

Of course, companies can forestall or mitigate many of the effects of stress—but only by building a stress-testing capability can a company know where to focus its efforts for resilience. Adding a stress-testing capability isn't onerous. Companies will probably need one or two additional researchers to complement their current market intelligence and analytics teams. In all likelihood, the scenario-planning models currently in use can be repurposed for stress tests.

Excerpted from "From scenario planning to stress testing: The next step for energy companies," February 2017, McKinsey.com.

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Exhibit

Stress tests show the material impact of a scenario.

Effects of extreme scenarios on finances of hypothetical utility

Impact <5% | Impact <15% | Impact >15%

	Revenue[1]	EBITDA[2]	Capital expenditures	Net debt	Key scenario drivers
Current	100	13	6	34	
Energy for free	83–94	9–12	6	36–41	• Total volume/market-share decrease in B2C segment by 25–75% • Reduction of retail prices by 5%
Decentralized	82–93	12–13	6	35–38	• B2C volume decreases by 20–50% • Shutdown of underutilized plants and 5–10% write-off of grid and generation assets • Decrease of wholesale prices by 5–10%
Emissions fraud	100	9	9	48	• O&M[3] costs in generation increase 50% • One-off penalty: 5% of total revenue • €0.5 billion cost for external services • No customer loss in B2C retail business
Cyberattack	99	8	10	43	• 5% PP&E[4] one-off write-offs • 7.5% PP&E one-off investment • 10% increase in grid field-crew expenses • No customer loss in B2C retail business
Price transparency	92	9	6	39	• Reduction of retail prices by 15% • 20% loss of B2C customers • 20% staff reduction, with severance payments of 150% of annual salaries

[1] Revenue set at 100; all other financial indicators indexed to revenue.
[2] Earnings before interest, taxes, depreciation, and amortization.
[3] Operations and maintenance.
[4] Plant, power, and equipment.

Source: McKinsey analysis

A materials company used a proportionate measure of the impact of the 2007–08 financial crisis on its business to stress test its current financial outlook. Managers then used the data to inform a strategy discussion with the board. In so doing, these companies gained a deeper appreciation for the magnitude these catastrophic shocks could have on their business and could allocate resources to prepare for them more effectively.

Model mitigation strategies as well as risks

Even nonfinancial companies that undertake a regular measurement of risks often neglect to measure the effects of their plans to mitigate the fallout of a downside scenario. Steps like reducing dividend payouts, cutting capital expenditures, or selling assets come with their own risks over the long term—and we believe risk-savvy managers should model both.

However, among our UK interviewees, several worried that modeling mitigations on top of the initial scenario or sensitivity amounted to piling assumptions on top of assumptions. There was also some debate as to the right perspective from which to comment on risk. Viability is one, but metrics such as the risk of a dividend being cut might be another—or, for companies that have promised a progressive dividend, the risk that the rate of growth might slow.

Whichever metric is used, companies and their boards would benefit from understanding which mitigations exist, when they should be triggered, and what rough magnitude of impact they could deliver. To understand mitigation steps, one approach that we've observed elsewhere is to immerse executives in a war game–like exercise. Teams representing different interests, such as competitors, suppliers, and regulators, debate a risk scenario and then run their respective reactions through the risk model to measure the effects. This has the benefit of ensuring that mitigation efforts are plausible and determining how these efforts might affect viability or dividends, for example. It also gives management confidence in their approach when an actual crisis comes to pass.

Broaden the conversation

The usefulness of risk-measurement exercises can be limited if they aren't dynamically linked to strategic planning, capital allocation, and other business decisions. That means such exercises need to include more than just a CFO or a board audit committee, or they amount—as one UK interviewee put it—to little more than a "tick-box exercise" that fails to change behaviors in the business.

Yet in cases where internal engagement is more comprehensive, we've seen risk-measurement exercises provoke a systematic review of a company's risk profile, risk-management approach, and strategic posture—even if it can take some time before the consequences become evident.
One UK retailer we met with described holding workshops with the company's executive team to reconsider its risk register and define plausible downside scenarios. Its board audit committee also spends significant time discussing the appropriate modeling methodology to arrive at robust and meaningful results. As with many of the companies we spoke with, it's too early to see concrete impact—we didn't hear of anyone who had made a major change in the business as a result. But several told us that a better understanding of risk was valuable input, and they wanted to deepen the process.

Indeed, several of our UK interviewees acknowledged that they'd previously had a limited understanding of their risk exposure. As a consequence, for example, they had no systematic understanding of how much capital they actually needed to absorb risk in current operations. Again, none reported after undergoing the risk-measurement exercise that they felt the need to raise or conserve more capital for such risks, though a few did report finding they were much more resilient to downside risks than they had expected. We also found broad recognition of the value of a more structured, analysis-enriched conversation with key decision makers about risks, and many companies were keen to improve their approach going forward. As the lessons from the viability-statement exercise are embedded and companies' approaches evolve, the intent can be summed up as it was by one interviewee: "You start with the risk process, and it develops and becomes richer in time."

■ ■ ■

For nonfinancial companies, a more structured approach to risk measurement can lead to a more nuanced and insightful appreciation of true risk levels, and eventually a better-informed strategic posture. ■

[1] Required by the UK Financial Reporting Council, starting with the 2015 reporting year. We saw this as a good opportunity to gauge whether the process might change the way executives at nonfinancial companies understand risk. We interviewed executives at 11 companies—from utilities to retailers to pharmaceutical companies.

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The authors wish to thank Emma Gibbs and Sven Heiligtag for their contributions to this article.

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A case study in combating bias

Following several disappointing investments, the German electric utility RWE overhauled its decision-making processes. Learn how from the CFO who spearheaded the effort.

Bernhard Günther, Sven Heiligtag, and Allen Webb

McKinsey: *Tell us a bit about the circumstances that motivated RWE's management to undertake a broad debiasing operation.*

Bernhard Günther: In the second half of the last decade, we spent more than €10 billion on big capital-expenditure programs and acquisitions in conventional power plants. In the business cases underlying these decisions, we were betting on the assumptions of ever-rising commodity prices, ever-rising power prices. We were not alone in our industry in hitting a kind of investment peak at that time. What we and most other peers totally underestimated was the turnaround in public sentiment toward conventional power generation—for example, the green transformation of the German energy system and the technological progress in renewable generation and related production costs. These factors went in a completely opposite direction compared with our scenarios.

Conventional power generation in continental Europe went through the deepest crisis the industry has ever seen. This ultimately led to the split of the two biggest German players in the industry, E.ON and RWE. Both companies separated their ailing conventional power-generation businesses from the rest of the company.

McKinsey: *Was it difficult to convince members of the executive and supervisory boards to scrutinize your decision-making practices?*

Bernhard Günther: Actually, it was the supervisory board asking, "Where has the shareholders' money gone?," and we in the executive board wanted to learn our lessons from this experience as well. So we embarked on a postmortem analysis to understand what went wrong and why, by looking at a sample of these €10 billion investments. We asked ourselves, "Is there anything we could have done differently, and if so, how can we learn from this in the future?" The spirit of it was not about shaming and blaming, but about learning from our own mistakes.

McKinsey: *What were the main contributing factors that you identified in your investigation?*

Bernhard Günther: There were a few outright areas of managerial underperformance such as some time and cost overruns on the €10 billion investments, totally unrelated to external factors. There were also exogenous factors that were not in our base-case assumption but that should have been within our solution space—the most obvious being the political intent to push renewables into the market, which was publicly known at the time our investment decisions were made. There was also at least one unforeseeable factor—the Fukushima disaster. The German government reacted by rushing into a sudden exit from nuclear-power generation. Roughly half of the nuclear plants were switched off immediately, significantly shortening the economic lifetime of the remaining plants. But even if you discount for Fukushima, I think the ultimate end game wouldn't have looked much different from today's perspective; it just speeded the whole thing up.

McKinsey: *As you analyzed the decision-making dynamics at work, what biases did you start to see?*

Bernhard Günther: What became obvious is that we had fallen victim to a number of cognitive biases in combination. We could see that status quo and confirmation biases had led us to assume the world would always be what it used to be. Beyond that, we neglected to heed the wisdom of portfolio theory—that you shouldn't lay all your eggs in one basket. We not only laid them in the same basket but also within a very short period of time—the last billion was committed before the construction period of the first billion had been finalized. If we had stretched this whole €10 billion program over a longer period, say 10 or 15 years, we might still have lost maybe €1 billion or €2 billion, but not the amount we incurred later.

We also saw champion and sunflower biases, which are about hierarchical patterns and vertical-power distance. Depending on the way you organize decision processes, when the boss speaks up first, the likelihood that anybody who's not the boss will speak up with a dissenting opinion is much lower than if you, for example, have a conscious rule that the bigwigs in the hierarchy are the ones to speak up last, and you listen to all the other evidence before their opinion is offered.

And we certainly overestimated our own abilities to deliver, due to a good dose of action-oriented biases like overconfidence and excessive optimism. Our industry, like many other capital-intensive ones, has had boom-and-bust cycles in investments. We embarked on a huge investment program with a whole generation of managers who hadn't built a single power plant in their professional lives; there were just a few people left who could really remember how big investments were done. So we did something that the industry, by and large, hadn't been doing on a large scale for 20 years.

McKinsey: *On the sunflower bias, how far down in the organization do you think that went? Were people having a hard time getting past their superiors' views just on the executive level, or all the way down?*

RAPID REFLECTIONS
FROM BERNHARD GÜNTHER

In your experience, what piece of common leadership advice is wrong or misleading?

People development based on weaknesses—or gaps versus "ideal candidate" profile—instead of building on strengths

Which historical figures do you admire the most?

Nelson Mandela and Martin Luther King Jr.

What's the best book you've read in the past year?

Freedom, by Jonathan Franzen (fiction)

You! The Positive Force in Change: Leveraging Insights from Neuroscience and Positive Psychology, by Eileen Rogers and Nick van Dam (nonfiction)

What skill do you think is most undervalued in leaders today?

Listening

Bernhard Günther: Our investigation revealed that it went much further down, to almost all levels of our organizational hierarchy. For example, there was a feeling within the rank and file who produced the investment valuations for major decisions that certain scenarios were not desired—that you exposed yourself to the risk of being branded an eternal naysayer, or worse, when you pushed for more pessimistic scenarios. People knew that there were no debiasing mechanisms upstairs, so they would have no champion if they were to suggest, for example, that if we looked at a "brilliant" new investment opportunity from a different angle, it might not look that brilliant anymore.

McKinsey: *So, what kind of countermeasures did you put in place to tackle these cultural issues?*

Bernhard Günther: We started a cultural-change program early on, with the arrival of our new CEO, to address our need for a different management mind-set in light of an increasingly uncertain future. A big component of that was mindfulness—becoming aware of not only your own cognitive patterns but also the likely ones of the people you work with. We also sought to embed this awareness in practical aspects of our process. For example, we've now made it mandatory to list the debiasing techniques that were applied as part of any major proposal that is put before us as a board.

It was equally important for us to start to create an atmosphere in which people are comfortable with a certain degree of conflict, where there is an obligation to dissent. This is not something I would say is part of the natural DNA of many institutions, including ours. We've found that we have to push it forward and safeguard it, because as soon as hierarchy prevails, it can be easily discouraged.

So, for example, when making big decisions, we now appoint a devil's advocate—someone who has no personal stake in the decision and is senior enough in the hierarchy to be as independent as possible, usually a level below the executive board. And nobody blames the devil's advocate for making the negative case because it's not necessary for them to be personally convinced; it's about making the strongest case possible. People see that constructive tension brings us further than universal consent.

McKinsey: *How did you roll all this out?*

Bernhard Günther: There were two areas of focus. First, over a period of two years, we sent the top 300 of our company's management to a two-week course, which we had self-assembled with external experts. The main thrust of this program was self-awareness: being more open to dissent, more open to a certain amount of controlled risk taking, more agile, as with rapid prototyping, and so forth.

Then we also launched a training program for managers and experts, especially those involved in project work—for example, the financial controllers that have to run the models for big investment decisions. This was a combination of a training course, some desktop training you could do on your own, and some distributed materials.

This program explicitly focused on debiasing. It started with these typical examples where you can show everybody how easily we fall into those cognitive traps, framing it not as a personal defect but as something that's just there. Second, it emphasized that debiasing can be done much more easily within a group, because it's a collective, conscious effort. And not some kind of empty ritual either. We taught very specific things that people could apply in their daily practices. For example, you can do a kind of premortem analysis and ask your team, "Imagine we are five years into the future, and this whole project we're deciding on today has turned out to be a complete disaster. What could have happened in the meantime? What could have gone wrong?" This is something that we are now doing regularly on big projects, especially when there are uncertain environmental factors—whether macroeconomic, technological, ecological, or political.

McKinsey: *Could you tell us about an example or two where you made a different decision as the result of debiasing practice, where it went the other way from what you initially thought was the right answer?*

Bernhard Günther: Two examples immediately come to my mind. The first one came up in the middle of 2015, when it became obvious that our company was in a strategic deadlock with the power-generation business—the cash cow of the company for years but now with a broken business model. There was a growing awareness among senior management that trying to cure the crisis with yet another round of cost cutting might not be good enough, that we needed to consider more radical strategic options. We established a red team and a blue team to come up with different proposals, one staffed internally and one with externals. We wanted an unbiased view from the outside, from people who were not part of our company or industry; in this case, we brought in external people with backgrounds in investment banking.

The internal team came up with the kind of solution that I think everybody was initially leaning toward, which was more incremental. And the external team came up with a more disruptive solution. But because it was consciously pitched as an independent view, everybody on the board took their time to seriously consider it with an open mind. It planted the seed of the strategy that we adopted to split the company into two parts, which now, a good year later, has successfully concluded with the IPO of Innogy. If we hadn't taken this approach, maybe months later or years later, somebody would have come up with a similar idea, but it wouldn't have happened that fast, with that kind of momentum.

The second example is a recent potential investment project in renewable energy that carried high reputational value for us, so there were emotional issues attached to winning the project. We were bidding for a wind park that was to be built, and the lowest bidder wins by offering the lowest electricity price. We knew it would be a very competitive auction for that project, and we had already decided in the run up to the decision making that we wanted to have a devil's advocate involved.

We had the project team make the case first in the board meeting. Then we had the devil's advocate put forward analysis of the risk–return trade-offs. All of this was in written form, so everybody had to read it before the meeting. This certainly helped our discussion a lot and made it much easier to have a nonemotional debate on the critical issues. And we came out of it with a different—and, I think, better—decision than we would have if we had just taken the proposal of our internal project team at face value.

McKinsey: *Now that these decision-making changes have taken hold, how do you see things running differently in the organization?*

Bernhard Günther: Looking back at where we were three or four years ago, I'd say that this practice of awareness and debiasing has now become almost a part of our corporate decision-making DNA. But it's something you have to constantly force yourself to practice again and again, because everyone at some point asks, "Do we really need to do it? Can't we just decide?" It's a very time-intensive process, which should be utilized only for the most important decisions of strategic relevance. About 30 percent of our board's decisions fall into this category—for example, major resource-allocation decisions—and it's similar elsewhere in the company.

Also, people's general awareness of the complex set of issues around cognitive biases has grown dramatically. Before this, things easily degenerated into blaming exercises going both ways. The naysayers were critiquing the others for wanting to push their pet projects. And the people promoting these projects were saying that the naysayers were just narrow-minded financial controllers who were destroying the company by eternally killing good business ideas. But now there's more mutual respect for these different roles that are needed to ultimately come up with as good a decision outcome as possible. It's not just about debiasing; it's given us a common language. It's now routine for somebody to say in a meeting, "I think we need some debiasing here." And then everybody can agree to this without

People's general awareness of the complex set of issues around cognitive biases has grown dramatically.

any need to get emotional. When in doubt, we just go through the process.

McKinsey: *Do you have any recommendations for other senior leaders who might be reading this interview?*

Bernhard Günther: I think when you read about these issues, it can seem a bit esoteric. You might say, "Well, maybe it's just their problem, but not mine." I think everyone should just do it; just start with it even on a pilot basis. You don't have to start rolling it out across 1,000 people. You can start with your own board, with a few test examples, and see if you think it helps you. But if you do it, you have to do it right; you have to be serious about it. Looking back, there were a few key success factors for us. For one, top management has to set an example. That's true of any kind of change, not just debiasing. If it's not modeled at the very top, it's unlikely to happen further down the hierarchy. Second, everyone has to be open to these ideas or it can be difficult to really make progress. At first glance, many of the tools might seem trivial to some, but we found them to have a very profound effect. ■

Bernhard Günther joined RWE in 1999 and served as the company's chief financial officer from 2013 until the 2016 spin-off and IPO of Innogy, where he is now CFO. This interview, which first appeared in the *McKinsey Quarterly*, was conducted by **Sven Heiligtag** (Sven_Heiligtag@McKinsey.com), a partner in McKinsey's Hamburg office, and **Allen Webb** (Allen_Webb@McKinsey.com), *McKinsey Quarterly*'s editor in chief, who is based in the Seattle office.

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Making sense of Chinese outbound M&A

Misperceptions of Chinese deal making can undermine otherwise good deals. Here's a closer look behind persistent myths.

David Cogman, Paul Gao, and Nick Leung

The past year saw Chinese companies spend $227 billion on acquiring foreign companies—six times what foreign companies spent acquiring Chinese firms. These "outbound" M&A volumes have grown at 33 percent per year for the past five years though regulatory controls on foreign exchange have slowed growth in 2017. Chinese companies were among the ten largest deals worldwide in 2016 (for example, the current ChemChina/Syngenta acquisition, which is going through the regulatory-approval process) and were involved in some of the most controversial transactions of the year, such as Anbang Insurance's high-profile battle for Starwood Hotels & Resorts, which added $0.4 billion to the price that Marriott eventually paid.

Despite all the media attention, a number of myths around Chinese outbound acquisitions persist. Let's discuss them one by one.

First myth—the 'wave of money'

China, the theory runs, is awash with cheap capital, and that is now fueling a global shopping spree. It has almost $3 trillion in foreign reserves, the world's second-largest sovereign-wealth fund, and four of the world's largest banks by assets—all of which are extremely well capitalized. Chinese companies therefore have almost unlimited firepower for overseas acquisitions, and that makes them willing to pay unrealistically high prices for high-profile megadeals.

It's important to put this supposed wave of money into context. The total amount of China outbound acquisitions has grown dramatically, from $49 billion in 2010 to $227 billion in 2016. However, the absolute level is still very low. For example, in 2015, Chinese companies spent around 0.9 percent of GDP on outbound acquisitions; EU companies spent 2 percent, and US companies spent 1.3 percent. We are still relatively early in a long growth trend.

The big-ticket deals that make the headlines are also not representative of the majority of transactions. These are mostly middle-market deals: the median deal size over the past three years was only $30 million. And for the most part, the valuations paid were not significantly above normal market levels. However, a Chinese company may have a legitimately different perception of valuation from their European or US peer. Nonstate firms listed in Shanghai had an average price-to-earnings ratio in 2016 of 60 times. If a Chinese acquirer is able to raise equity capital at this valuation, this will naturally make prices paid for overseas assets look much less irrational.

Moreover, the source of the funding is often not even Chinese. Many of the deals with very high leverage were financed enthusiastically by Western banks. The financing of many of the largest deals in recent years was done by foreign-led syndicates of banks. Of course, the Chinese acquirers accepted high levels of leverage for some of these deals, such as in ChemChina's acquisition of Syngenta, where $33 billion of the $47 billion purchase price was financed by debt. But from a Chinese firm's perspective, this is not a significant leap of faith. The Chinese economy has for many years relied heavily on bank debt more than on public-equity markets, and most Chinese companies are more comfortable with high levels of leverage than their Western counterparts. Moreover, high-leverage megadeals led by financial sponsors are hardly unusual in Western markets.

Second myth—the invisible hand of the Party

There is a persistent suspicion that somewhere in Beijing resides a collective brain that directs Chinese companies' actions—and that the recent outbound acquisitions have been directed by this pervasive government planning.

The government does like making plans: the extent to which it drives corporate decisions, however, is greatly overstated. The central government sets an overall policy framework, and managers of state-owned firms are rewarded in career progression for advancing it, but they are acutely aware that they are responsible for their own decisions. With very few exceptions, acquisitions are identified and pursued by management teams for commercial reasons.

Being aligned with policy can, however, bring help in executing the deal. Approvals arrive faster, loans are more readily available, and at times the government will quietly tell other Chinese bidders to drop out of auctions so that only one is contesting a deal. In some sectors—notably semiconductors, in recent years—there is active pressure on companies to find acquisitions. The deals they pursue may align with industrial policy, but mainly because policy reflects the interests of the firms in the first place, and the larger state-owned enterprises (SOEs) participate in shaping major policy instruments such as the five-year plans. But the responsibility for sourcing and executing deals remains firmly with the companies, and they are also responsible for their failures.

The role of government—or lack thereof—can also be seen in how companies use the government-linked investment funds. There is a very substantial amount of capital available to investment funds controlled by central government, such as the Africa

Fund, China Investment Corporation (CIC), and the Silk Road Fund. If there really were an invisible hand directing acquisitions, the government would be using these to coinvest with corporates. In practice, this rarely happens. The Silk Road fund, for example, has only invested in one company to date, compared with dozens of project-financing deals.

The only government-linked fund that has done numerous investments into foreign companies is CIC. However, these deals are portfolio investments, done purely in pursuit of CIC's commercial remit to make returns and not in pursuit of any policy objective; moreover, a significant portion of CIC's portfolio is deployed into fixed-income securities and funds.

Third myth—it's all capital flight

Between 2005 and 2014, the renminbi had only strengthened against the dollar, and a generation of managers came to take that as given. From 2014 onward, however, the renminbi has progressively weakened, and growth continues to slow. Many managers found themselves looking for ways to move capital offshore, and acquisitions provided a quick way to do that in large quantities. Are the acquisitions of prestige assets—hotels and property in major cities, often at relatively high prices—simply companies getting money out of China into "safe" assets?

Capital flight is unquestionably happening through multiple channels, of which overseas acquisition is only one: through 2016, the government worked hard to close these loopholes, which in the first quarter resulted in a significant drop-off in deal volumes. The question is whether it was a major driver of the growth in outbound M&A. Between 2015 and 2016, outbound deal volumes grew by 125 percent: this was clearly an acceleration compared with the growth rates in the preceding five years, ranging from 7 to 41 percent growth. Some of the deals done—real-estate deals in particular—made little apparent sense for the acquirers beyond simple financial diversification. Yet the growth in outbound M&A had started long before 2014: the capital flight of the past few years has contributed, but it was never the primary driver.

Fourth myth—crazy gamblers

For many sellers, having Chinese buyers participate in an auction can be a frustrating experience. Their decision making often appears opaque and irrational, with limited visibility into their funding, priorities, or intention to actually complete a transaction.

What appears to be irrationality, however, is often decision processes that aren't fully transparent to the sellers. A Chinese buyer, particularly a state-owned company, has to work with a complex set of stakeholders both inside and outside the company, and the person communicating with the seller may not be able or willing to explain these considerations.

Among many Chinese buyers there is also a suspicion that the standard M&A sales process does not play to their strengths. It is designed to place buyers in competition on equal footing and limit their access to the target company; this is exactly the opposite of the one-on-one negotiation and closer relationship building with the counterpart that they would prefer. Moreover, many management teams remain unfamiliar with the process itself and do not understand how to navigate it. This is changing fast, particularly among the private companies that have business-development staff with international experience and among the more sophisticated SOEs with experienced deal teams, but there is still far to go.

This impression often masks a genuine desire, even need, for some of these transactions.

The lack of focus on integration is one of the reasons that over the past ten years, the track record of success by Chinese acquirers has been extremely mixed.

For Chinese companies that are approaching the limits of growth in their domestic markets, access to technology, brand, and distribution networks abroad can be critical to their growth plans. Hence sellers often receive extremely mixed messages that can be challenging to decode; they frequently write these off as cultural differences, when in fact they reflect the unique circumstances of these buyers.

Fifth myth—integration isn't important to these buyers

In many deals, there is relatively little discussion of what will happen postdeal apart from securing the management team—and often the acquired managers are pleasantly surprised by the degree of autonomy they enjoy after the deal. This has led to the perception that Chinese companies aren't particularly interested in integrating their acquisitions into the parent companies to the same degree that a US or European acquirer would want to.

It's certainly true that Chinese companies are more likely to take a "hands off" approach to managing acquisitions postdeal than would most Western companies. However, this is largely because in the past, they lacked the capabilities to integrate: they simply didn't have enough managerial bench strength that could function in the acquisition's region. It's not that they didn't want to integrate: they doubted their ability to do so. The lack of focus on integration is one of the reasons that over the past ten years, the track record of success by Chinese acquirers has been extremely mixed.

Consequently, the integration models used look quite different. In most Western countries, there's a fairly well-understood approach to postmerger integration—speed is critical; companies eliminate overlaps and pursue synergies aggressively. Many Chinese integrations chose to prioritize stability first, keeping the company separate and looking at one or two major areas of synergy, such as R&D sharing or localization of product manufacturing in China to reduce cost.

As the track record shows, the approach to integration made a significant difference in the success of these deals. Those companies that had an organized and systematic approach to integration, on average, showed much better results than those that kept the asset at arms' length, managing through the board and treating it essentially as a financial investment.

There is, in most cases, a solid logic behind these acquisitions, be it acquiring capabilities, building a footprint outside China, or buying brands or technology. However, without a plan, potential synergies are simply numbers on paper. Increasingly, Chinese companies are recognizing this and developing more concrete integration plans earlier in the deal process. The bottleneck for most is building the resources to execute those plans—developing a cadre of managers with experience both operating abroad and in integrating acquisitions that they can deploy. This is easier said than done. Often deep functional experience is required—engineers and technical staff to support technology transfer or procurement, marketing teams to support cross-selling, IT staff to support platform consolidation—and the teams need to be able to function in the acquisition's language and working environment as well as the acquirer's. There are not, for instance, many Italian-speaking Chinese aerospace engineers available on the job market.

■ ■ ■

We are still at the beginning of a long growth trend, and the persistent myths surrounding these deals reflect this. Chinese companies will in time be an important part of global cross-border M&A, and that means levels of activity substantially higher than what we have seen to date. This will require some adaptation on both sides. However, Chinese companies need the brands, channels, technology, and relationships that these transactions can bring; and the investee companies benefit from access to the rapid innovation, scale, and cost advantages of the China market. In the long run, everyone gains from China's participation in the global deal market. ■

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The real story behind US companies' offshore cash reserves

The healthiest thing to do is to bring the cash home. But the details of who holds it and what would happen to it should shape the repatriation debate.

David Cogman and Tim Koller

The burgeoning excess cash reserves of US companies continue to provoke debate among economists, investors, and legislators. By our reckoning, the 500 largest US nonfinancial companies have now accumulated around $1 trillion more than their businesses need. The majority of this is held offshore, in non-US overseas subsidiaries, to avoid the incremental US income taxes they would pay if they repatriated the money under current US laws.[1]

All this excess cash is not good for the economy, since it isn't being used productively. It can tempt companies to make acquisitions or other capital investments that could even destroy value. And it also creates distortions in the economy, compelling investors in these companies, in effect, to hold cash positions in their portfolios that they may not want. When investors bought a share of Apple for $156 on May 12 of this year, for example, they were investing $107 in Apple's operations, and $49 in Apple's cash.

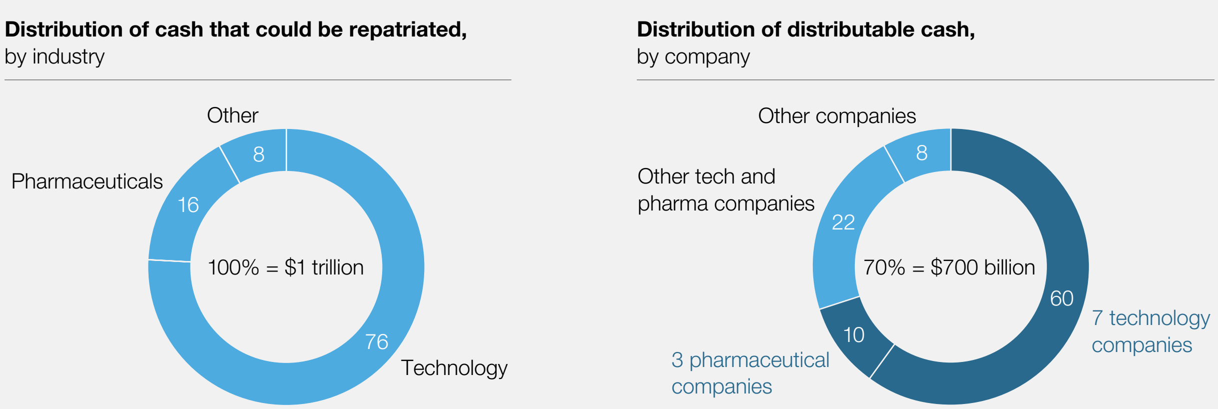
The debate over changing US tax law to encourage repatriating the cash revolves around how much productive investment bringing the cash home would create. To inform the discussion, it can help to understand a few practical details about who exactly holds the bulk of this cash, and what they might do with it if they brought it back to the United States. The bottom line: initially, most of the repatriated cash would likely end up going to shareholders in the form of share buybacks or special dividends, rather than in the form of investment in factories and equipment. Nonetheless, bringing it home is still healthier than letting it sit overseas.

Most discussions about how much cash could be brought home focus on a marquee number of anywhere between \$1.5 trillion and \$2.5 trillion of untaxed profits—depending on whether banks and other financial companies are included. But that's only a starting point for our calculation. We've excluded banks because it's hard to say from the outside how much cash they're required to hold by regulation. And we've adjusted for the portion of profits of nonfinancial companies that has already been reinvested outside the United States. What's relevant is how much of the cash held by US-based multinationals could easily be repatriated. Our analysis of the balance sheets of the 500 largest US-based nonfinancial companies confirmed that they had a combined market capitalization of \$17.9 trillion at the end of 2016 and revenues of \$8.9 trillion. Their \$1.66 trillion reserves in cash and near-cash investments amounted to around 10 percent of their total market capitalization and nearly 20 percent of their revenues. And while companies do need to hold some cash to do business, we've found in the past that companies can typically make do with cash balances of less than 2 percent of revenues. Conservatively, we estimate that about \$1.5 trillion of the total cash is above the 2 percent threshold. That's how much cash companies are holding beyond what finance theory tells us is necessary—but it still doesn't tell us how much could be repatriated.

That's because the marquee number also overlooks the highly concentrated distribution of cash across companies and industries. We estimate that about a third of overseas cash is widely dispersed across companies that operate (or earn their profits) primarily in the United States (or where their operations make it difficult to estimate their unrepatriated earnings.) The remaining \$1 trillion is held by companies that operate globally and that hold cash outside the United States as unre-

Exhibit

Ten companies in two industries hold almost three-quarters of the excess in offshore cash.



patriated profits. That's the amount that could be brought back to the United States under tax-reform proposals that include provisions, as most do, to substantially reduce the tax obligation.

Some of that cash could be used to reduce US-based debt, it's true. But if the main objective is that companies will bring it back to reinvest in new factories and equipment, the objective of past tax holidays, there's another fact often lost in the shuffle. The companies holding more than 90 percent of that $1 trillion don't have much need for more factories and equipment, with the bulk of it, $700 billion, held by just ten multinational companies in two industries: technology and pharmaceuticals (exhibit). These companies earn very high returns on capital—more than 30 percent after tax[2]—and most of them have modest growth.

The amount of investment any company needs to reinvest to sustain growth can be calculated as expected growth divided by return on capital. Most large pharmaceutical companies, for example, are expected to grow revenue less than 5 percent a year and would only need to invest less than about 15 percent of the profits back in the business to continue growing at that pace. The other 85 percent or so would normally be returned to shareholders[3] unless the company has attractive acquisition opportunities. The same holds true for the large technology companies. Although some are expected to grow faster, they also have higher returns on capital. This forward view is consistent with their recent behavior.

So if all the offshore cash of these companies were suddenly repatriated without tax, it would likely be returned to shareholders. Indeed, this is what happened in 2004, the last time offshore cash repatriation was permitted with a lower tax rate: the vast majority of it was returned to investors as share buybacks. And as long as excess cash continues to accrue—for each year that firms generate much more cash than they can reinvest—companies inevitably have few other options.

Returning cash to shareholders, in fact, would be better for investors and the economy than if the companies themselves attempted to invest $1 trillion rapidly in new plants and equipment. Access to capital has not been a constraint on growth for these companies. Furthermore, these companies are already spending large amounts on R&D. For example, pharma companies typically already spend 15 to 20 percent of revenues on R&D.

Economists can debate where the money will end up if distributed to shareholders—whether it will simply spur demand for shares or make its way to other companies that do have investment opportunities. Even if it's reinvested by US investors in non-US companies, it increases the returns coming back to the United States. In any case, bringing the cash home is better than leaving it sit. ■

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1 Effectively, the 35 percent US tax rate less local taxes. Local taxes can be as low as 8.5 percent in Switzerland (where the effective rate also varies due to regional taxes) or 12.5 percent in Ireland.

2 Excluding goodwill.

3 Even if the company makes acquisitions, the cash effectively gets returned to the selling shareholders.

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