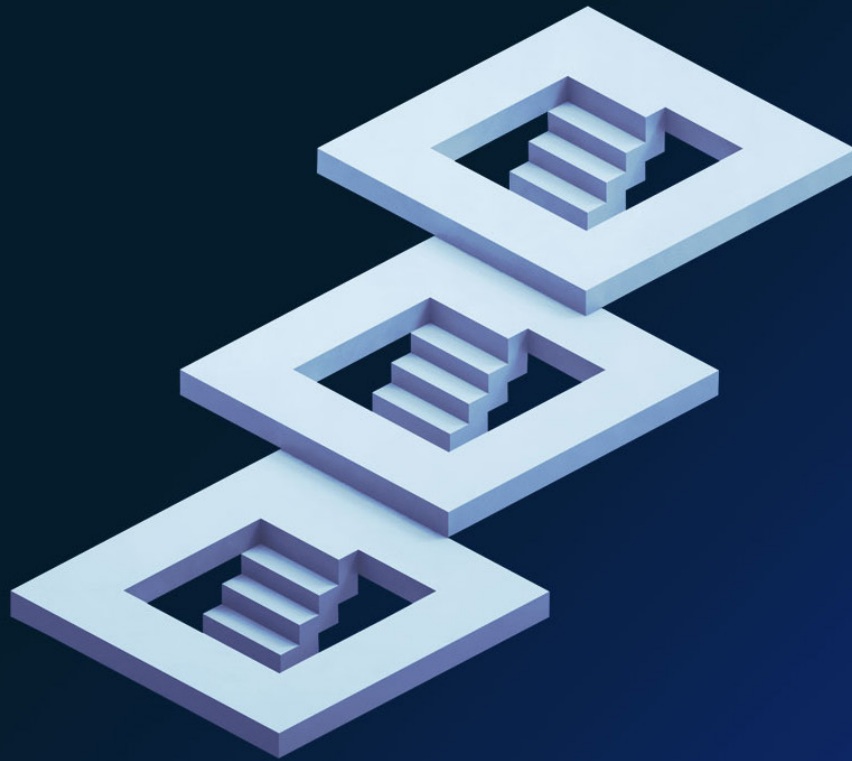


Strategy & Corporate Finance Practice

Growth through a downturn

How companies outperform on growth during downturns and the subsequent recovery.



Sean Brown: From McKinsey's Strategy and Corporate Finance Practice, I'm Sean Brown, and welcome to *Inside the Strategy Room*. For many business leaders, wrestling with the challenge of the coronavirus pandemic, growth may seem like a distant priority. However, once the health of employees is protected and the business is secured, many executives are quickly shifting their focus to restarting their stalled growth engines. A recent McKinsey article reports that only one in ten companies managed to outperform on growth both during downturns and during the subsequent recovery. Today we're speaking with the article's authors about what these through-cycle outperformers do differently. Rebecca Doherty is a partner in our San Francisco office and leads our Growth Strategy service line globally. Anna Koivuniemi is a partner in our Amsterdam office and leads our Growth Analytics globally. Their article "Rev Up Your Growth Engine: Lessons from through-cycle outperformers" is available now on McKinsey.com. Rebecca, can you start us off by telling us how you define through-cycle outperformers?

Rebecca Doherty: Thank you, Sean. When we think about growth, we don't want just growth for growth's sake; we really want value creation. We define this as companies that grow faster than their peers and have higher profits than their peers. And if we look at our through-cycle outperformers, these companies will generate three times higher revenues during the downturn versus others, and then nine times higher profitability. This growth really happened in the downturn and recovery and that really turbocharges them to go through the entire period. So companies that are able to do this really drives value creation in the form of excess return to shareholders, 5.3 percent in fact, which is five times higher than the average company. We did this research over the course of 15 years, 2003 to 2017, and have looked at other time periods as well, and the findings are all consistent.

Sean Brown: In what direction do the companies you study typically pursue this growth?

Rebecca Doherty: So when we think about growth there are four potential directions: your core business, expanding geographically, see the value chain integration or disruption (in many cases, today), and when moving to adjacent fields. The majority of companies, actually 95 percent of the value-creating growers, will look at three directions or more of growth. And that doesn't mean placing bets in the same way for every single one. They will say, I'm going to place some bets and then on one or two, I'm really going to lean in hard. What is key here is actually not falling in love with one direction of growth and not falling in love with ideas, but actually taking a step back and thinking, you know, how do I think about my entire portfolio. The majority of companies are thinking about growing their core business in a downturn. Some companies think about really turbocharging the commercial side of it, but start to look a little bit outside. So you see that in the geographic-expansion value chain and moving to adjacent fields, as they think about diversifying their portfolio, for example, into less cyclical adjacencies.

Sean Brown: So how does your through-cycle outperformers approach to growth differ from other companies?

Rebecca Doherty: Almost most importantly, is leading with a through-cycle mindset. It's not completely redoing your strategy. It's not completely putting the brakes on everything, but being thoughtful about, hey, where do I pull back? Where do I actually lean forward? And how do I protect my innovation and sales capabilities? Because those things will propel me in the future. I've talked to many leaders, and what they are thinking about doing is taking their strategy, and just making slight tweaks in terms of where they really can accelerate versus not. The second point here, like the highlight as well is, you know, we're not saying blindly go toward growth, what we're saying is if you have a strong balance sheet, and you've created the optionality to do this, right now is a great time to be opportunistic. So if we looked at our through-cycle-growth outperformers in 2007, so right before

the financial crisis, you know, they had about 20 percent higher excess cash than their peers. You play that forward to 2012, they actually had 53 percent, higher excess cash. So these companies were doing multiple things both around, you know, preserving this optionality but also strategically placing bets.

Sean Brown: Anna how did these companies manage to free up cash during a downturn so that they could have these growth options?

Anna Koivuniemi: So in our sample of roughly 2000 companies, 10 percent were the through-cycle outperformers (and, by the way, representing almost all industries). When we look at how they actually were freeing up resources, so creating the optionality in their spend, we found something very interesting. In a downturn, there is no significant difference between the through-cycle outperformers and other companies on how they save cost. Everybody saves costs, everybody ramped down the spending, although the through-cycle outperformers their relative spend decrease was more. So they actually saved, but they saved a little bit less than the rest. When the recovery started, the through cycle outperformers were really increasing their absolute spend. Especially, for example, areas like capex and R&D, which is four times higher than the, than the rest of the sample. They actually think thoroughly, where to invest, and when the times are looking better, they are early on investing for the future. And they are investing radically more than the rest of the companies.

Sean Brown: So what allowed these companies to make such large investments sooner than their competitors? Were they just better at predicting when the recovery would start so that they could make these big bets?

Anna Koivuniemi: Qualitatively, when we look at the players, and when we talked to a few of them, I think they were much more thoroughly looking at the old directions of growth. So not only focusing on core, and they had this, basically clarity, on where to invest

when there is a room to invest. Rather than knowing the exact moment, it was a really thorough process of understanding where to grow, and then creating the optionality and freedom to invest when, when the opportunities were starting during the downturn.

Rebecca Doherty: One point Anna, if I may add, through-cycle outperformers actually also grew during the downturn. Right? So even though they ramped back their spend a bit, they were still making bets, and still growing during the downturn, 95 percent of the companies at least we're doing that. And so even though they ramped up in a bigger way in recovery, one of the lessons is actually, you still are placing some strategic bets, both broadening and deepening it, you know, when, when things start to look better.

Sean Brown: Anna, where did these companies focus their growth initiatives? Did they concentrate their efforts on their core business or expand into new areas?

Anna Koivuniemi: One of the key choices is where to grow. Core is where to look first for the options of growth. Through-cycle outperformers need to look at their core also. And here is an example: Philips manufacturer. In the last downturn, what they did very actively was actually investing in their services. They did have a service efficiency core, but they doubled down the investments and focused on that during the crisis. When the capex investments are going down, you still actually need the services. But they did this very thoroughly by redesigning their service portfolio. They actually made their services much more modular, and therefore flexible to offer, but they also invested heavily on the capabilities to deliver and sell those services. So in the downturn, to scale up the part of their core, where the demand was still there, which was services. The other example was adjacencies. Many of these through-cycle outperformers looked into the part of the close part of their portfolio that gave them buffer against the cyclicity of their core business. For example, the construction company, they had a portfolio when they entered the downturn, which

is very construction- and engineering-focused services. In the crisis, they made the decision of diversifying the industry exposure. So they went to the environmental services, they went to oil and gas equipment in order to grow through the adjacencies and counter cyclical part of their portfolio grew substantially after the crisis.

Rebecca Doherty: Anna, that's a great example. And I'd love to complement it with a retail company out of South America. They thought the same way, in terms of what is the customer segment I may actually go after. So organically, they added this financing business, the low income customer segment, and the growth rates of this business just skyrocketed as they went on. It was a great example of them looking at the customer landscape, and thinking, well, what does a new customer need and what's the capability I can innovate within my core portfolio to move into an adjacency to capture a new opportunity?

Sean Brown: Thanks, Rebecca. What about geographic expansion? Anna, was that a path many outperformers chose in the last economic downturn?

Anna Koivuniemi: We actually found out interestingly, that during the cycle, during the down cycle, actually, the outperformers expanded more to the other geographies 1.5 to 2.0 times as high, than the rest of the sample. Outperformers really targeted geographies that were growing, or even countries, cities, or regions that were growing and investing in those. First on a retailer, the last rises in 2007 really looking at the Polish market and thought about that market, GDP and retail part of the business it will help you there and that in many other parts of the M&A and market. And they actually had a very targeted acquisitions, doubling their store presence in Poland.

Sean Brown: And were there any big differences between sectors in terms of the strategies that the growth outperformers pursued?

Anna Koivuniemi: I think that we did find differences on throughout cycles in the different sectors. Rebecca mentioned earlier that 95 percent grew in the downturn. Well, this was the case almost across sectors, except three sectors which were outliers, which was basic materials, consumer packaged goods, and energy, and especially in basic materials that was related to, of course, on the raw-material price erosion, but those sectors then picked up in the recovery enormously. So the idea of the resource allocation that you've put in the recovery, you index and you catch the accelerated growth after that, is also a way to become outperformer. I think the point here is that just don't wait until things stabilize, because then you lose the momentum, which you can capture throughout the cycle.

Sean Brown: And what about M&A and portfolio moves to the outperformers have any common approaches to mergers, acquisitions, and divestitures?

Anna Koivuniemi: So the M&A has been a core strategy to get that growth and expand into those other areas. If you look at the through-cycle outperformers, during the downturn they actually did 1.8 times larger deals. So they spent 238 million US dollars in the M&A while the other spent \$135 million. Now this doesn't mean that they did only one big deal, they did multiple deals. So the programmatic M&A was the core of the strategy. Then on the recovery, what was interesting was that the size were leveling up. So through-cycle outperformers were roughly doing 1.3 deals, while the other ones were doing 1.7.

Sean Brown: And what about digital M&A in particular, was that a major focus of the deals during and after the last downturn?

Anna Koivuniemi: We looked into the digital M&A also in general, from the period of 2003 to 2019. So slightly longer than covering the downturn and upturn. What's interesting if you look at that period is that the size of the deal. The capital deployed in digital M&A has grown 11 percent by year. Also size of these deals have been increased, I have to say that it's very skewed still there are a few very large deals and then a lot of small deals. But still in general also the large deals are going up. What we found interesting is their share of what we call nondigital buyers, so companies whose business model is not fully digital, has grown enormously in that period. So actually 30 percent more deals are done by nondigital buyers.

Rebecca Doherty: Yeah, another interesting point here and just one statistic for you, if you will, is we also, you know looked at digital M&A from the perspective of nondigital acquirers as well as digital acquirers. And what we saw from a purely performance-related metric was that those that did multiple deals over time and over a year programmatic if you will, actually had higher of TRS. But the other thing we also saw is that nondigital acquirers, while they're growing and their digital M&A, know they are, "quote," behind, if you will, digital acquired, many people haven't done it or have started to do it, but don't feel quite as prepared, because a lot of times it's growth oriented, and kind of a space, you know, that is less familiar.

Sean Brown: Rebecca, while many companies if not most, are noting the importance of digital capabilities during this crisis, how should they approach potential digital acquisitions, since it's typically a more difficult arena for a traditional company to break into?

Rebecca Doherty: Right, I think it's very important to be clear upfront, what you're really doing an acquisition for, and really understanding the deal rationale. But the second point on the due diligence, in particular nondigital acquirers, or the the requirement is really to do more diligence on the commercial and the technical piece. So for example, on the technical pieces, understanding what is the roadmap, what is the technical capability of the team? And how do we think about accelerating

that to achieve the strategic objective? On the commercial piece, some of these companies are following a good market motion in the industry or in a market, if you will, that is still growing. So understanding the TAM, understanding how that may evolve in the commercial elements is very important. The third point is about how you value the target. I think most were very familiar with doing a DCF and doing a kind of straight valuation doing a few comps. In some cases that may work, but a lot of digital M&A is with prerevenue companies as well. How do we think about their growth trajectory? A lot of times what we've seen companies do successfully, is really think about, well, I'm doing not just one acquisition, but I'm really building a new business or a new capability. And to me that business or that capability is worth x. And if we think about this one target or two targets, contributing to that new business value of x, you know, what is their contribution based on the capabilities that they're bringing to this business. So a lot of times that could include revenue synergies with other capabilities. And how do we think about that holistically? Because a lot of times, acquisitions if they're pieced together in the right way can very much be one plus one plus one equals ten. And then finally, on the integration, a lot of the same classic questions around integration. But there is often a focus even more on talent retention, in particular for the Aqua hire, and how do we set up the incentives, as long as it's really a lot of thought around culture to make it attractive.

Sean Brown: Another issue that can arise when nondigital companies buy digital organizations or digitally focused organizations, is this notion of a clash of cultures. Rebecca, can you explain how acquirers can best mitigate that culture risk?

Rebecca Doherty: That's obviously a tough one and one that, you know, everyone is battling. You know, here, what we would say what we've seen really worked well, it's actually spending a lot of time and diligence on the culture. There's a lot of things you can do outside in, and frankly, a lot of conversations you can have with the top team. And a lot of times what we've also seen work well is to talk about, very frankly, and very upfront about what the expectation is, of the leaders that you're often trying to keep and

really listening to them in terms of what the culture is that's needed. You know, "ring fence" is a term that's thrown around that, honestly, sometimes work and sometimes doesn't really depend on the rationale of the acquisition. So if you if you have one where it's all about kind of go-to market, and there's actually very little interaction point that's needed between the target and the acquirer, your matcher may be able to do that, and just set up the right incentives for cross sell, and upsell, and really making sure those handoffs are clear. If you're actually integrating two engineering teams, that looks very different. And actually thinking through who are the key people you need to keep and what's the culture of engineering you need to, you know, promote. In particular, if they're in different locations, how do you think about rotation? How do you think about, you know, growth, and setting up a attractive career path?

Anna Koivuniemi: The times we are in, where digital is radically changing the way we buy, the way actually we sell, the way we have these meetings like that, but we cannot meet each other. It's already implying culture change in your organization. And maybe actually, now the time to integrate a digital native where all of us need to learn new digital tools is somewhat better than it was half a year ago.

Sean Brown: Thanks, Anna. And Rebecca, where do you see the biggest focus on digital capabilities, in terms of growth strategies?

Rebecca Doherty: I think kind of unique to the situation we're in right now, a lot of sales in particular is remote. So a lot of companies have been thinking about how do we innovate? And how do we think about our go-to market, you know, both B2B and B2C. In some cases, how do I invest in digital? In some cases, how do I, you know, both the front end of digital in terms of reaching more consumers and reaching, you know, other businesses as well as the back end, to make my processes more efficient?

Anna Koivuniemi: To look at what is happening in this crisis and the speed it's happening. What we see is the boost of investing in digital capabilities. And of course, the change of buying and selling behaviors are forcing us to do that. I found it particularly interesting what happened in China on January, February, March when they were exiting the lockdown earlier than Europe and America. The companies there that extremely rapid allocation of your spend from traditional channels to online channels to capture the market share and structurally capture the traffic that has more online was skincare manufacturer. What they did this and here is my example. So they had to face people hosting their own videos with skincare tips. The very bottom up is kind of an entrepreneurial behavior. They invested in really key opinion leaders to get them on TikTok to drive the demand. They actually did a lot also live streaming on the certain events like Valentine's Day, they had live streaming, so they really really reallocated the resources, but also innovated the way they reach to their customers.

Sean Brown: So let's move now from discussing acquisitions to divestitures. Rebecca, can you talk a little bit about the role that divestitures play in the outperformers' growth strategies?

Rebecca Doherty: So Sean, I love the question you asked, because I feel like part of the answer is already in there. You know, one of the really key pieces to look at your portfolio is actually thinking about, hey, what are the granular pockets of growth? And what are the attractive businesses you want to keep versus not? You know, what, what we've seen over time is that the companies that are most successful are kind of programmatic acquirers, who do you know, a few deals a year along a few specific themes and really build a business with selective divestitures, so segments of the business that no longer jive with their portfolio or, you know, just don't make as much strategic sense, and to the extent they're able, companies are able to divest those and really being

honest and saying, Hey, you know, this actually is not the right fit for me, you know, to shed that business, to open up, you know, really the dry powder, if you will, to make moves that make the most sense.

Sean Brown: So, Anna, with many companies and their potential valuations under stress from the economic impact of the pandemic, is this a really good time to grow by acquiring businesses?

Anna Koivuniemi: This perception that now is a cheap time to buy, we should buy something, I think that is a very dangerous one. You need to continue to stick to your strategy. And the acquisition targets that you're currently looking should speak to that long-term strategy and the value-generation principle that you're actually following. You should not now go crazy looking outside because there are bargains.

Sean Brown: Thank you. And what are some of the most important points companies trying to position themselves for post-COVID growth should keep in mind?

Anna Koivuniemi: There's basically four key messages. One of them is setting the bar high. One reason we have done the through-cycle outperformer or the whole out performer research is that we want to trigger the companies to put their growth aspiration high enough to show where you stand against your peer, but also show that what are the outperformers really doing well, in order to learn that. The second one is really making sure that you are not stuck to your core idea. So stuck to the one idea. And there is of course, also referring that in M&A don't fall in love with one idea. All of these through-cycle outperformers what we have identified stable, very systematically looking, multiple directions of growth, to ensure that they are up to the game in the right market, in the right value-chain integration when it happens. The third one is the big move outside of the core. So new geographies adjacencies evaluate that it's enough to make sure you don't miss anything. And then the last point is that the through outperformers 95 percent grew in the downturn. Now, if you were not able to manage that, then double down the first

two years in recovery, because you need to take the momentum now if you want to be one of those through cycle outperformers who grew faster than their peers, and ended up more profitability than their peers.

Sean Brown: Great. My final question is how can our listeners take the insights that you've shared today, to best quickly align their leadership team around the importance of doing this and getting everybody excited about moving forward?

Rebecca Doherty: I love that question, because it is about you know, how do you take theory and make it practical? First and foremost, a lot of times this does need to be led top down. So having your CEO on board is absolutely critical. Because I think, you know, if I can reinforce one element that Anna talked about, it is setting the bar high. So that aspiration needs to come from the CEO and the mindset around, hey, this is how we're going to think about growth, and this is how we're going to think about strategically allocating a portfolio is really key. We often find it's the combination of some of the facts, a little bit is thinking about really the legacy of the company and his or her ten years that will be set. And actually thinking about, okay, well, what does the different scenarios look like? And how do I want to come out on that? I think the second thing is really the change management, if you will, around how to think about strategy is not just being incremental, or thinking about it in a way that just makes tweaks to the budget from last year. I think there is a broader mindset here that the whole executive team and company needs to adopt. It's not around making tweaks like where do we actually really want to clean sheet things. But a lot of times we find that if the mindset is there, everything else is fixable, right, you can put in the processes, you can bring in the facts, you can do a critical thinking that will get you here, but getting that first piece of alignment is sometimes actually the toughest. I don't know, Anna, what you would add?

Anna Koivuniemi: I think that's important. And I think that the one thought, which I would also like to do to leave you with is that this is not the game for

next year. This is the game for the next three to five years. So dare to have that longer-term perspective on growth, and dare to look at all the different directions of growth.

Sean Brown: Anna, Rebecca, thank you so much for taking the time to share your insights with us today. For our listeners, we hope you enjoyed this episode of *Inside the Strategy Room*. An edited version of this discussion will be available soon on the Strategy and Corporate Finance Practice site on McKinsey.com where you may also find links to other episodes. If you'd like to access McKinsey's

latest insights on the COVID crisis, please visit [McKinsey.com/coronavirus](https://www.mckinsey.com/coronavirus). If you have feedback or an idea for a future episode, please email us at Strategy CF (that's for corporate finance underscore strategycf_practice@McKinsey.com). If you'd like to receive alerts on our latest publications, you can sign up at the bottom of each page of the Strategy and Corporate Finance section of [McKinsey.com](https://www.mckinsey.com). You can also follow us on Twitter and [McKStrategy](https://www.mckstrategy.com), or connect with us on LinkedIn via the McKinsey Strategy and Corporate Finance Practice page. Thanks again for listening and we look forward to having you join us again soon *Inside the Strategy Room*.

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