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Perspectives on corporate finance and strategy

Preparing for adversity

Plus, building better partnerships, conducting premortems, and developing contingency plans to cull projects

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Table of contents

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Is a leverage reckoning coming?

Not yet. Despite rising corporate-debt levels, research shows companies can cover their obligations for now. But they should prepare for a possible downturn by stress-testing their capital structure.

by Tarun Khurana, Werner Rehm, and Anurag Srivastava

Economic analysts and policy experts have been sounding the warning bell about rising corporate-debt levels for the past few years. For instance, the former chair of the US Federal Reserve Board, Janet Yellen, has warned that companies (non-financial ones, in particular) are taking on too much debt and could have trouble meeting their obligations in the case of another financial crisis.[1]

It's true that in developed-market companies, leverage ratios (expressed as debt to EBITDA[2]) have gone up, as have the share and absolute number of companies earning sub-investment grades from credit-rating agencies such as Moody's Investors Service and S&P Global.[3] The analysts and policy experts chalk up these figures to companies' pursuit of share buybacks and other forms of financial engineering.

But a look behind the numbers tells a different story. In fact, our analyses indicate that downgrades of companies' credit ratings have not been significantly widespread, that much of the increase in sub-investment-grade companies is because of changes in newly rated corporate debt, and that most companies can cover payments on outstanding corporate debt as easily as they did ten years ago.

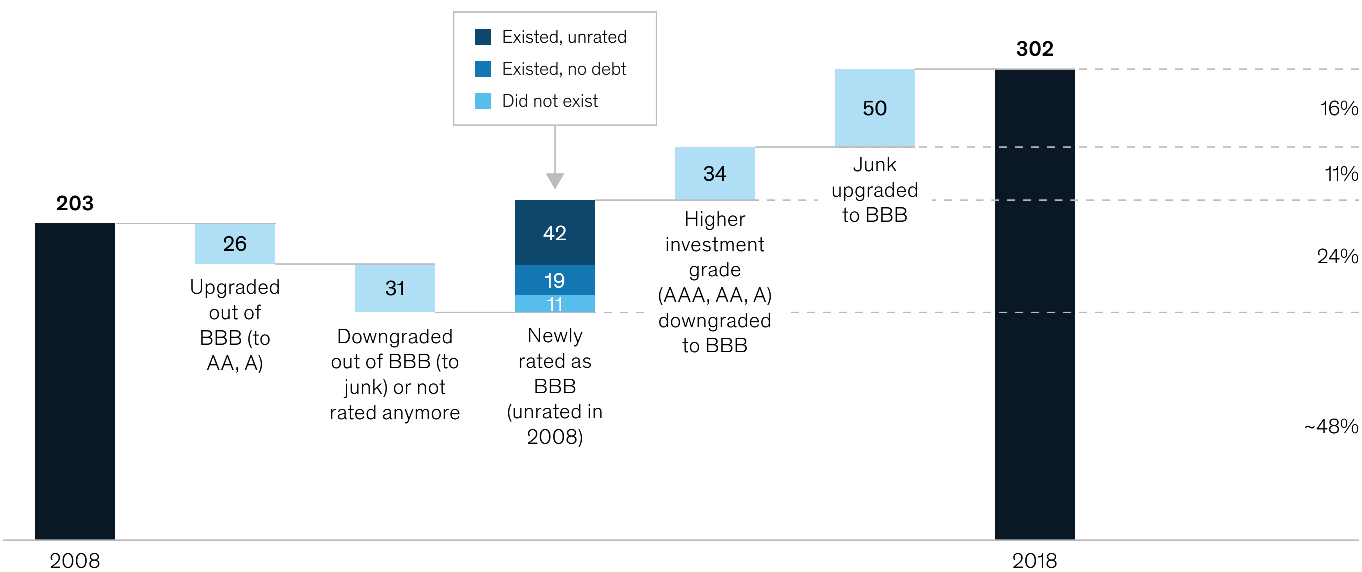
What a look behind the numbers shows

Strong economic growth and historically low interest rates in the wake of the 2008 credit crisis have allowed companies to increase the amount of debt they have taken on. Overall corporate debt in the United States grew from $2.3 trillion in 2008 to $5.2 trillion in 2018. But our research casts a counterintuitive light on discussions about corporate leverage in the United States.

Exhibit 1

Most growth in BBB-rated companies has come from newly rated debt.

Changes in BBB-rated companies, 2008–18, number, % share[1]



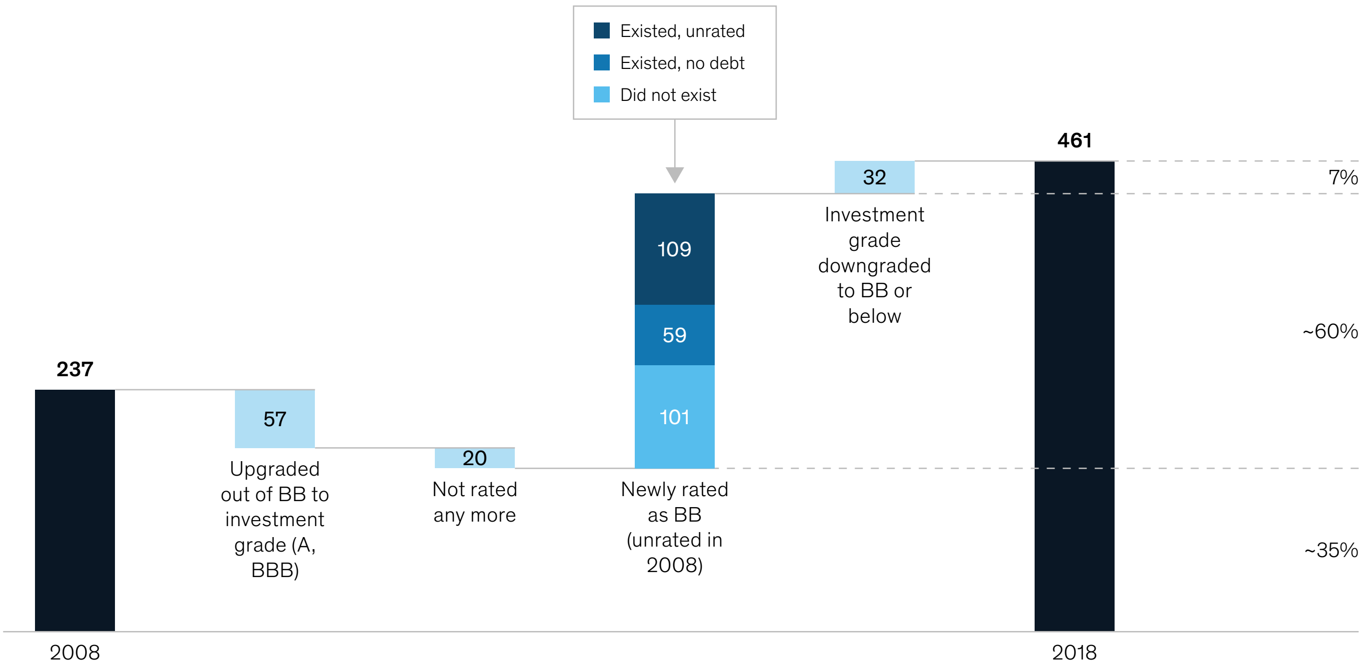
[1]Figures may not sum to 100%, because of rounding.
Source: S&P Global Market Intelligence RatingsDirect

[1] Jeff Cox, "Yellen and the Fed are afraid of a corporate debt bubble, but investors still aren't," CNBC, December 11, 2018, cnbc.com.
[2] Earnings before interest, taxes, depreciation, and amortization.
[3] An investment grade (AAA, AA+, et cetera) is a rating that indicates relatively low risk of default of a municipal or corporate bond. Anything below investment grade (BBB+, BBB, BBB–, et cetera) indicates increased risk of default.

Exhibit 2

Most of the growth in BB-rated bonds has come from newly rated debt.

Changes in BB-rated companies, 2008–18, number, % share[1]



[1] Figures may not sum to 100%, because of rounding.
Source: S&P Global Market Intelligence RatingsDirect

Our analysis of credit ratings, for instance, reveals that the general increase in sub-investment-grade companies is, by and large, not the result of widespread downgrades from credit-rating agencies; rather, it's the result of changes in newly rated corporate debt. Consider that the actual number of investment-grade (AAA through BBB) US companies grew from 311 in 2008 to 445 in 2018. But of the 300-plus investment-grade bonds in 2008, only 36 were downgraded to junk status in the intervening years—five were moved from AA or A status, and 31 from BBB.

Our research also revealed that there were 203 BBB-rated companies in 2008. By 2018, 31 of them were at junk-bond status based on an explicit downgrade in rating, and another 50 junk bonds from 2008 were upgraded to BBB—thereby compensating for any changes (Exhibit 1).

However, more than half of the 72 newly rated companies in our database had debt in 2008 that was not rated. Similar dynamics are at play among BB-rated companies, where the absolute number of BB and below bonds has grown but about 60 percent are the result of newly rated corporate debt (Exhibit 2).

The upshot? The observed increase in BBB and junk-rated companies cannot be attributed to downgrades of traditional large corporations. Most low-rated corporate debt wasn't rated ten years ago, or simply didn't exist. This suggests that many more companies than ever before are tapping into debt markets to take advantage of a strong economy and low interest rates.

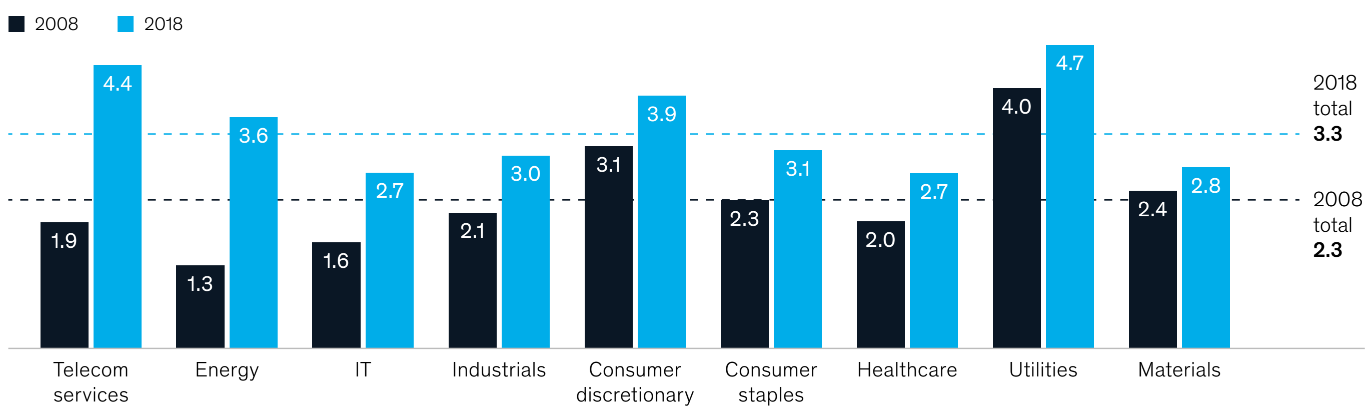
Our research also revealed that between 2008 and 2018, companies' debt-to-EBITDA ratios increased moderately across all sectors, in part because interest rates were so low (Exhibit 3). However, our analyses also showed that median interest-rate coverage, another measure of a company's riskiness relative to current debt or future borrowing, remained almost constant during the same period (Exhibit 4).

An examination of the coverage data shows some variation in the telecommunications and energy industries—for instance, the coverage ratios for top-quartile companies in those sectors were markedly worse in 2018 than they were in 2008. This makes sense given weak pricing in the energy sector and greater consolidation among

Exhibit 3

Companies' debt-to-EBITDA ratios are higher now than in 2008.

Debt to EBITDA[1] by sector, 2008–18, ratio

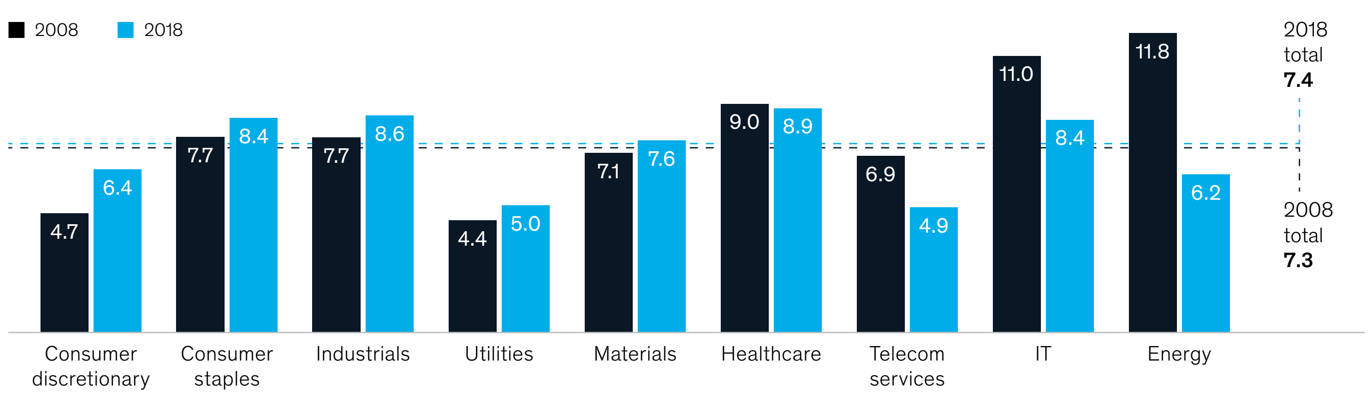


[1] Earnings before interest, taxes, depreciation, and amortization.

Exhibit 4

Companies can cover payments as easily today as ten years ago.

EBITDA[1] to interest by sector, 2008–18, ratio



[1] Earnings before interest, taxes, depreciation, and amortization.

Research suggests that most companies have enough of a cushion to withstand economic or interest-rate shocks in the near term.

telecom companies. But based on our findings, it looks like most companies today can cover payments on outstanding debt as easily as they did ten years ago.

Moreover, companies' financial engineering is less of a factor in their leverage scenarios than industry pundits would have you believe. Our research shows that stock buybacks contributed to fewer than 20 percent of companies' downgrades between 2008 and 2018. M&A has been a factor in half of the downgrades for investment-grade companies, and the presence of higher business risk (for instance, lower oil prices and weak retail spending) has been a factor in about a quarter of the downgrades. For junk-rated bonds, the weakening business environment has been a primary driver, according to our figures.

Finding balance

The evidence suggests that companies are not overleveraged—at least not yet. But what if interest rates increase again quickly? What if predictions of a sharp downturn in the economy in the next three years come true? (See "Building up for leaner times," on page 8.) As Janet Yellen and others have warned, there is always the possibility that holding such high leverage could create difficulties for some companies. Our research, however, suggests that most companies have enough of a cushion to withstand economic or interest-rate shocks in the near term.

We estimate that about 75 to 80 percent of total corporate debt is in the form of corporate bonds, which tend to be fixed-rate investments. These are not typically affected by interest-rate changes until refinancing, and our estimates suggest that less than 35 percent of outstanding corporate bonds will need to be refinanced within three years. Overall, about 40 to 45 percent of the total outstanding corporate debt could be affected by higher interest rates by 2020 (if they come).[4]

Still, it's never a bad idea for companies to stress-test their strategic plans and investment strategies, keeping leverage in mind. Senior management should feel comfortable in the business's ability to service current corporate-debt levels under different scenarios.

Consider the case of a global consumer company. For many years, it had traditionally held little debt; its debt-to-enterprise-value rate was less than 10 percent. Over time, the company increased its debt levels to about 25 percent of its total enterprise value in order to make several crucial acquisitions. Once the dust settled on those deals, executives had to decide whether it would be

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[4] To assess the impact of corporate debt on company resilience and risk in the event of a downturn, we considered two scenarios for the economy. One modeled continued growth, with 4 percent growth in earnings before interest, taxes, depreciation, and amortization (EBITDA) and the US Federal Reserve Board instituting aggressive interest-rate hikes. The other modeled extreme recession, with a decline of 13 percent in EBITDA, as experienced in 2008 and 2009, and increased interest rates.

more advantageous to return the company to its previous low levels of corporate debt or hold it stable at the higher level.

The company followed a standard process for pressure-testing its capital structure. That is, it built scenarios looking three to five years out that forecast market momentum as well as a potential downside case (to adjust for the uncertainty of the economic environment, and future cash flows). For each scenario, it estimated financing deficit or surplus and a target credit rating. After plugging these data into cash-flow models, the company was able to determine the level of leverage that made the most sense and readjusted its mix of borrowing, repayments, dividends, and share buybacks and issuances to reflect its post-M&A reality.

In the shadow of recession, the "right" corporate-debt levels and capital structure will, of course, look different for different companies. Some may decide to issue very long-term fixed-rate bonds to ensure near-term predictability of interest expense and maximum operating flexibility in case of a downturn. Others may want to look at bond covenants—defining coverage ratios, for instance, or establishing restrictions on issuers' ability to take on more corporate debt.

For those companies that are dealing with borderline investment-grade ratings, it might be best to press pause on any increases in leverage for now, or to use cash flow to reduce leverage. Those businesses with low ratings might indeed struggle in recession. They may end up as targets for the larger, healthier companies that have both the debt capacity and war chest to pursue a countercyclical M&A strategy.

Like the analysts and economic forecasters, finance and business executives should heed the flashing red and yellow lights. They should use this time as an opportunity to pressure-test their investment strategies and financials. In fact, such pressure tests should be conducted regularly—because regardless of the economic climate, executives who have a fine-grained understanding of where they hold leverage will inevitably make better business decisions than those who don't.

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Building up for leaner times

When the going gets tough, not all companies fare the same. Here's how to join the ranks of the resilient.

by Martin Hirt, Kevin Laczkowski, and Mihir Mysore

Geopolitical shifts, economic downturns, and other "shocks" that can significantly affect your company's fortunes are inevitable—and not entirely predictable. Recessions, for instance, may come on fast and cut deep, only for markets to bounce back quickly. Or they may be prolonged, with uncertain recovery periods. Scenario analyses can help put some boundaries around such uncertainties, but there is no guarantee that in today's volatile business environment they will be 100 percent bulletproof. A big question for executives, then, is: How can we best prepare for crises whenever they strike?

In times of crisis, not everybody fares the same. When we traced the paths of more than 1,000 publicly traded companies, we found that during the 2008 recession, only about 10 percent fared materially better than the rest. What made this cohort of resilient companies different? Was it because of the industries they operated in, or was it just luck?

We investigated more deeply and found some note-worthy characteristics in how the resilient companies weathered storms, how they prepared for them, how they acted during tougher periods, and how they came out of them. We saw that they reacted to market shifts earlier than industry peers did, so they entered the crisis in better shape. As a result, their performance dipped comparatively less than that of their peers during the downturn, and they came out stronger on the other side of the recession. Their moves are instructive for companies seeking to be similarly resilient—to ride the waves of uncertainty instead of being overpowered by them.

How the resilient companies performed

The focal point of our analysis was a group of approximately 1,100 publicly traded companies, across a range of industries and geographies, with revenue exceeding $1 billion. We found that, between 2007 and 2011, in each of 12 economic sectors analyzed, there was a power curve[1] of corporate performance.[2] The top quintile of companies in each sector—the resilients—delivered total returns to shareholders (TRS) growth that was higher than the median in their sector.

Further review revealed that in the three boom years before 2007, these resilient companies actually

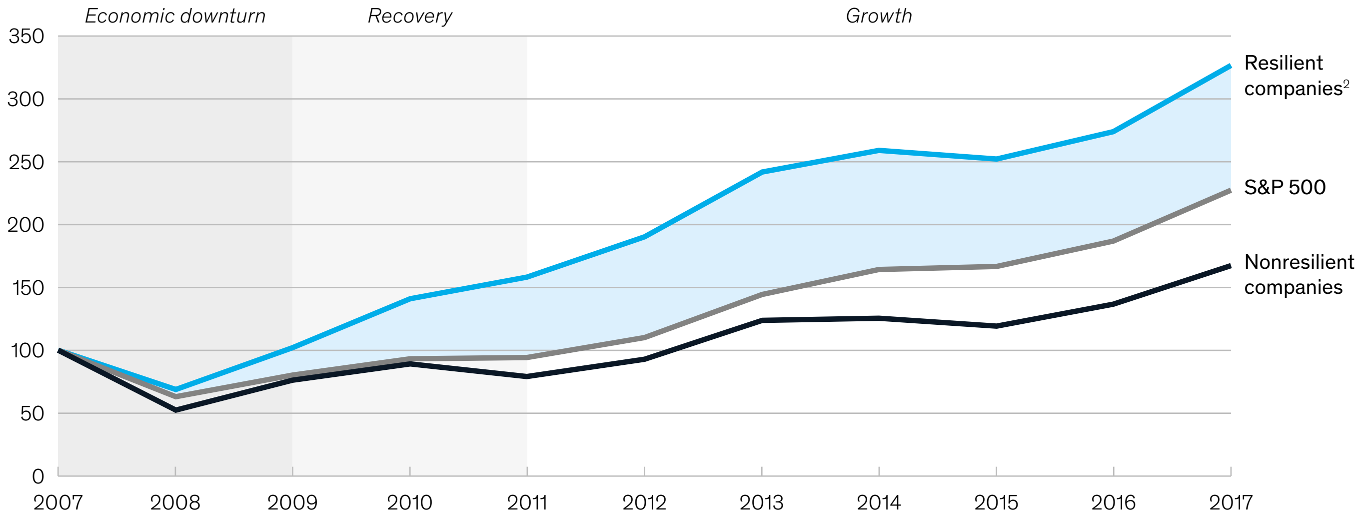
Resilient companies prepared earlier, moved faster, and continued to try to grow earnings, even when revenue declined significantly.

[1] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[2] Performance was measured in terms of companies' total returns to shareholders (TRS) or excess TRS growth between 2007 and 2011, relative to the sector median.

Exhibit

Resilient companies did better at the outset of the downturn and after.

Cumulative TRS performance[1]



[1] TRS = total returns to shareholders; calculated as average of subsectors' median performance within resilient and nonresilient categories; n = 1,140 companies; excludes financial companies and real-estate investment trusts.
[2] Resilient companies defined as being in top quintile of TRS performance by sector.

Source: S&P Capital IQ; McKinsey analysis

underdelivered on TRS, but they opened up a slight lead in TRS relative to sector peers during the downturn, and they extended this lead through the recession (exhibit). By 2017, the cumulative TRS lead of a typical resilient company had grown to more than 150 percent over industry peers. This lead was tough to reverse: nearly 70 percent of the resilients remained top-quintile performers in their sectors, with just a small fraction of the industry peers joining them.

The resilient companies were distinguished by their earnings, not their revenues. Barring those in a few outlier sectors, such as oil and gas and pharmaceuticals, resilient companies lost nearly as much revenue as industry peers did during the downturn. However, by the time the downturn reached its trough in 2009, the resilients' earnings (measured as earnings before interest, taxes, depreciation, and amortization [EBITDA]) had risen by 10 percent, while industry peers had lost nearly 15 percent.

What the resilient companies did differently

To create this earnings advantage, the resilients trained their attention in four main areas.

They grew earnings without interruption

There is little evidence to suggest that the resilient companies were better at timing the market. However, we can see that they prepared earlier, moved faster, and continued to try to grow earnings, even when revenue declined significantly. Many resilients accomplished this through deep cost cutting: by the first quarter of 2008, they had already cut operating costs by 1 percent compared with the year before, even as their peers' year-on-year costs were growing by a similar amount. The resilients maintained and expanded their cost lead as the recession moved toward its trough, improving their operating edge in seven out of the eight quarters during 2008 and 2009.

They kept their eye on the highest-value customers

The resilient companies didn't forget about growth in the middle of the recession—nor did they succumb to a "revenue at all costs" mind-set. Instead, they managed the decline in revenue by overinvesting in a few high-value customer segments, effectively positioning themselves as the "organization of choice" for critical customer groups that could help the company grow in the future. This approach allowed the resilient companies to maintain customer loyalty during the downturn and grow faster than peers during the recovery period.

They built a buffer

The resilient companies cleaned up their balance sheets before the trough of the 2008 recession, which gave them the flexibility they needed to be more acquisitive afterward. During 2007, resilient companies reduced their debt by more than $1 for every dollar of total capital on their balance sheet, while peers added more than $3 of debt. Of course, there were some exceptions: some companies sacrificed financial flexibility and increased their leverage while shifting to variable contracts and increasing operational flexibility.

They divested and acquired—early and often

The resilient companies entered the trough with more financial flexibility, and at the first sign of economic recovery, they shifted their attention to M&A—using their deeper troves of cash to acquire assets that their peers were dumping in order to survive. Overall, the resilients were 11 percent more acquisitive early in the recovery. They accelerated when the economy was stuck in low gear.

There were some sectors where "resiliency" looked different from what we've described so far, primarily because these industries saw little impact on their revenues from the downturn and only slightly slower growth. The oil and gas sector, for instance, was in the middle of a commodities boom in the early part of the 2008 recession, with prices going as high as $120 per barrel. Meanwhile, demand for healthcare and pharmaceuticals proved relatively inelastic. Resilient companies in these sectors actually overdelivered significantly on revenue, while taking on higher costs.

The road ahead

The takeaways from our study of resilient companies are consistent with findings from previous McKinsey research outlining the importance of making big moves.[3] You'll need cash to get through a recession, which means cleaning up your balance sheet, as the resilient companies did. You'll want to maintain a target list of assets and companies you'd like to acquire if they become inexpensive as other companies dump their portfolios. Ideally, you'll follow the resilient companies' lead and divest your own noncore assets early, before the fire sales start.

At the same time, though, you must be cognizant of changes in the external environment. For example, reducing costs in the way that the resilients did during 2008 and 2009 is likely to be difficult for companies in most industries. That's partly because competition in global markets and the relentless pressure of activist shareholders have left businesses with less fat to trim than in previous cycles. Cost cuts also create risks, starting with the risk of underinvesting in people at a time when our increasingly digitized, knowledge-based economy means many organizations need more talent, not less. And then there are the wider social costs of layoffs, which companies are starting to feel in the form of backlash from communities, customers, politicians, and workers.

[3] Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," *McKinsey Quarterly*, April 2018, McKinsey.com.

Meanwhile, the accelerating pace of digitization since 2008 also has been changing competitive dynamics in significant ways. There's a widening gap in capabilities and performance between digital leaders and laggards (nearly 6 percent in EBITDA growth, according to McKinsey research). The next downturn could be extremely challenging for the laggards.

At the same time, digital and analytics capabilities may also be a critical piece of the response to the obsolescence of across-the-board cost-cutting efforts and an alternative to the pursuit of cross-border labor-cost arbitrage. We expect companies to increasingly turn to digital tools and advanced analytics to bolster productivity and drive growth.

To ensure some measure of resiliency in the future, business leaders should start now to assess the degree of exposure they have to economic and geopolitical shocks, identify initiatives that can help to mitigate that exposure, and establish a "nerve center" to monitor progress on those initiatives. Indeed, citing the lessons we've learned from the resilient companies may help executives jump-start conversations about these moves in their own businesses and accelerate their preparation for the competition that lies ahead.

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Improving the management of complex business partnerships

Adhering to four key principles can help companies increase the odds that their collaborations will create more value.

by Ruth De Backer and Eileen Kelly Rinaudo

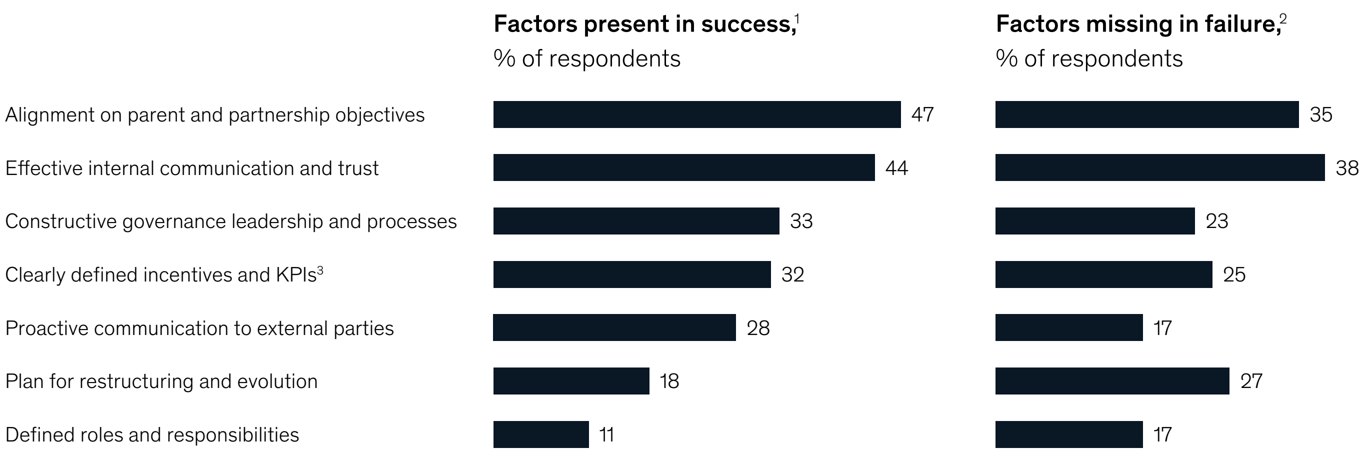
Partnerships never go out of style. Companies regularly seek partners with complementary capabilities to gain access to new markets and channels, share intellectual property or infrastructure, or reduce risk. The more complex the business environment becomes—for instance, as new technologies emerge or as innovation cycles get faster—the more such relationships make sense. And the better companies get at managing individual relationships, the more likely it is that they will become "partners of choice" and able to build entire portfolios of practical and value-creating partnerships.

Of course, the perennial problems associated with managing business partnerships don't go away either—particularly as companies increasingly strike relationships with partners in different sectors and geographies. The last time we polled executives on their perceived risks for strategic partnerships,[1] the main ones were: partners' disagreements on the central objectives for the relationship, poor communication practices among partners, poor governance processes, and, when market or other circumstances change, partners' inability to identify and quickly make the changes needed for the relationship to succeed (exhibit).

In our work helping executive teams set up and navigate complex partnerships, we have witnessed firsthand how these problems crop up, and we have observed the different ways companies deal with them. The reality is: successful partnerships don't just happen. Strong partners set a clear foundation for business relationships and nurture them. They emphasize accountability within and across partner companies, and they use metrics to gauge success. And they are willing to change things up if needed. Focusing on these priorities can help partnerships thrive and create more value than they would otherwise.

Exhibit

Managers cite several core reasons for joint-venture success and failure.



[1] Respondents' top choices out of a list of 10 components whose presence could have a favorable effect on their partnerships (n = 708).
[2] Respondents' top choices out of a list of 10 components whose absence could have a negative effect on the partnership (n = 262).
[3] Key performance indicators.

Source: 2015 McKinsey Joint Ventures and Alliances Survey

[1] Observations collected in McKinsey's 2015 survey of more than 1,250 executives. Sixty-eight percent said they expect their organizations to increase the number of joint ventures or large partnerships they participate in over the next five years. A separate, follow-up survey in 2018 showed that 73 percent of participants expect their companies to increase the number of large partnerships they engage in.

Establish a clear foundation

It seems obvious that partner companies would strive to find common ground from the start—particularly in the case of large joint ventures in which each side has a big financial stake, or in partnerships in which there are extreme differences in cultures, communications, and expectations.

Yet, in a rush to complete the deal, discussions about common goals often get overlooked. This is especially true in strategic alliances within an industry, where everyone assumes that because they are operating in the same sector they are already on the same page. By skipping this step, companies increase the stress and tension placed on the partnership and reduce the odds of its success. For instance, the day-to-day operators end up receiving confusing guidance or conflicting priorities from partner organizations.

How can the partners combat it? The individuals expected to lead day-to-day operations of the partnership, whether business-unit executives or alliance managers, should be part of negotiations at the outset. This happens less often than you think because business-development teams and lawyers are typically charged with hammering out the terms of the deal—the objectives, scope, and governance structure—while the operations piece often gets sorted out after the fact.

Transparency during negotiations is the only way to ensure that everyone understands the partners' goals (whether their primary focus is on improving operations or launching a new strategy) and that everyone is using the same measures of success. Even more important, transparency encourages trust and collaboration among partners, which is especially important when you consider the number of executives across the organizations who will likely rotate in and out of leadership roles during the life of the relationship.

Inevitably, points of tension will emerge. For instance, companies often disagree on financial flows or decision rights. But we have seen partners articulate such differences during the negotiation period, find agreement on priorities, and reset timelines and milestones. They defused much of the tension up front, so when new wrinkles—such as market shifts and changes in partners' strategies—did emerge, the companies were more easily able to avoid costly setbacks and delays in the business activities they were pursuing together.

Nurture the relationship

Even business relationships that start off solidly can erode, given individual biases and common communication and collaboration issues. There are several measures partners can take to avoid these traps.

Connect socially

If executives in the partner organizations actively look for opportunities to understand one another, good collaboration and communication at the operations level are likely to follow. Given time and geographic constraints, it can be hard for them to do so, but as one energy-sector executive who has negotiated and managed dozens of partnerships noted, "It's important to spend as much time as you can on their turf." He says about 30 to 40 percent of partnership meetings are about business; the rest of the time is spent building friendships and trust.

Keep everyone in the loop

Skipping the step of keeping everyone informed can create unnecessary confusion and rework for partner organizations. That is what happened in the case of an industrial joint venture: the first partner in the joint venture included a key business-unit leader in all venture-related discussions. The second partner apprised a key business-unit leader about major developments, but this individual did not actually join the discussions until late in the joint-venture negotiation. At that point, as he learned more about the agreement, he flagged several issues, including inconsistencies in the partners' access to vendors and related data. He immediately recognized these issues because they directly affected operations in his division. Because he hadn't been included in early discussions, however, the partners wasted time designing an operating model for the joint venture that would likely not work for one of them. They had to go back to the drawing board.

Recognize each other's capabilities, cultures, and motivations

Partners come together to take advantage of complementary geographies, corresponding sales and marketing strengths, or compatibilities in other functional areas. But it is important to understand which partner is best at what. This process must start before the deal is completed—but cannot stop at signing. In the case of one consumer-goods joint venture, for instance, the two partner organizations felt confident in their plan to combine the manufacturing strength of one company with the sales and marketing strengths of the other. During their discussions on how to handle financial reporting, however, it became clear that the partner with sales and marketing strengths had a spike in forecasting, budgeting, and reporting expertise. The product team for the first partner had originally expected to manage these finance tasks, but both partner teams ultimately agreed that the second partner should take them on. In this way, they were able to enhance the joint venture's ongoing operations and ensure its viability.

Equally important is understanding each partner's motivation behind the deal. This is a common point of focus during early negotiations; it should continue to be discussed as part of day-to-day operations—particularly if there are secondary motivators, such as access to suppliers or transfer of capabilities, that are important to each partner. Within one energy-sector partnership, for instance, the nonoperating partner was keen to understand how its local workforce would receive training over the course of the partnership. This company wanted to enhance the skills of the local workforce to create more opportunities for long-term employment in the region. The operating partner incorporated training and skill-evaluation metrics in the venture's quarterly updates, thus improving the companies' communication on the topic and explicitly acknowledging the importance of this point to its partner.

Invest in tools, processes, and personnel

Bringing different business cultures together can be challenging, given partners' varying communication styles and expectations. The good news is that there are a range of tools—among them, financial models, key performance indicators, playbooks, and portfolio reviews—companies can use to help bridge any gaps. And not all these interventions are technology dependent. Some companies simply standardize the format of partnership meetings and agendas so that teams know what to expect. Others follow stringent reporting requirements.

Another good move is to convene an alliance-management team. This group tracks and reviews the partnership's progress against defined metrics and helps to spot potential areas of concern—ideally with enough time to change course. Such teams take different forms. One pharmaceutical company with dozens of commercial and research partnerships has a nine-member alliance-management team charged mostly with monitoring and flagging potential issues for business-unit leaders, so it consists of primarily junior members and one senior leader who interacts directly with partners. An energy company with four large-scale joint ventures has taken a different approach: its alliance-management team comprises four people, but each is an experienced business leader who

Sometimes partnerships need a structural shake-up—and not just as an act of last resort.

can serve as a resource for the respective joint-venture-leadership teams.

How companies structure these teams depends on concrete factors—the number and complexity of the partnerships, for instance—as well as intangibles like executive support for alliances and joint ventures and the experiences and capabilities of the individuals who would make up the alliance-management team.

Emphasize accountability and metrics

Good governance is the linchpin for successful partnerships; as such, it is critical that senior executives from the partner organizations remain involved in oversight of the partnership. At the very least, each partner should assign a senior line executive from the company to be “deal sponsor”—someone who can keep operations leaders and alliance managers focused on priorities, advocate for resources when needed, and generally create an environment in which everyone can act with more confidence and coordination.

Additionally, the partners must define “success” for their operations teams: What metrics will they use to determine whether they have hit their goals, and how will they track them? Some companies have built responsibility matrices; others have used detailed process maps or project stage gates to clarify expectations, timelines, and critical performance measures. When partnerships are initially formed, it is usually the business-development teams that are responsible for building the case for the deal and identifying the value that may be created for both sides. As the partnership evolves, the operations teams must take over this task, but they will need ongoing guidance from senior leaders in the partner organizations.

Build a dynamic partnership

Sometimes partnerships need a structural shake-up—and not just as an act of last resort. For instance, it might be less critical to revisit the structure of a partnership in which both sides are focused on the joint commercialization of complementary products than it would be for a partnership focused on the joint development of a set of new technologies. But there are some basic rules of thumb for considering changes in partnership structure.

Partner organizations must acknowledge that the scope of the relationship is likely to shift over time. This will be the case whether the partners are in a single- or multiasset venture, expect that services will be shared, anticipate expansion, or have any geographic, regulatory, or structural complexities. Accepting the inevitable will encourage partners to plan more carefully at the outset. For example, during negotiations, the partners in a pharmaceutical partnership determined that they had different views on future demand for drugs in development. This wasn’t a deal breaker, however. Instead, the partners designated a formula by which financial flows would be evaluated at specific intervals to address any changes in expected performance. This allowed the partners to adjust the partnership based on changes in market demand or the emergence of new products. All changes could be incorporated fairly into the financial splits of the partnership.

Partners should also consider the potential for restructuring during the negotiation process—ideally framing the potential endgame for the relationship. What market shifts might occur, how might that affect both sides' interests and incentives, and what mechanisms would allow for orderly restructuring? When one oil and gas joint venture began struggling, the joint-venture leader realized he was being pulled in opposing directions by the two partner companies because of the companies' conflicting incentives. "It made the alliance completely unstable," he told us. He brought the partners back to the negotiation table to determine how to reconcile these conflicting incentives, restructure their agreement, and continue the relationship, thus avoiding deep resentment and frustration on both sides of the deal.

Such dialogues about the partnership's future, while potentially stressful, should be conducted regularly—at least annually.

The implementation of these four principles requires some forethought and care. Every relationship comes with its own idiosyncrasies, after all, depending on industry, geography, previous experience, and strategy. Managing relationships outside of developed markets, for instance, can present additional challenges involving local cultures, integration norms, and regulatory complexities. Even in these emerging-market deals, however, the principles can serve as effective prerequisites for initiating discussions about how to change long-standing practices and mind-sets.

An emphasis on clarity, proactive management, accountability, and agility can not only extend the life span of a partnership or joint venture but can also help companies build the capability to establish more of them—and, in the process, create outsize value and productivity in their organizations.

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Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Premortems: Being smart at the start

by Gary Klein, Tim Koller, and Dan Lovallo

The dilemma

Your company just finished launching a parking app for a large US city—but lots went wrong along the way. Development and rollout were delayed because financing and system updates took longer than expected. Pilot tests revealed unanticipated flaws in the software and the physical infrastructure. The app hadn't been configured for all computing platforms, for instance, and sensors embedded in parking areas in some parts of the city failed to communicate with central servers that fed the app. A postmortem session showed exactly where and when the project went off the rails. Why couldn't the team have seen these things up front?

The research

There are lots of well-documented reasons why teams avoid considering potential problems at the outset of a project or initiative. Studies show that project leaders overwhelmingly tend to be overconfident.[1] The plans they've mapped out are reasonable, and every step is plausible—why worry? Additionally, the start of a project is typically the time of greatest harmony among team members. Bringing up problems can seem obstructionist and disloyal. In fact, research also shows that most individuals are afraid to speak out against the group and explicitly identify problems with a plan.[2] Even if a project leader asks for honest critiques, team members often hold back to protect political, organizational, or personal interests. Everyone desperately wants to believe in the plan they are getting ready to carry out.

The remedy

To ensure that projects get the scrutiny they need, teams should conduct a premortem.[3] This is an exercise in which, after a project team is briefed on a proposed plan, its members purposefully imagine that the plan has failed. The exercise prompts everyone to review the plan and anticipate potential threats and hurdles. The very structure of a premortem makes it safe to identify problems. Under this approach, the psychology is flipped, and blind support for ideas gives way to creative problem solving. In fact, we've seen team members compete to see who can raise the most worrisome issues, and those team members are admired for their foresight, not ostracized.

One technology company used this approach when designing a new advanced-analytics system for an aviation program. Before the project launch, the project leader (with support from the project sponsor) gathered the team in a conference room and asked members to peer into "an infallible crystal ball," looking six months into the future. Bad news: the project was a flop.

The project leader asked each team member to take two minutes to write down thoughts on why the plan had failed. He then asked each person, in turn, to share one reason for the failure. (The project leader went first to model behaviors and assure everyone that the meeting was about honest disclosure.) All the answers were captured on a whiteboard.

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[1] Philip Meissner, Olivier Sibony, and Torsten Wulf, "Are you ready to decide?" *McKinsey Quarterly*, April 2015, McKinsey.com.
[2] *Strategy & Corporate Finance blog*, "How biases, politics, and egos trump good strategy," blog entry by Chris Bradley, January 18, 2018, McKinsey.com.
[3] Daniel Kahneman and Gary Klein, "Strategic decisions: When can you trust your gut?," *McKinsey Quarterly*, March 2010, McKinsey.com.

After three rounds of disclosure, so multiple ideas could be recorded and everyone's opinions could be heard, the potential pitfalls became apparent. The biggest issues were organizational and cultural ones—for instance, getting the resources and senior-level sign-offs needed to design, build, and roll out the advanced-analytics system quickly and countering key stakeholders' resistance to having to learn a new system. Once the project team had identified the potential vulnerabilities, it conducted another reflection exercise—this time, discussing the things it could do to mitigate the issues listed on the whiteboard. The end results were a stronger plan and a more resilient team that was more aware of the challenges it was facing.

Research shows that premortems reduce teams' overconfidence significantly more than other critiquing and risk-analysis methods do.[4] The process lets teams identify a wide range of potential stumbling blocks, many of which hadn't been considered before. And it helps to forge a culture of candor: uncomfortable truths can be spoken without repercussion and instead received with gratitude for courage and cleverness.

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[4] Gary A. Klein, Beth Veinott, and Sterling Wiggins, "Evaluating the effectiveness of the premortem technique on plan confidence," *Proceedings of the 7th International Information Systems for Crisis Response and Management Conference*, May 2010.

Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Up-front contingency planning

by Hugh Courtney, Tim Koller, and Dan Lovallo

The dilemma

Investing in a new process technology was supposed to breathe new life into an established business unit within your manufacturing company. It was supposed to be a sure bet, one that would reduce costs and allow your company to compete better on price. But it's a full year into the rollout, and those benefits haven't materialized. Meanwhile, your closest competitors have launched their own technology initiatives and are reducing costs, lowering prices, and growing market share.

You know that when it comes to implementing new technologies, early failures are common. It takes time to work out the kinks; maybe a redesign or redeployment of the technology to address the company's needs better would do the trick. You still see the potential upside here, but you can't afford to throw good money after bad. Given the uncertainties, should you continue to invest in this new technology and business unit? Research suggests that if you do, you may never stop.

The research

When making staged-investment decisions, managers should focus only on expected future returns from their investments, not the costs associated with previous investments. These sunk costs have already been spent and cannot be recovered and are thus irrelevant when deciding whether to continue investing. Yet research demonstrates that decision makers often focus inappropriately on them.[1] Studies also reveal the degree to which decision makers are subject to loss aversion, or putting greater value on avoiding losses than on acquiring equivalent gains. It is this combination—loss aversion and an inappropriate focus on sunk costs—that prompts managers to escalate their commitment to certain investments, even when there is evidence suggesting that the initial decision was probably wrong.

The remedy

You can counter such irrational escalation and make better decisions by developing "contingent road maps," or plans for implementing and updating your strategy over time based on unbiased feedback from the market. Such road maps capture all the changes that may occur in uncertain markets and when they might occur. Most important, they prescribe specific changes your company must make to its strategy under different scenarios. Decision makers commit up front to follow the road map and take the actions required each step of the way—including, in some cases, killing a project entirely. The road map then becomes both a catalyst for change and a means to insulate decision makers from biases.

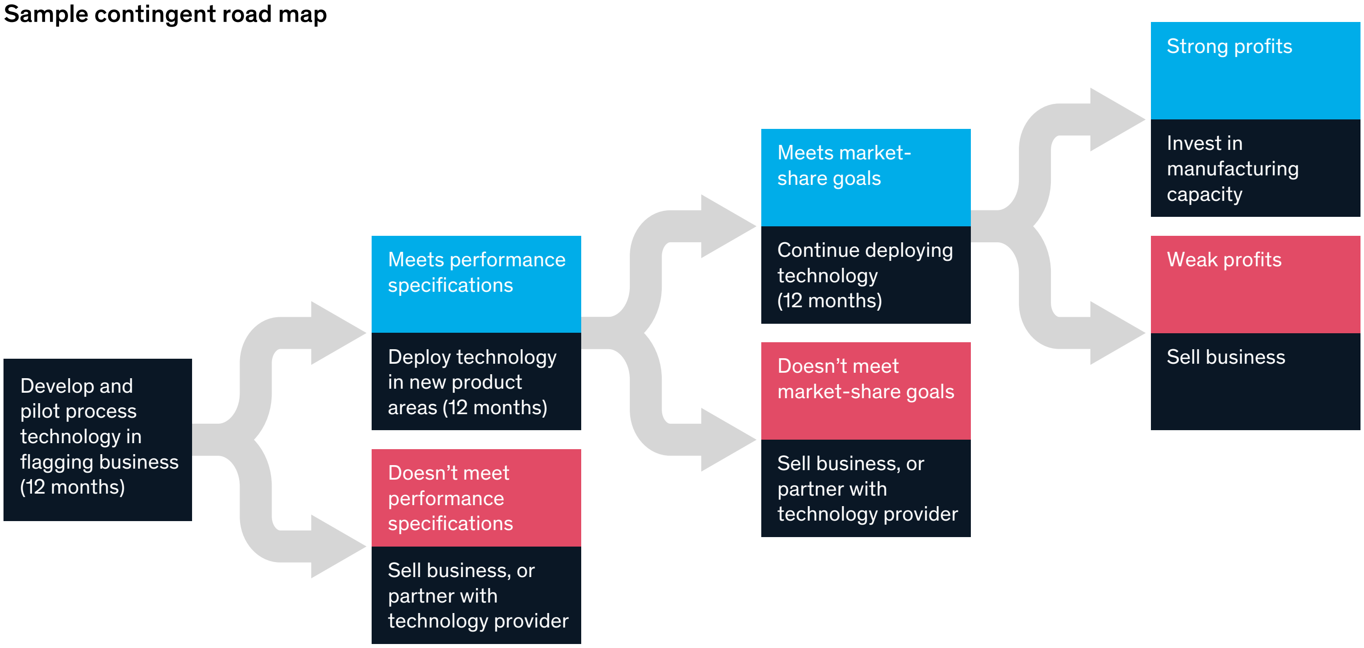
When making staged-investment decisions, managers should focus only on expected future returns from their investments, not the costs associated with previous investments.

[1] Daniel Kahneman, *Thinking, Fast and Slow*, first edition, New York, NY: Farrar, Straus and Giroux, 2011.

Exhibit

A company built a 'contingent road map' to assess investment in a new process technology.

Sample contingent road map



When considering the investment in the new process technology, for instance, you could define a series of "decision forks" (exhibit). At the first fork, either the technology would achieve well-defined performance specifications within the first year of use or the company would sell the business unit or link up with a partner that has superior technology. If the technology meets its performance goals, the company would continue using it in new, differentiated product segments.

The second fork in the road map would occur a year later: if the technology meets well-specified market-share goals by that time, the company would continue with its new strategy. If not, again it would look to sell the business or seek a partnership.

The final fork would occur another year later, when the company has more information on competitive conduct and profit margins. Strong profits would result in the company investing in increased manufacturing capacity for this product, while weak profits would lead the company to divest the business line.

As this example illustrates, contingent road maps can help business leaders manage uncertainty by generating crucial insights about potential market outcomes, allowing business leaders to make the right decisions at the right times. More important, the tool can help senior leaders steer away from status quo strategies when the environment calls for bold new ones.[2]

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[2] Chris Bradley, Martin Hirt, and Sven Smit, "Eight shifts that will take your strategy into high gear," *McKinsey Quarterly*, April 2018, McKinsey.com.

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