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Measuring long-term **performance**

Earnings per share and share prices aren't the whole story—particularly in the medium and long term.

Richard Dobbs and Timothy Koller

It's natural for companies and their investors to be happy, even complacent, when their earnings per share (EPS) and share prices rise. A falling share price may not be a sign of poor performance, however: The Home Depot's fell from 1999 to 2003, yet the company created more value than every North American retailer except Wal-Mart Stores by continuing to grow and improve its return on capital.

After the extreme ups and downs of financial markets during the past decade, boards of directors, senior managers, and investors are rethinking the way they define and assess corporate performance. There's nothing wrong with good accounting results and rising share prices, but they don't necessarily indicate whether a company is fundamentally healthy, in the sense of being able to sustain its current performance and to build profitable businesses in the future.

Nonetheless, a company can construct a comprehensive performance assessment that measures the value it has created and estimates its ability to create more. As a way of judging how well a company is doing, such an assessment is far superior to any single performance metric. It can also help management to balance the short- and long-term creation of value and help board members and investors to determine whether management's policies and the company's share price are on target.

Testing for fitness

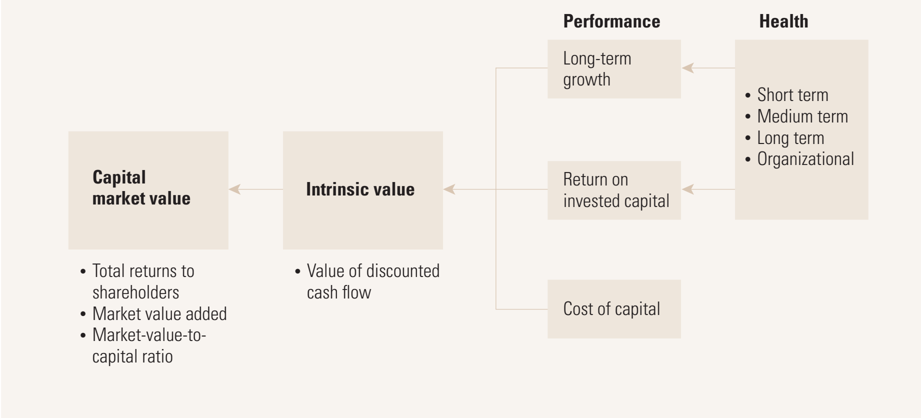
Since only a company's historical growth and returns on capital—not its future performance—can be measured directly, the potential for future growth and returns must be inferred. To do so, it is necessary to devise metrics that gauge the longer-term health of companies and that complement the metrics for their short-term performance. A patient visiting a doctor may feel fine, for example, but high cholesterol could make it necessary to act now to prevent heart disease. Similarly, a company may show strong growth and returns on capital, but health metrics are needed to determine if that performance is sustainable.

A company's cash flow and, ultimately, its market value stem from its long-term growth in revenues and profits and from its returns on invested capital (ROIC) relative to its cost of capital. A discounted-cash-flow (DCF) analysis, based on projected performance, can be linked to key performance and health indicators in order to demonstrate the links between shareholder value, as measured by stock markets, and the drivers of value (Exhibit 1).

With these links in mind, it is possible to organize performance measurement according to three different perspectives. The economic value that a company has created historically can be explored through its financial statements. This set of metrics gauges what we call a company's performance. Metrics can also gauge a company's ability to create economic value in the future and the risks that might prevent it from doing so. These metrics assess what we call the company's health.

EXHIBIT 1

The drivers of value



In using these metrics, it is important to understand the impact of factors outside management's control: consider, for example, the case of an oil company whose improving profitability comes from rising oil prices rather than better exploration techniques or of a bank whose stock price rises because of changing rates, not increased efficiencies. To use any metric that assesses how a company is doing, you must strip out the impact of such factors. We will explore performance and health metrics here; a discussion of a third set of metrics to assess a company's capital market performance will appear in the next issue of *McKinsey on Finance*.

Performance: Value delivered

Assessing a company's historical financial performance would appear to be straightforward, but even these metrics are subjective. Accountants and managers decide when to record revenues and costs, and personal motives can color this judgment—a boss may want the current quarter to look good, for example.

Some ways of measuring a company's financial performance are better than others. Metrics, such as ROIC, economic profit,[1] and growth, that can be linked directly to value creation are more meaningful than traditional accounting metrics like EPS. Although growing companies that earn an ROIC greater than their cost of capital generate attractive EPS growth, the inverse isn't true: EPS growth can come from heavy investment or changes in financial structure that don't create value. In fact, companies can easily manipulate earnings per share—by repurchasing shares or undertaking acquisitions, for example.

The true drivers of value—growth and ROIC—are a better place to start measuring the performance of a company. Specifically, how does its ROIC compare with its cost of capital and with the ROIC of its peers? Has its ROIC been increasing or decreasing? How fast has the company grown, absolutely and relative to its peers? Is its growth accelerating or slowing?

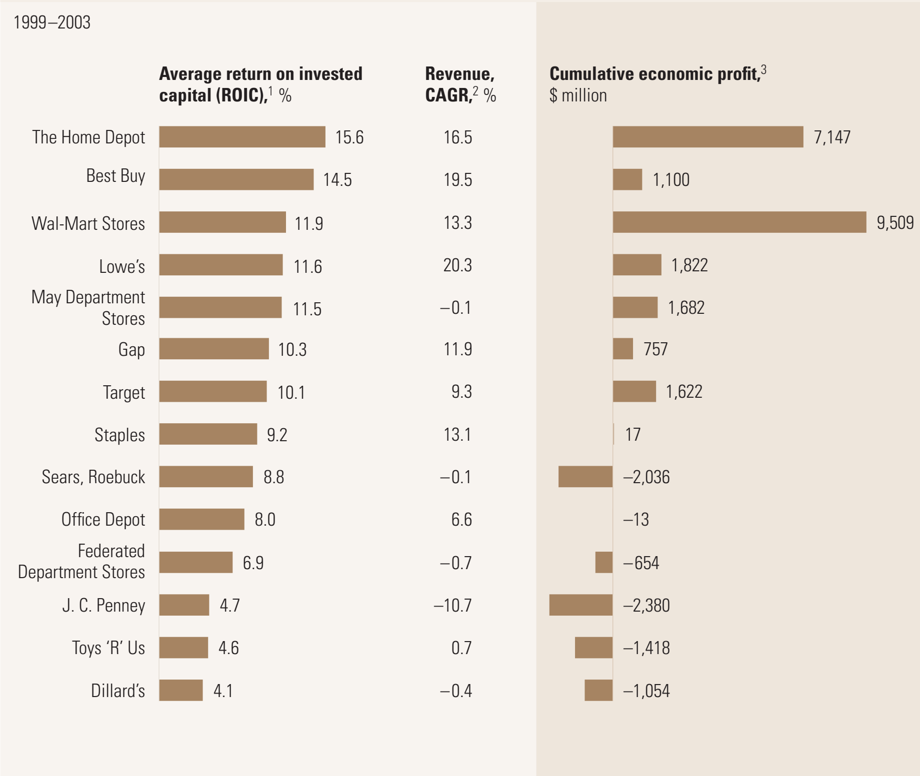
Home Depot's average ROIC from 1999 to 2003 was 15.6 percent—higher than its 9.2 percent cost of capital during that period and the highest among large US retailers. From 1999 to 2003, its revenue rose by an average of 16.5 percent annually, at the high end of the range for such companies. This performance was exceptional for what was already one of the largest US retailers.

One disadvantage of ROIC and growth, however, is that neither incorporates the magnitude of the value created, so a small company or business unit with a 30 percent ROIC seems more successful than an enormous company with a 20 percent return. We use economic profit to convert ROIC into a dollar metric so that we can incorporate the size of the value created into comparisons with other companies.

[1] Economic profit = invested capital × (return on invested capital – weighted average cost of capital).

EXHIBIT 2

Winners and losers



[1]With operating-lease adjustments.
[2]Compound annual growth rate.
[3]Economic profit = invested capital × (return on invested capital – weighted average cost of capital).

By adjusting for size, economic profit provides a better assessment of value creation than do metrics based on ROIC and growth. Exhibit 2 shows the economic profit of large retailers. Home Depot—second only to Wal-Mart Stores—generated $7.1 billion in economic profit over the five years through 2003. Viewed from this angle, it and Wal-Mart constitute a class of their own. Although other highfliers, such as Best Buy, also have superior ROIC and growth, they are much smaller.

Health: Scope to create additional value

Health metrics supplement those for historical performance by providing a glimpse into the future. It's important, for instance, to know whether a company has the products, the people, and the processes to continue creating value. Assessing the risks a company faces and the procedures in place to mitigate them is an important dimension of all efforts to measure health.

To identify a company's key health metrics, we start with a value creation tree illustrating the connections between a company's intrinsic value and the generic categories of health metrics: the short-, medium-, and long-term factors that determine a company's long-term growth and ROIC (Exhibit 3). This approach shares some elements with the "balanced scorecard"—popularized in a 1992 *Harvard Business Review* article[2] by Robert Kaplan and David Norton—whose premise was that financial performance is only one aspect of total performance. Kaplan and Norton pointed to three equally important perspectives: customer satisfaction, internal business processes, and learning and growth.

Our concept of health metrics resembles Kaplan and Norton's "nonfinancial measures," but we differ in believing that companies should develop their own metrics tailored to their particular industries and strategies. These metrics should be based on rigorous analytics and linked, as explicitly as possible, to the creation of intrinsic value: product innovation is important in some industries, for instance, while in others government relations, tight cost controls, and customer service matter more.

Every company will have its own health metrics, but the eight generic categories in Exhibit 3 can ensure that it systematically explores all the important ones.

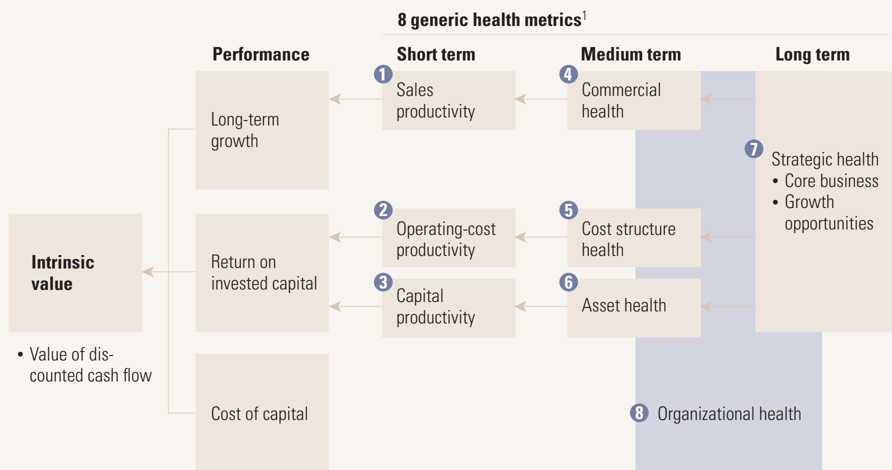
Short-term metrics

Short-term metrics explore the factors that underlie historical performance and

[2]Robert S. Kaplan and David P. Norton, "The balanced scorecard: Measures that drive performance," *Harvard Business Review*, January 1992, Volume 70, Number 1, pp. 71–9.

EXHIBIT 3

Do you have what it takes?



[1]Assessment of risk must be embedded in each health metric.

help indicate whether growth and ROIC can be sustained at a given level or will probably rise or fall. These metrics might include costs per unit (for a manufacturing company) or same-store sales growth (for a retailer). They fall into three categories:

- *Sales productivity metrics* explore the factors underlying recent sales growth. For retailers, these metrics include market share, a retailer's ability to charge higher prices than its peers, the pace of store openings, and same-store sales increases.
- *Operating-cost productivity metrics* explore the factors underlying unit costs, such as the cost of building a car or delivering a package. UPS, for example, is well known for charting out the optimal delivery paths of its drivers to enhance their productivity and for developing well-defined standards on how to deliver packages.
- *Capital productivity metrics* show how well a company uses its working capital (inventories, receivables, and payables) and its property, plant, and equipment. Dell revolutionized the personal-computer business by building products to order and thus minimizing inventories. Because the company keeps them so low and has few receivables to boot, it can operate with negative working capital.

Home Depot's short-term health was strong across a number of fronts. It increased its store count by 13.4 percent a year from 1999 through 2003 while simultaneously increasing its same-store sales by 3.5 percent a year. Its ROIC increased to 18.2 percent, from 14.9 percent, during the same period thanks to improved margins, largely resulting from improved purchasing and from the development (with manufacturers) of exclusive product lines.

Medium-term metrics

Medium-term metrics go beyond short-term performance by looking forward to indicate whether a company can maintain and improve its growth and ROIC over the next one to five years (or longer for companies with extended product cycles, as in pharmaceuticals). These metrics fall into three categories:

- *Commercial health metrics,* indicating whether a company can sustain or improve its current revenue growth, include the metrics for its product pipeline (the talent and technology to market new products over the medium term), brand strength (investments in brand building), regulatory risk, and customer satisfaction. Metrics for medium-term commercial health vary widely by industry. For a pharmaceutical company, the obvious priority is its product pipeline and its relationship with governments—a major customer and regulator. For an online retailer, customer

satisfaction and brand strength may be the most important considerations.
- *Cost structure health metrics* gauge a company's ability, as compared with that of its competitors, to manage its costs over three to five years. These metrics might include assessments of programs like Six Sigma, which companies such as General Electric use to reduce their costs continually and to maintain a cost advantage relative to their competitors across most of their businesses.
- *Asset health metrics* show how well a company maintains and develops its assets. For a hotel or restaurant chain, to give one example, the average time between remodelings may be an important driver of health.

In the quest for growth during the 1990s, Home Depot temporarily lost sight of its medium-term health, as measured by its customer service and the quality of its stores. Recognizing the problem, in 2001 the company began to reinvest in its existing locations, with the intention of making them more appealing to customers, and to refocus on customer service—for example, by raising its incentives for employees. It also offered installation services and do-it-yourself clinics and set up sales desks specifically for professional customers. Continued success will depend on Home Depot's ability to go on satisfying its customers by carefully measuring and monitoring its customer service, its customer traffic, and the age and condition of its stores.

Long-term strategic health metrics

Metrics of long-term strategic health show the ability of an enterprise to sustain its current operating activities and to identify and exploit new areas of growth. A company must periodically assess and measure the threats—including new technologies, changes in public opinion and in the preferences of customers, and new ways of serving them—that could make its current business less attractive. In assessing a company's long-term strategic health, specific metrics are sometimes hard to identify, so more qualitative milestones, such as progress in selecting partners for mergers or for entering a market, are needed.

While Home Depot's leading position in the home-improvement business appears to be solid in the medium term, a longer-term threat comes from Wal-Mart, which sells many of the same fast-moving items, such as lightbulbs. The cost base of Wal-Mart is lower because it provides less in-store help than does Home Depot, which must therefore ensure that store associates focus on higher-margin areas where support is critical (such as plumbing) rather than on products whose price doesn't incorporate assistance to customers.

Besides guarding against threats, companies must continually watch for new growth opportunities in new geographies or in related industries; many Western companies, for example, have begun preparing to serve China's enormous, fast-growing markets. Adding new services helped Home Depot to squeeze more profits from its existing stores, but it has been less successful at expanding abroad and at developing new store formats. By 2003, only 7 percent of its revenues came from outside North America, and though it has experimented with new formats, such as its Expo Design Center, only 4 percent of its stores used them as of 2003.

Organizational health

Metrics are also needed to determine whether a company has the people, the skills, and the culture to sustain and improve its performance.

Diagnostics of organizational health typically measure the skills and capabilities of a company, its ability to retain its employees and keep them satisfied, its culture and values, and the depth of its management talent. Again, what's important varies by industry. Pharmaceutical companies need deep scientific-innovation capabilities but relatively few managers. Companies expanding overseas need people who can work in new countries and negotiate with the governments there.

Given the rapid growth and substantial size of Home Depot, one of its core challenges continues to be attracting and retaining skilled employees at a competitive cost. When it took on lower-cost part-time workers who often knew much less than its traditional store associates did, customers began to wonder what made the company special. Even holding on to its store managers became a problem, since the drive for efficiency through centralization had stifled its original entrepreneurial spirit. To address the long-term challenges, the company began offering incentive programs for managers and added more full-time staff in stores—moves that have been credited with helping to improve same-store sales.[3] MoF

[3] Justin Lahart, "Housing just keeps going up," *Fortune,* June 16, 2003; and Betty Schiffman, "Home Depot remodels its growth plans," *Forbes,* November 30, 2001.

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Viewpoint: How to escape the short-term trap

Markets may expect solid performance over the short term, but they also value sustained performance over the long term. How can companies manage both time frames?

Ian Davis

Companies around the world increasingly complain that financial markets focus on quarterly results and give little credit to longer-term value creation strategies, particularly those that depress today's profits.

Such claims must be challenged. They not only are contradicted by empirical evidence but also do nothing to improve corporate performance and investor returns. If anything, they undermine confidence and trust in markets.

Whatever the cause of the misconception, management teams should take the lead in correcting it. They need to make clear to their boards and to the capital markets the importance to long-term value creation of both the short-term *performance* of a business and its underlying *health*—that is, its ability to sustain and improve performance year after year after year. They also may need to manage their companies differently.

There is undoubtedly a noisy segment of analysts and traders fixated on next quarter's earnings. But many management teams, apparently believing that *all* market participants behave this way, don't attend to the longer-term health of their companies.

Short-term commitments are important, of course, and only by delivering on them will management build confidence in longer-term strategies. The health of a company is crucial not just to its customers, suppliers, and employees but to its investors as well. It's crucial to turning the company's growth prospects, capabilities, relationships, and assets into future cash flows. Contrary to conventional wisdom, markets recognize this.

An examination of share prices demonstrates that expectations of future performance are the main driver of shareholder returns. In almost all industry sectors and almost all stock exchanges, up to 80 percent of a share's market value can be explained only by cash flow expectations beyond the next three years. These longer-term expectations are in turn driven by judgments on growth and—a lesson relearned after the dot-com bust—on long-term profitability. For example, cash flows in the global semiconductor industry need to grow at more than 10 percent a year during the next ten years to justify current market valuations. In retailing and consumer packaged goods, that growth rate is between 3 and 6 percent. In electric utilities, it's around 2 percent.

Future expectations clearly drive the stock price of individual companies too, thus explaining the often widely differing P/E or market-to-book ratios of companies with similar reported earnings. In the pharmaceutical sector, for example, the market ascribes significant value to a healthy drug pipeline even though it will not affect short-term earnings.

Even in the private equity sector, renowned for its focus on short-term operational improvements, health matters. Most private equity companies look to realize their investments in a five-year time frame. But they must still have a credible proposition for future earnings and cash flow growth to underpin a sale or IPO.

What makes a healthy company?

There are several generic components of a healthy company—a robust and credible strategy; productive, well-maintained assets; innovative products, services, and processes; a fine reputation with customers, regulators, governments, and other stakeholders; and the ability to attract, retain, and develop high-performing talent.

Thinking about health, as opposed to short-term performance, helps management teams understand how to look after companies today in a way that will ensure that they remain strong in the future. It focuses the mind on what must be done today to deliver the outcome of long-term performance. Companies are not focusing enough on managing the health of their businesses.

One major European company, for example, pulled off an impressive turnaround in short-term financial performance. But to its dismay, its financial success was accompanied by a fall in customer service levels and by a huge increase in staff turnover. The share price soared initially but then fell back. The company's management complained that the financial markets didn't understand what it had achieved. But the problem was that the markets did: short-term success at the expense of health.

Such behavior is widespread. In one recent survey,[1] a majority of managers said that they would forgo an investment that offered a decent return on capital if it meant missing quarterly earnings expectations. In another, more than 80 percent of the executives responding said that they would cut expenditure on R&D and marketing to ensure that they hit quarterly earnings targets—even if they believed that the cuts were destroying value over the long term.

Beyond the misperception of what financial markets want, a number of factors contribute to management's short-term focus. Recent tough economic conditions have concentrated the collective minds of many companies on pure survival. The fact that 10 of the largest 15 bankruptcies have occurred since 2001 is a strong deterrent when it comes to business building and its inherent risk.

Regulatory and legal reforms have also been major contributors to "short-termism." Management teams have struggled to cope with a wealth of new regulations, many of which focus on the reporting of historical financial results. The same is true of board directors, who have been distracted from their role as stewards of a company's health. So despite an average 50 percent increase in the time commitment required of directors, many boards don't have the time to understand the kind of strategic trade-offs needed to get the appropriate balance between short-term performance and long-term health. A recent McKinsey survey of more than 1,000 directors around the world found that more than half admitted to having only a "limited" understanding of where the company's long-term objectives would position it in five to ten years. The good news is that our respondents told us that they are now eager to devote more time to these issues.

Managing multiple time horizons

There is also a much older reason that management tends to be overly focused on

[1] John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "The economic implications of corporate financial reporting," NBER working paper 10550, January 11, 2005 (www.ssrn.com).

the short term: it is very hard to manage both time frames. It is difficult to build the resilience and organizational capacity not only to deliver but also to sustain performance. Three things can help.

First, a company's strategy should consist of a portfolio of initiatives that consciously embraces different time horizons. Companies do, of course, have different business units with distinct strategies. But few strategies direct a company in a way that will enable it to adapt to events and capitalize on opportunities as they arise. Some initiatives in the portfolio will influence short-term performance. Others will create options for the future—the development of new products or services, entry into new markets, or the restructuring of processes or value chains. A key management challenge is to design and select those initiatives and options to ensure, on a risk-adjusted basis, that the company's underlying health remains strong.

Second, companies need organizational processes to support a focus on both performance and health. Companies with a long-term-value orientation are always relentless about setting short-term-performance commitments and delivering on them. But such companies also define what they are doing to ensure their health and how they will measure their efforts to do so. Reckitt Benckiser, the leading household-cleaning-products company, emphasizes innovation as the key to its long-term strategy and specifically measures the proportion of its revenues that new products generate.

Companies with a long-term-value orientation are always relentless about setting short-term-performance commitments and delivering on them

Different companies will identify the health and performance metrics—product development, customer satisfaction, or the retention of talent—appropriate to their industry or situation. But executives should insist on a balance of metrics that cover all areas of the business while grabbing every opportunity to talk about these metrics, both internally and to analysts and investors.

Career tracks and incentives—money, recognition, promotion—should reflect the time required to deliver on longer-term goals; the current trend of rotating people in roles every two or three years isn't necessarily good for corporate health. Moreover, companies ought to be mindful of the different leadership qualities needed to manage for performance and health. Corporate health typically requires new skills, not necessarily the reinforcement of the capabilities and leadership traits that worked in the past.

Third, companies need to change the nature of their dialogue with key stakeholders, particularly the capital markets and employees. That means first identifying investors who will support a company's strategy and then attracting them. There is no point, for example, talking about the company's health to court arbitrageurs or hedge fund managers looking for the next bid.

A management team should then spend serious time with analysts, explaining its views on the outlook for the industry and on how the company's strategic stance will create a source of sustainable advantage. Management will also need to highlight the metrics it has developed to track the company's performance and health. Just talking vaguely about shareholder value without a time frame or without addressing the specifics of the business is not meaningful.

Companies might also be wise to separate discussions about quarterly results from those that focus on strategic development, as BP has done recently. And they should ensure that analysts spend time with operational managers. When it comes to forming judgments about sustained performance, the caliber of these managers is often the crucial factor.

Communicating with employees is just as important. The complaint that "we don't know what's going on" often reflects an emphasis on communicating results rather than long-term intent. It is no coincidence that a hallmark of great, enduring companies is that they make their future generations of leaders feel involved in their long-term development.

The current focus on short-term performance is understandable given the recent economic and regulatory environment. Survival and the avoidance of risk have been of primary concern. But the focus is nevertheless unbalanced. Financial markets, as well as employees and all other stakeholders, place a real value on a company's future. Corporate managements and boards should square up to the challenge of managing for performance and health. And they should communicate loud and clear that this is exactly what they are doing. MoF

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The view from the **boardroom**

A McKinsey survey of directors shows that they're tired of playing defense.

Robert F. Felton and Pamela Keenan Fritz

New energy is stirring in corporate boards. After years when accounting scandals and charges of inadequate governance put them on the defensive, they are looking to step up their engagement with core areas of corporate performance and value creation. The principal finding of a *McKinsey Quarterly* survey of more than 1,000 directors is that having focused for a time on accounting-compliance issues, they are now determined to play an active role in setting the strategy, assessing the risks, developing the leaders, and monitoring the long-term health of their companies.

At one level, our survey underlines the way the US Sarbanes-Oxley Act is holding boards, not only in the United States, but also around the world, more responsible for meeting high standards in reporting and controlling the financial affairs of their companies. Yet the implications for governance are even more far-reaching. To achieve as much involvement as directors say they want, they will have to use their time in meetings more effectively and develop a new understanding of their roles and responsibilities; otherwise, they will give management the impression that they intend to take on day-to-day roles. Moreover, the composition and culture of boards, as well as the agendas of board meetings, will require fresh thinking.

A changing role

Directors want to be more actively involved in three areas: what we call a company's health (its ability to survive and develop over the longer term) and its short-term financial performance, its strategy and assessment of risk, and its leadership.

Performance and health

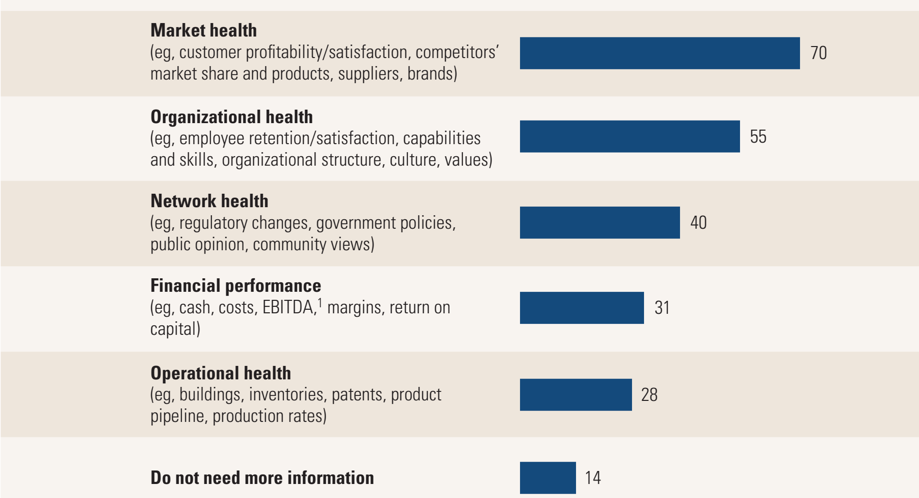
Although the survey shows that directors focus primarily on financial matters reflecting short-term corporate performance, they wish to expand their reach into issues shedding light on the longer-term health of their companies (Exhibit 1). Indeed, fully 70 percent of the directors want to know more about customers, competitors, suppliers, the likes and dislikes of consumers, market share, brand strength, levels of satisfaction with products, and so forth. Upward of

EXHIBIT 1

Directors want to know

% of respondents

As a director, I would like to know more about the following areas pertaining to the performance and long-term health of my company:

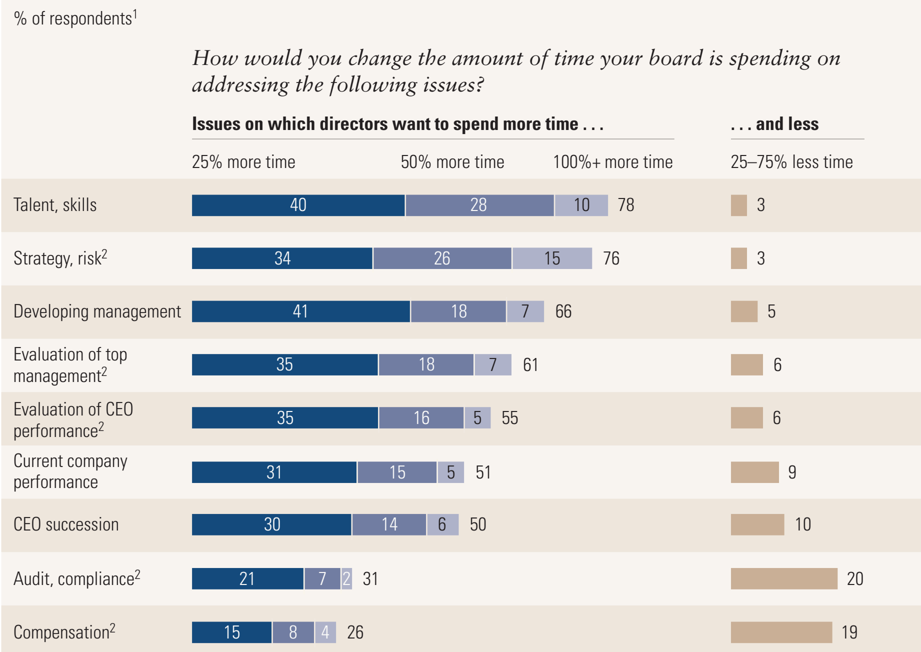


[1]Earnings before interest, taxes, depreciation, and amortization.

Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

EXHIBIT 2

More time, please



[1]Figures do not sum to 100%, because respondents who don't want to change the amount of time they spend on these activities are not shown.
[2]Figures do not sum to total, because of rounding.

Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

half want to know more about the state of the organization, including the skills and capabilities needed to realize the corporate business strategy, both now and in the future. Two in five respondents are eager for insights into external networks, such as the nature and level of regulatory and government risk, as well as public, media, and community attitudes toward the business.

But directors don't want to spend significantly less time on their current activities (Exhibit 2). The main exceptions are auditing and compliance and the compensation of top management. About one-fifth of the directors feel that they already spend too much time on those two issues.

Strategy and risk

More than 75 percent of the directors say that they want to spend more time on strategy and risk. This refocusing seems to reflect three forces at work among them: a shortfall of knowledge about the current and future strategy of their companies, a certain lack of confidence in management, and a desire to assume a more active overall role.

Surprisingly, more than a quarter of the directors have, at best, a limited understanding of the current strategy of their companies (Exhibit 3). Only 11 percent claim to have a complete understanding. More than half say that they have a limited or no clear sense of their companies' prospects five to ten years down the road. Only 4 percent say that they fully understand their companies' long-term position. More than half indicate that they have little or no understanding of the five to ten key initiatives that their companies need to secure the long-term future.

Similar gaps emerged on the question of risk. Only 11 percent of the directors claim to have a complete understanding of the risks their companies currently bear, while 23 percent have a limited understanding or none. When it comes to long-term risks, just 8 percent claim to have a complete understanding, and 37 percent say they have little or none. Likewise, since more than half of the directors admit that they have no way of tracking changes in risks over time, boards are vulnerable to unforeseen shifts.

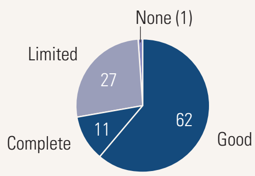
The survey also highlighted a lack of confidence in executives. Only 8 percent of the directors feel that management fully understands the key initiatives required by strategies for the future, while 38 percent say that it has, at most, a limited understanding.

EXHIBIT 3

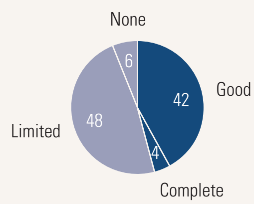
Troubling

% of respondents[1] (n = 1,016)

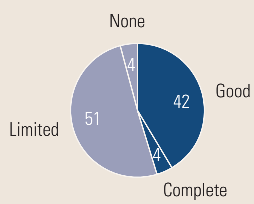
How would you describe your board's understanding of the company's current strategy?



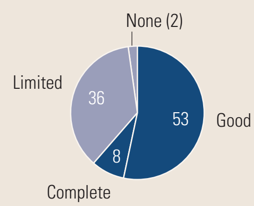
How would you describe your board's understanding of where long-term objectives will position the company in 5–10 years?



How would you describe your board's understanding of 5–10 key initiatives needed to achieve long-term objectives?



How would you describe management's understanding of 5–10 key initiatives needed to achieve long-term objectives?



[1]Figures do not sum to 100%, because of rounding.
Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

Leadership

Most directors, as our survey indicates, want to devote more attention to developing the talents and skills of the people who work for their companies. That interest isn't limited to hiring and developing the CEO; it extends to the top-management team and even to the broader company.

Directors already appear to be taking the lead in CEO successions, to judge by the 39 percent who say that they and their colleagues on the board led the most recent CEO search. That is good news. As former Sara Lee Corporation CEO John Bryan commented, the most significant task for the board is to decide who gets "to run the place."[1] This responsibility is particularly important today: research shows that 71 percent of all US CEOs leave their posts involuntarily.[2] Leaving the succession to the incumbent CEO is therefore a high-risk strategy.

The board's involvement in the process does not, however, guarantee a favorable outcome. In our survey, nearly one-quarter of the directors report that the most recent CEO succession at their companies had failed. When we probed for the reasons, the response was intriguing. According to the directors, CEO successions that work well and those that don't can be explained, in many cases, by the presence or absence of the same things: alignment between the board and the CEO on the company's strategy and future direction; finding a CEO with sufficient drive, energy, and ambition; the CEO's honesty and integrity; and a core skill set that includes investor relations and M&A (Exhibit 4). The absence of appropriate core skills is the most important factor in abortive successions but their presence is less important in good ones.

In practice, active board involvement in planning, implementing, and evaluating CEO succession plans seems to be rare. Our survey showed that more than 50 percent of boards have little or no formal process for evaluating the performance of CEOs, despite the huge responsibility entrusted to them. Boards that do get involved tend to focus on short-term business goals, which, according to the directors, account for the largest part of the assessment: 35 percent. Longer-term goals play a smaller role, as do other metrics, such as the ability to lead people and manage stakeholders, as well as professional ethical behavior. The short-term bias is even more pronounced in the realm of CEO compensation: long-term factors are only half as important as short-term ones.

Fortunately, directors are keen to change this mind-set. When they were asked

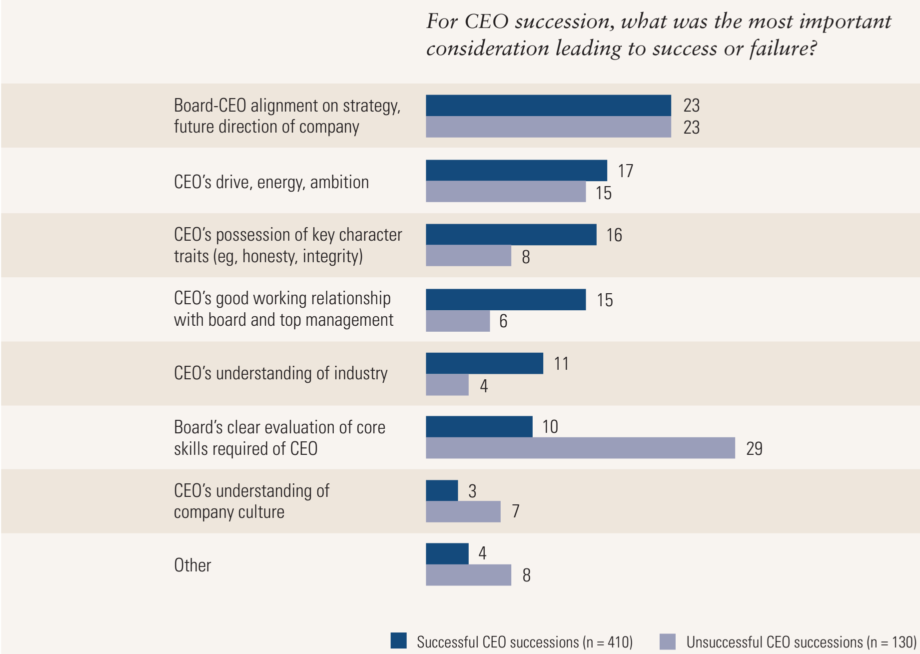
[1]John A. Byrne, Richard A. Melcher, and Jennifer Reingold, "Wanted: A few good CEOs," *Business Week,* August 11, 1997, pp. 64–70.

[2]Margarethe Wiersema, "Holes at the top: Why CEO firings backfire," *Harvard Business Review,* December 2002, Volume 80, Number 12, pp. 70–7.

EXHIBIT 4

Succession stories

% of respondents[1]



[1]Figures do not sum to 100%, because of rounding.

Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

how the CEO's performance *should* be measured, long-term goals outranked short-term goals, and leadership too was more important than it is in today's actual succession process (Exhibit 5). Directors apparently know that they should evaluate the CEO's ability to promote the long-term health of the company and not just its recent financial results.

A more active evaluation of the CEO has an added benefit: it prepares the board for the next succession process and forces directors to think about important issues and skills. Many directors have little or no experience selecting a CEO. Their involvement in rigorous annual evaluations will leave them better prepared to judge candidates when the time comes.

The selection and evaluation of a CEO isn't the board's only human-resources task. Our survey showed that 60 percent of the directors are also eager to spend more time developing and evaluating top management and that 65 percent want to spend more time developing the skills and capabilities of the company as a whole. This finding augurs well for the future. Although talents, skills, and capabilities play a crucial role in helping a business make good on its strategy, in our experience management teams and boards often overlook the importance of assessing them and spotting the gaps. As a result, companies often need "quick-fix" responses to shortages of talent and skills—shortages that often result from poor planning, which can be costly if labor markets tighten suddenly. One large industrial company based in Asia, for example, identified a need for 670 managers, in addition to the current roster of 960, to meet the challenges resulting from the introduction of a new strategy. But when the company assessed its current managers, only 150 of them turned out to have the right skills. The resulting gap of 1,480 managers was significant enough to raise questions about the viability of the company's new course.

Wider implications for the board

The survey results show clearly that boards want to engage more actively with management teams. Such a relationship can prove fruitful, but it will also be more complex than the present one. Making it work will require effort from both sides.

First, to cover this wider range of issues, boards will have to become more efficient, particularly since their time has already been stretched in recent years: the average commitment of a director of a US listed company increased from 13 hours a month in 2001 to 19 hours in 2003 (and then

EXHIBIT 5

A willingness to change

Median of all respondents, %

On a percentage basis, how important is each of the following factors when you evaluate your CEO's performance? How important should they be?

Source: Jan 2005 *McKinsey Quarterly* survey of 1,016 corporate directors

fell to 18 hours in 2004), according to a 2004 Korn/Ferry survey. Boards can conduct their meetings more efficiently if the directors receive clear, concise, and focused information in a regular format, but nearly a third of our respondents say that the information they receive is formatted inconsistently from meeting to meeting. An additional 18 percent feel they receive too much information. Second, directors and executives should understand when and how a board's role changes. Above all, both sides must know whether the changes mean that management can or can't expect the board to become involved with a particular issue.

Corporate boards seem eager to shake off the perception that they are defensive and lethargic. So far they have responded satisfactorily to the call for higher standards and strong compliance with the new accounting rules. Now they apparently want to become more active in core areas of the companies they govern. Boards and management alike can benefit from such a new relationship, but only if both understand its complexity and mitigate the tensions it is sure to create. **MoF**

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The **value** of share buybacks

Companies shouldn't confuse the value created by returning cash to shareholders with the value created by actual operational improvements. After all, the market doesn't.

Richard Dobbs and Werner Rehm

Share buybacks are all the rage. In 2004 companies announced plans to repurchase $230 billion in stock—more than double the volume of the previous year. During the first three months of this year, buyback announcements exceeded $50 billion.[1] And with large global corporations holding $1.6 trillion in cash, all signs indicate that buybacks and other forms of payouts will accelerate.[2]

In general, markets have applauded such moves, making buybacks an alluring substitute if improvements in operational performance are elusive. Yet while the increases in earnings per share that many buybacks deliver help managers hit EPS-based compensation targets, boosting EPS in this way doesn't signify an increase in underlying performance or value. Moreover, a company's fixation on buybacks might come at the cost of investments in its long-term health.

A closer inspection of the market's response to buybacks illustrates these risks, since some companies' share price declined—or didn't respond at all. For example, Dell's announcement earlier this year that it would increase its buyback program by an additional $10 billion didn't slow the decline of its share price, which had begun to slide because of worries about operating results.

Buybacks aren't without value. It is crucial, however, for managers and directors to understand their real effects when deciding to return cash to shareholders or to pursue other investment options. A buyback's impact on share price comes from changes in a company's capital structure and, more critically, from the signals a buyback sends. Investors are generally relieved to learn that companies don't intend to do something wasteful—such as make an unwise acquisition or a poor capital expenditure—with the excess cash.

EPS may be up, but intrinsic value remains flat

Many market participants and executives believe that since a repurchase reduces the number of outstanding shares, thus increasing EPS, it also raises a company's share price. As one respected Wall Street analyst commented in a recent report, "Share buybacks . . . improve EPS, return on equity, return on capital employed, economic profit, and fundamental intrinsic value." At first glance, this argument seems to make sense: the same earnings divided by fewer shares results in a higher EPS and so a higher share price. But this belief is wrong.

Consider a hypothetical example that illustrates how transferring cash to shareholders creates no fundamental value (setting aside for now a buyback's impact on corporate taxes), because any increase in EPS is offset by a reduction in the P/E ratio. The company's operations earn €94 million annually and are worth €1.3 billion.[3] It has €200 million in cash, on which it earns interest of €6 million (Exhibit 1). What happens if the company decides to use all its excess cash to repurchase its stock—in this case, a total of 13.3 million shares?[4]

Since the company's operations don't change, its return on operating capital is

[1] McKinsey analysis.

[2] US listed companies (excluding financial institutions) valued at more than $1 billion have a total of $1 trillion in cash—nearly 9 percent of their market capitalization. Non-US companies with American Depositary Receipts on US exchanges have about $600 billion in cash and cash equivalents, a solid 12 percent of their market capitalization.

[3] Based on a discounted-cash-flow valuation with 5 percent growth.

[4] At €15 a share. The calculation assumes the shares are bought back at the current value.

EXHIBIT 1

No fundamental value from buyback

Share buyback, hypothetical example[1]

	Before	After
Balance sheet		
Cash, € million	200	0
Operating assets, € million	580	580
Total assets, € million	780	580
Equity, € million	780	580
Value		
Value of operations, € million	1,300	1,300
Cash, € million	200	0
Total equity value, € million	1,500	1,300

	Before	After
Income statement		
Earnings before interest, taxes (EBIT), € million	94	94
Interest, € million	6	0
Net income, € million	**100**	**94**
Shares outstanding, million	100.0	86.7
Share price, €	15.00	15.00
Earnings per share (EPS), €	1.00	1.08
P/E	15.0	13.8
Return on invested capital (ROIC)[2]	**16%**	**16%**

[1]Excludes corporate taxes; assumes cost of equity = 10%, cost of debt = 3%, growth = 5%.
[2]Posttax EBIT ÷ operating capital.

the same after the buyback. But the equity is now worth only €1.3 billion—exactly the value of the operations, since there is no cash left. The company's earnings fall as a result of losing the interest income, but its EPS rises because the number of shares has fallen more than earnings have. The share price remains the same, however, as the total company value has fallen in line with the number of shares. Therefore, the P/E ratio, whose inputs are intrinsic value and EPS, drops to 13.8, from 15. The impact is similar if the company increases debt to buy back more shares.

Why does the P/E ratio decline? In effect, the buyback deconsolidates the company into two distinct entities: an operating company and one that holds cash. The former has a P/E of 13.8; the latter, 33.3.[5] The P/E ratio of 15 represents a weighted average of the two. Once the excess cash is paid out, the P/E will go down to that of the operating company, since the other entity has ceased to exist. Thus the change of EPS and P/E is a purely mechanical effect that is not linked to fundamental value creation.

Taxes shield value from leverage

When corporate taxes *are* part of the equation, the company's value does increase as a result of share buybacks—albeit by a small amount—because its cost of capital falls from having less cash or greater debt. The cost of capital is lower when a company uses some debt for financing, because interest payments are tax deductible while dividends are not. Holding excess cash raises the cost of capital: since interest income is taxable, a company that maintains large cash reserves puts investors at a disadvantage. In general, having too much cash on hand penalizes a company by increasing its cost of financing.

The share price increase from a buyback in theory results purely from the tax benefits of a company's new capital structure rather than from any underlying operational improvement. In the example, the company incurs a value penalty of €18 million from additional taxes on the income of its cash reserves.[6] A buyback removes this tax penalty and so results in a 1.4 percent rise in the share price. In this case, repurchasing more than 13 percent of the shares results in an increase of less than 2 percent. A similar boost occurs when a company takes on more debt to buy back shares (Exhibit 2).

We can estimate the impact on share prices from this tax effect (Exhibit 3), but historical and recent buyback announcements typically result in a much bigger rise in share price than this analysis indicates. Research from both academics and practitioners consistently finds that companies initiating small repurchase programs see an average increase in their share price of 2 to 3 percent on the day of

[5]A cash value of €200 million divided by €6 million of interest income.

[6]Assuming €200 million in cash, a 3 percent interest rate, and a 30 percent tax rate, discounted at the cost of equity of 10 percent. See also Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies,* fourth edition, Hoboken, New Jersey: John Wiley & Sons, 2005 (available at www.mckinsey.com/valuation), for a discussion of using the cost of equity for discounting instead of the cost of debt. This calculation assumes that the amount of cash doesn't grow and that it is held in perpetuity.

EXHIBIT 2

The tax benefit

Share buyback, hypothetical example[1]

	Before	After
Balance sheet		
Cash, € million	200	0
Operating assets, € million	580	580
Total assets, € million	780	580
Equity, € million	780	580
Value		
Value of operations, € million	1,300	1,300
Cash, € million	200	0
Tax penalty of cash, € million	–18	0
Total equity value, € million	**1,482**	**1,300**

	Before	After
Income statement		
Earnings before interest, taxes (EBIT), € million	134	134
Interest, € million	6	0
Earnings before taxes, € million	140	134
Tax, € million	–42	–40
Net income, € million	**98**	**94**
Shares outstanding, million	100	86.5
Share price, €	14.80	15.00
Earnings per share (EPS), €	0.98	1.09
P/E	15.1	13.8
Return on invested capital (ROIC)[2]	**16%**	**16%**

[1]Assumes cost of equity = 10%, cost of debt = 3%, growth = 5%; assumes no growth in excess cash, posttax interest streams discounted at cost of equity.
[2]Posttax EBIT ÷ operating capital.

the announcement; those that undertake larger buybacks, involving around 15 percent or more of the shares, see prices increase by some 16 percent, on average.[7] Other, more subtle reasons explain this larger positive reaction to share buybacks.

Sending signals

The market responds to announcements of buybacks because they offer new information, often called a signal, about a company's future and hence its share price.

One well-known positive signal in a buyback is that management seems to believe that the stock is undervalued. Executives can enhance this effect by personally purchasing significant numbers of shares, since market participants see them as de facto insiders with privileged information about future earnings and growth prospects. A second positive signal is management's confidence that the company doesn't need the cash to cover future commitments such as interest payments and capital expenditures.

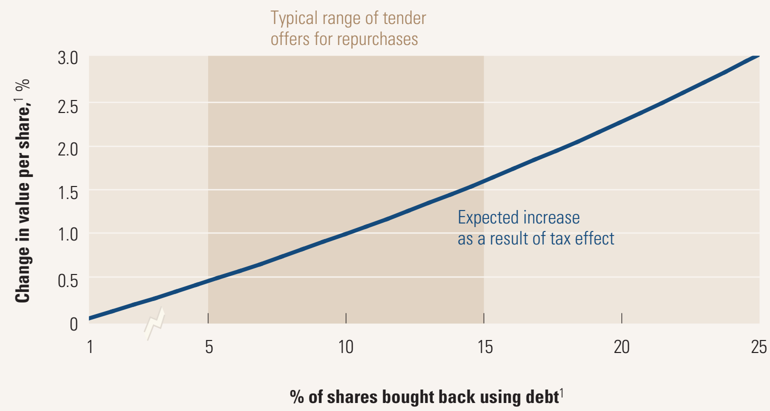
But there is a third, *negative,* signal with a buyback: that the management team sees few investment opportunities ahead, suggesting to investors that they could do better by putting their money elsewhere. Some managers are reluctant to launch buyback programs for this reason, but the capital market's mostly positive reaction to such announcements indicates that this signal isn't an issue in most cases. In fact, the strength of the market's reaction implies that shareholders often realize that a company has more cash than it can invest long before its management does.

Therefore, the overall positive response to a buyback may well result from investors

[7]Robert Comment and Gregg A. Jarrell, "The relative signalling power of Dutch-auction and fixed-price self-tender offers and open-market share repurchases," *Journal of Finance*, 1991, Volume 46, Number 4, pp. 1243–71; and Theo Vermaelen, "Common stock repurchases and market signaling: An empirical study," *Journal of Financial Economics*, 1981, Volume 9, Number 2, pp. 138–83.

EXHIBIT 3

Expected tax impact of buyback



[1] Assumes value of operations = $1.3 billion; initial share price, $15; 30% tax; constant debt; tax shields discounted with unlevered cost of equity; no excess cash.

being *relieved* that managers aren't going to spend a company's cash on inadvisable mergers and acquisitions or on projects with a negative net present value. In many cases, a company seems to be undervalued just before it announces a buyback, reflecting an uncertainty among investors about what management will do with excess funds.

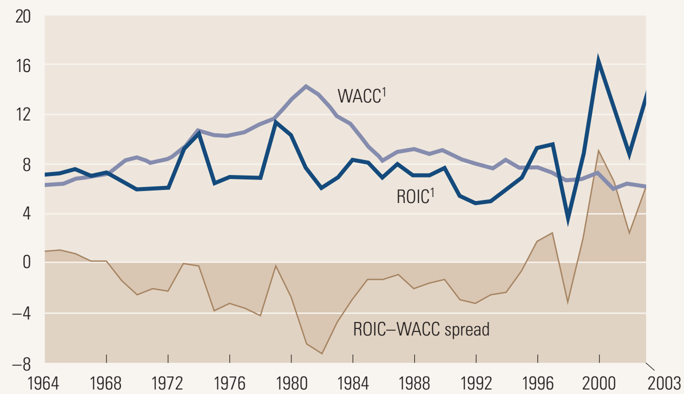
Such shareholder skepticism would be well founded. In many industries, management teams have historically allocated cash reserves poorly. The oil industry since 1964 is one example (Exhibit 4): a huge price umbrella for much of this period, courtesy of the Organization of Petroleum Exporting Countries (OPEC), provided oil companies with relatively high margins. Nevertheless, for almost three decades the spread between ROIC and cost of capital for the industry as a whole was negative. Convinced that on a sustained basis the petroleum industry could not deliver a balanced source of income, many companies committed their excess cash to what turned out to be value-destroying acquisitions or other diversification strategies. For example, in the 1970s, Mobil bought retailer Montgomery Ward; Atlantic Richfield purchased Anaconda, a metal and mining company; and Exxon bought a majority stake in Vydec, a company specializing in office automation. All of these cash (or mostly cash) acquisitions resulted in significant losses.

With cash levels at an all-time high and mergers on the increase, managers risk repeating past behaviors. Clearly, for cash-rich industries with insufficient investment opportunities, a critical task for boards will be forcing management to pay out the excess cash sooner rather than later. But by allowing management compensation to be linked to EPS, boards run the risk of promoting the short-term effects of buybacks instead of managing the long-term health of the company. Similarly, value-minded executives in industries where good investment opportunities are still available must resist the pressure to buy back shares in order to reach EPS targets.

EXHIBIT 4

Poor returns on capital

Oil and gas sector, %



[1]ROIC = return on invested capital; WACC = weighted average cost of capital.
Source: Standard & Poor's; McKinsey analysis

In most cases, buybacks create value because they help improve tax efficiency and prevent managers from investing in the wrong assets or pursuing unwise acquisitions. Only when boards and executives understand the difference between fundamental value creation through improved performance and the purely mechanical effects of a buyback program on EPS will they put share repurchases to work creating value. MoF

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Does **scale** matter to capital markets?

Simply getting bigger won't produce a higher valuation multiple.

Robert S. McNish and Michael W. Palys

With deal making back in vogue, can the "bigger-is-better" crowd be far behind? It's only a matter of time before a new wave of mergers results in a deluge of analyses, white papers, and reports bearing the same tantalizing message: getting bigger can lead to a higher valuation multiple. These pitches usually come dressed up with seemingly authoritative charts showing that smaller companies in a given industry have lower P/E ratios or EBITDA multiples than larger companies. There's only one problem. It isn't true.

Most senior managers understand that a combination of growth and returns on invested capital (ROIC) drives shareholder value.[1] But this knowledge won't spare executives from people who argue that if two small companies with low P/Es merge, the larger entity would naturally attain the higher multiples of its new peers. Empirical research, they will suggest, demonstrates real differences between the cost of capital for big and small companies. Or they will mount logical arguments about bigger companies having preferential access to the capital markets—including improved

EXHIBIT 1

Cost of equity is quite stable for larger companies

Size and long-term historical total returns to shareholders (TRS) for publicly traded companies[1]

	Size by decile	**Market capitalization of largest company within decile,** $ billion	**Average TRS, 1926–2004,** %	**Size premium (return in excess of CAPM[2]),** %
Larger companies	1	342.1	11.4	–0.4
	2	14.1	13.2	0.6
	3	6.3	13.8	0.8
	4	3.5	14.4	1.1
	5	2.3	14.9	1.5
	6	1.7	15.5	1.8
	7	1.1	15.7	1.6
	8	0.8	16.7	2.4
	9	0.6	17.7	2.9
Smaller companies	10	0.3	21.8	6.4

[1]For companies traded on AMEX, Nasdaq, NYSE.
[2]CAPM = capital asset-pricing model which describes expected return of a security or a portfolio as equal to rate of return on a risk-free security plus a market risk premium (calculated by subtracting actual return [TRS] from expected return under CAPM).

Source: *2005 SBBI Valuation Edition Yearbook*, Ibbotson Associates

[1]Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies,* fourth edition, Hoboken, New Jersey: John Wiley & Sons, 2005 (available at www.mckinsey.com/valuation).

EXHIBIT 2

Performance expectations, not size

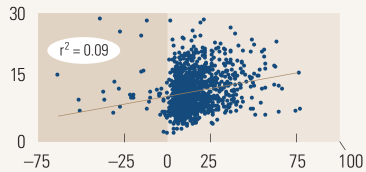
For publicly traded companies with revenues >$300 million[1]

A multivariate regression of enterprise value to EBITDA[2] vs profitability and growth is statistically significant[3] . . .

. . . while a partial correlation analysis of enterprise value to EBITDA[2] vs a series of size metrics is less significant, even after adjusting for profitability and growth

Profitability

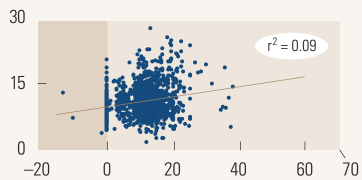
Enterprise value/EBITDA,[2] multiple



Average ROIC,[2] 1998–2003, %

Growth

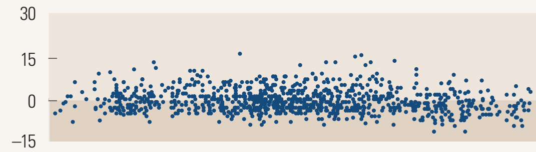
Enterprise value/EBITDA,[2] multiple



Average long-term growth (estimated as of year-end 2003), %

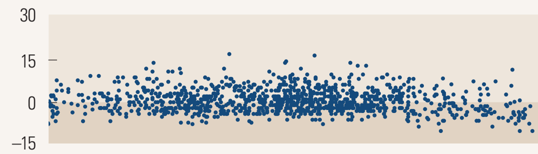
Size

Enterprise value/EBITDA,[2] multiple



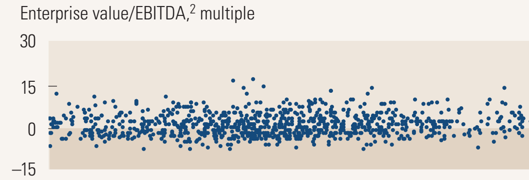
Adjusted revenue,[4] 2003, $ million

Enterprise value/EBITDA,[2] multiple



Adjusted EBITDA,[2] 2003, $ million[4]

Enterprise value/EBITDA,[2] multiple



Adjusted total assets,[4] 2003, $ million

r^2 is the proportion or percentage of variance explained by a regression.

[1] For companies traded on AMEX, Nasdaq, NYSE; excludes those in financial-services industry; 2003 data are most current available—not all companies had filed 2004 annual reports by time of publication.

[2] EBITDA = earnings before interest, taxes, depreciation, and amortization; ROIC = return on invested capital.

[3] With p values of <0.0001 for both profitability and growth variables.

[4] Adjusted for performance and growth; results based on partial correlation analysis.

Source: Thomson; McKinsey analysis

analyst coverage, greater suitability for increased institutional ownership, or a stronger balance sheet with more risk diversification.

Such research withers under closer scrutiny, however. Analysis of publicly traded companies indicates that long-term shareholder returns—which are a proxy for the cost of equity—are quite stable for corporations with a market capitalization of approximately $500 million and above[2] (Exhibit 1). Companies below the $500 million threshold—only 49 of the Fortune 1000—have a historically higher cost of capital.[3] And, as other experts have noted, the traditional capital asset-pricing models used to estimate risk-adjusted returns are inadequate for very small companies.[4] For most companies, capital market scale has no meaningful effect on the cost of equity or, therefore, the valuation multiples.

What does? Differences in valuation multiples are best explained by underlying variations in growth and ROIC, which predict a company's future performance—and not by measures of size such as revenues, earnings, or assets, even after adjusting for differences in performance (Exhibit 2).

Scale can be important if it confers a significant strategic or commercial advantage—for example, by improving industry structure or conduct, which in turn drives higher returns on capital and growth. And scale is helpful for very small public companies, which historically have had higher costs of capital.

The arguments executives hear about the need to get bigger don't focus on these justifiable circumstances, however. Too often, the bigger-is-better crowd offers proof based on an illusory relationship, between size and valuation multiples, that vanishes when fundamental differences in returns and growth are taken into account. MoF

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[2] Cost of equity is frequently estimated by using long-term historical shareholder returns (including dividends), as this measure is often a proxy for expected returns.

[3] Fortune 1000 companies from 2005; market values as of March 2005.

[4] Eugene F. Fama and Kenneth R. French, "Size and book-to-market factors in earnings and returns," *Journal of Finance,* 1995, Volume 50, Number 1, pp. 131–55.

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You may also complete this brief survey online using the URL below. There is no need to register to complete the survey—although please note that the survey will end on August 15, 2005.

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