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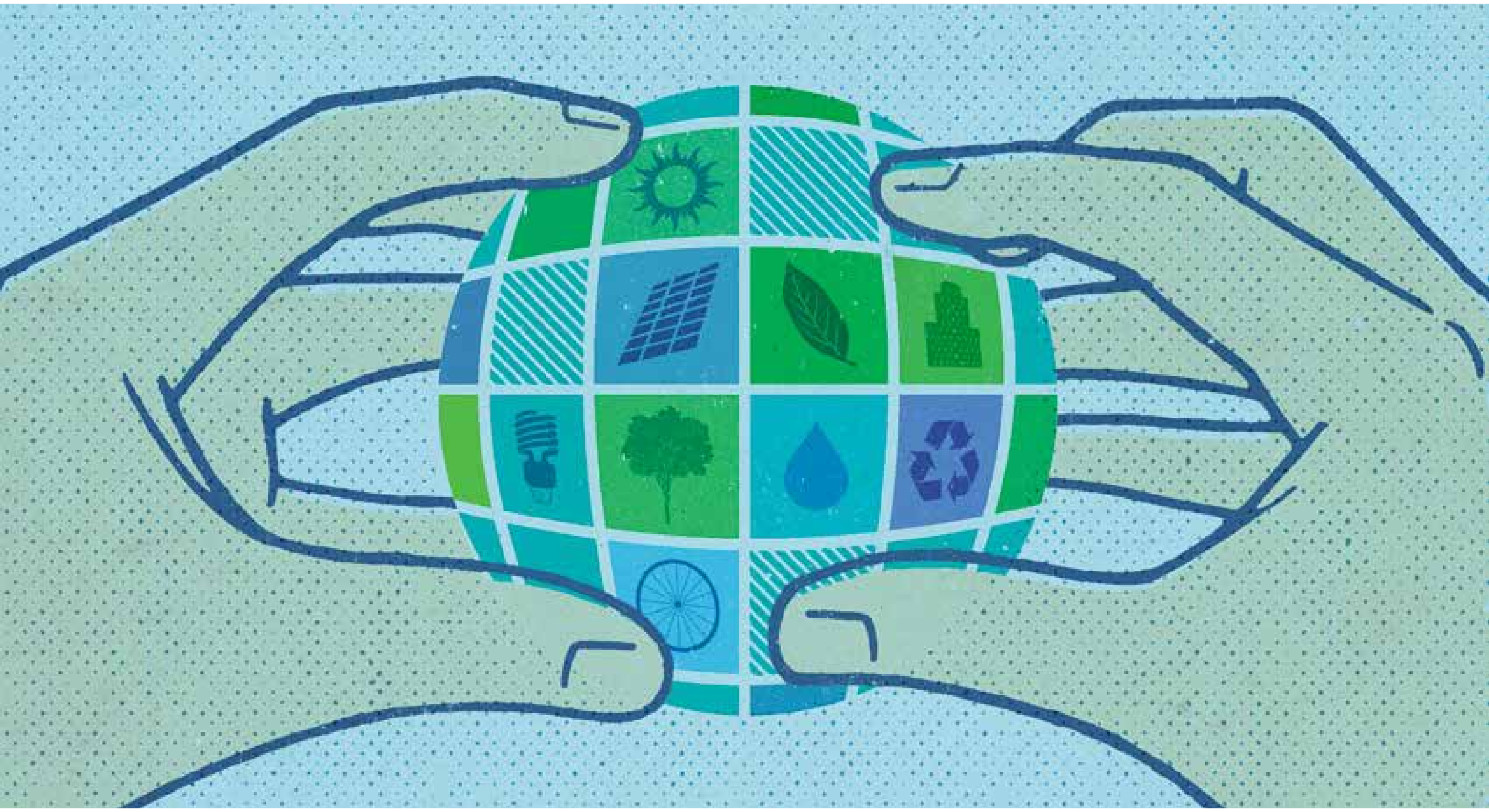

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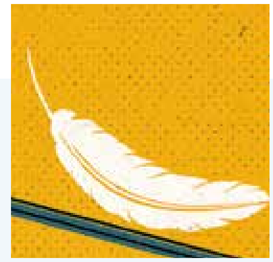

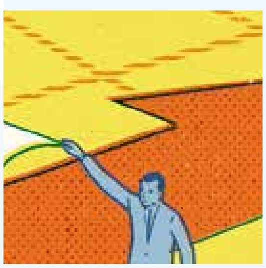

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Bringing discipline to your sustainability initiatives

Many companies have more sustainability initiatives than they can possibly manage. Here's how to get them under control.

Sheila Bonini and Steven Swartz

Sustainability has become a part of life for many companies. For some, it's a matter of meeting demands from customers seeking socially responsible goods and services. For others, it's about addressing pressure from stakeholders—including investors—or pursuing their own corporate values. For still others, especially those in a resource-constrained environment, it's a strategic imperative. Whatever the impetus, sustainability has become sufficiently pervasive that defining it and executing business programs, products, and practices with an eye to their environmental and social implications has become a demanding managerial exercise.

For some, sustainability has proved to be a valuable lens through which they have identified opportunities that they might have otherwise missed—to cut costs, reduce risk, and generate revenues. Consider the multinational consumer-goods company Unilever, for example, which changed the shape of a deodorant to use less plastic in packaging and created a concentrated laundry product that sharply reduces its use of water. German pharmaceutical company Bayer expects to save more than $10 million a year with a resource-efficiency check it developed to improve operations by using by-products and reducing wastewater. Global chemical company DuPont has recorded $2 billion in annual revenue from products that reduce greenhouse-gas emissions and another $11.8 billion in revenue from nondepletable resources.

Others, though, have struggled. To better understand the challenges they face at creating value from sustainability, we worked with several sustainability membership groups[1] to identify managers at 40 companies to volunteer to collaborate on analyzing their programs. What we found is that companies often have more initiatives under way than they can effectively manage. The sustainability movement is quite malleable, often including everything from environmentalism and resource management to corporate governance and human rights, and different managers in different regions can get quite enthusiastic about their own efforts without taking a company-wide perspective. In the most benign of such cases, the efforts are too fragmented to create much value—either for the company or for society.

Fortunately, the solution to that kind of problem is well-known. In fact, we found that most companies would benefit from bringing more discipline to their sustainability initiatives by applying principles commonly associated with performance management: to keep their programs focused, set specific concrete goals, create accountability for performance, and communicate the financial impact.

Agree on where to focus

One of the biggest challenges companies face in sustainability is getting top-leadership attention. In a recent report for the United Nations Global Compact, 84 percent of the 1,000 global CEOs surveyed agreed that business "should lead efforts to define and deliver new goals on global priority issues," but only a third said that "business is doing enough to address global sustainability challenges."[2]

In our observation, the problem at many companies is often one of focus; two-thirds of companies in a representative sample from the S&P 500 have more than 10 different sustainability focus topics; some have more than 30. That's too many: it's hard to imagine how a sustainability agenda with more than 10 focus areas can break through and get the necessary buy-in to be successful. And if top management doesn't prioritize, then individual business units won't either, and the result is fragmented, decentralized, and not necessarily aligned with one another or with overall top-level goals. That diminishes not only the social and environmental impact but also the economic value. A recent McKinsey Global Survey found that companies with a unified strategy and no more than five strategic priorities were almost three times as likely to be among the strongest performers, both financially and on measures of sustainability.[3] Coca-Cola, for example, has set for itself a strategy it describes as "me, we, the world," which encompasses its approach to improving personal health and wellness, the communities in which it operates, and the environment. Within this strategy, the company reports making material, tangible progress on metrics related to three specific areas of focus: "well-being, women, and water." The company does not ignore other issues such as climate change and packaging, but it has made it clear that this is where it wants to lead.

To develop a clear set of priorities, it is important to start by analyzing what matters most along the entire value chain, through internal analysis and consultations with stakeholders, including customers, regulators, and nongovernmental organizations (NGOs). This process should enable companies to identify the sustainability issues with the greatest long-term potential and thus to create a systematic agenda—not a laundry list of vague desirables. After extensive consultations, for example, BASF, the global chemical company, put together a “materiality matrix.” This chart ranked the importance of 38 sustainability-related issues, based on their importance to BASF and its stakeholders. (Other companies use similar matrixes.) Such exercises help companies to recognize the most important issues early and get internal stakeholders to agree on what will create the most value. Their focus needn’t be mechanical but should instead reflect discussion on the strategic, reputational, and financial merits of different efforts.

Once the priorities are identified—in our experience, no more than three to five is best—the next step is to develop a fact base from which to create a detailed financial and sustainability analysis. This includes the same kind of valuation and financial analysis a company would do for any other business opportunity, including a detailed analysis of the market value or value at risk and implementation. Siemens, for example, used such an approach to sort through a range of potential priorities and home in on one—helping customers to reduce their carbon impact. As a result, it has created an environmental portfolio of green products and services, including energy efficiency, renewable energy, and environmental technology. In a 2013 interview, Siemens reported that this had generated revenues of €32.3 billion and saved 377 million metric tons of carbon emissions.

Set specific, concrete goals

After completing the initial analysis, the next step is to translate this information into external goals that can be distilled into business metrics. These goals should be specific, ambitious, and measurable against an established baseline, such as greenhouse-gas emissions; they should have a long-term orientation (more than five years) and be integrated into business strategy. Finally, their intent should be unmistakable. One company stated as a goal: “Reduce the impact of our packaging on the environment.” From a different company came a sharper version: “Eliminate 20 million pounds of packaging by 2016.” Along the same lines, “reducing emissions” is a vague and almost meaningless phrase—it doesn’t say by how much the company should reduce emissions, by when, or compared with what benchmark. The approach taken by another sustainability leader is stronger and more specific: “Reduce 2005 CO_2 emissions by half by 2015.”

It is important to build internal support to meet these goals. Our analysis found that the companies that excelled at meeting sustainability goals made sure that they involved the business leaders responsible for implementing them from the start. One global manufacturer we interviewed announced in 2010 that it would reduce greenhouse-gas emissions and energy consumption by 20 percent by 2020. To do so, it has set up energy assessments and energy-management plans, established global programs to optimize procurement and building standards, trained and developed internal “champions” and coordinated best practices, and began to use renewable energy where possible—communicating early wins internally through a newsletter and regular conference calls. Four years into the ten-year effort, the project is already net present value positive.

Stronger goals seem to encourage innovation; people may feel more motivated to find ways to meet them.

Setting ambitious external goals motivates the organization, forces resources to be allocated, and promotes accountability. An analysis of companies that are part of the Carbon Disclosure Project found that those that set external goals did better when it came to cutting emissions—and also had better financial returns on such investments. Stronger goals, then, seem to encourage innovation; people may feel more motivated to find ways to meet them. Lack of goals is a sustainability killer: "What gets measured gets managed" is as true of sustainability as it is for any other business function. And yet it is not happening. McKinsey analysis of S&P 500 companies suggests that as of this writing only one in five S&P 500 companies sets quantified, long-term sustainability goals; half do not have any.

Communicate the financial impact

Despite the growing evidence of the value of investing in sustainability, many executives wrestle with lingering doubt. Senior leaders will give sustainability lip service but not capital if they do not see financial benefits. "Sustainability metrics can seem like random numbers and don't do much," one chemical-industry executive told us. "For our businesses, sustainability efforts have to compete directly with other demands, which means that financial impact is key." Indeed, nearly half of the research participants reported that the pressure of short-term earnings performance is at odds with sustainability initiatives. A constructive response is to make the case that sustainability can pay for itself—and more. This needs to be done rigorously—even overcommunicated—reinforced with fully costed financial data and delivered in the language of business.

This is, of course, much easier said than done. At Intel, for example, although business leaders were interested in saving water, they saw little financial justification to do so: water was cheap. Advocates of the initiative were able to calculate that the full cost of water, including infrastructure and treatment, was much higher than the initial estimates. Saving water, they argued, could therefore create value in new and unexpected ways. On that basis, Intel went ahead with a major conservation effort. The company now has a finance analyst who concentrates on computing the financial value of sustainability efforts.

Making the business case for sustainability might sound like an obvious thing to do, but apparently it isn't. Only around a fifth of survey respondents reported that the financial benefits are clearly understood across the organization.

Sustainability initiatives can be challenging to measure because savings or returns may be divided across different parts of the business, and some benefits, such as an improved reputation, are indirect. It is important, then, not only to quantify what can be quantified but also to communicate other kinds of value. For example, an initiative might improve the perception important stakeholders—including consumer groups, NGOs, or regulators—have of the company, the better to build consumer loyalty, nurture relationships with like-minded nonprofits, and inform policy discussions.[4]

Create accountability

The top reason that respondents gave for their company's failure to capture the full value of sustainability is the lack of incentives to do so, whether positive or negative. According to the United Nations Global Compact, only 1 in 12 companies link executive remuneration to sustainability performance; 1 in 7 reward their suppliers for good sustainability performance. Among survey respondents, 1 in 3 named earnings pressure and lack of incentives as reasons for poor sustainability results; 1 in 4 named lack of key performance indicators and insufficient resources.

In this area, a number of companies exhibit good practices from which others learn. Some are strong when it comes to tracking data and reporting indicators, tracking carbon emissions and energy use, monitoring water use and waste, and recycling. Adidas demonstrates one useful approach. The sporting-goods company breaks down its long-term goals into shorter-term milestones. Its suppliers, for example, are given strategic targets three to five years ahead, as well as more immediate goals to encourage them to focus. The effort makes it very clear what is expected of suppliers for the current year. The beer company MillerCoors does something similar. It tracks and quantifies progress in ten areas, ranging from water to energy to packaging to human rights, using its own sustainability-assessment matrix. The idea is for MillerCoors to understand its performance, in quantitative terms, in areas that are often difficult to quantify.

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Becoming a sustainability leader can pay off, but it is not easy. "It's a perception issue," one executive told McKinsey. "We need to show that it makes good business sense to get over the hurdle." Fair enough—and the evidence is building that for the best companies, this standard is within reach. ○

1 Corporate Eco Forum (corporateecoforum.com), The Sustainability Consortium (sustainabilityconsortium.org), and Sustainability Leadership Forum (onthecourtcoaching.net).

2 *The UN Global Compact–Accenture CEO Study on Sustainability 2013: Architects of a Better World*, Accenture and United Nations Global Compact, 2013, unglobalcompact.org.

3 In February 2014, McKinsey surveyed 3,344 executives about their companies' sustainability activities. The respondents represented the full range of regions, industries, company sizes, tenures, and functional specialties.

4 Sheila Bonini, Timothy M. Koller, and Philip H. Mirvis, "Valuing social responsibility programs," *McKinsey Quarterly*, July 2009, mckinsey.com.

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Preparing to make big-ticket investment decisions

When the stakes couldn't be higher, the quality of the decision making can make all the difference. Process improvements can help.

Michael Birshan, Ishaan Nangia, and Felix Wenger

Few decisions in an executive's career are as complex or sensitive as a multibillion-dollar investment with a payback timetable that can stretch on for decades. The right call can positively transform a company's value. The wrong one can damage the company's share price, draw public criticism, and perhaps even cost responsible managers their jobs.

Insight into the process by which successful managers make such decisions is hard to come by.[1] By their nature, projects of this size are highly individual and fairly rare, so quantitative data typically are insufficient to reliably calculate the root causes of failed investments. And qualitative data are hard to generalize about, given big differences among the practices of various companies and industries.

To get at what it takes to prepare for such high-stakes decisions, we interviewed executives from sectors where big-ticket investments regularly arise—natural resources, utilities, heavy industrials, and even pharmaceuticals—and pooled our collective experience. Despite variations among sectors and projects, we concluded that many good practices in interviewees' decision-making processes could be more widely applied, both within capital-intensive industries and indeed in any company that faces a material investment decision. These include examining the handful of characteristics that are most critical to a project early in the process of evaluating an investment proposal, employing both quantitative and qualitative insight in risk discussions, and keeping decision biases in check.

Start with the swing factors

Due to their long-term nature, large, complex projects have many more uncertainties that affect revenue, cost, and investment than do smaller ones. Development and construction alone can span a decade or more, and a project's operating life can last several times longer than that. And over that time, there's often little correlation among factors such as global commodity prices, local labor costs, and geological characteristics.

One approach to managing this challenge is to focus analysis on those material factors where uncertainty is greatest before jumping fully into the detailed business plan that such investments require. These factors are what one practitioner we spoke with calls "the most critical swing factors." Looking back and rigorously evaluating why projects failed or succeeded, "You find very few factors that really made the difference," he says. "You analyze them as best you can, then set aside the projects that don't look great—even if other factors seem attractive."

When considering a mining project in a remote location, for example, it's easier to get good information on building a prerequisite railway line through difficult topology than it is to build the entire project's business case. Moreover, companies can use the actual cost of comparable railway projects to get a feel for the likely range of investment required. This analysis is really about understanding those factors that will affect costs, and then making useful comparisons, such as cost per kilometer of railway track.

Swing factors vary from industry to industry. Managers will be familiar with most of them when past experience and familiar technologies are involved but may be mistaken or blindsided by others that are only revealed through analysis. In the case of mining, as the example above suggests, a common swing factor is the cost of putting in place the infrastructure to deliver a bulk product to market. For other mining companies, additional swing factors might be highly unusual and project-specific, such as the cash and reputation costs of resettling a community living too close to a planned mine. An early look at political and regulatory risk can also be important, leading many resource companies to avoid certain geographies entirely, despite compelling geological opportunities.

Even after making an initial decision to invest, some managers shift their attention as a project evolves, looking for other swing factors that may have arisen along the way. Has the price outlook changed, for example? Is the project on time, with cost and capital expenditure under control? In bad cases, projects can take twice as long as planned and cost double the original projections, while producing less output than expected. Substantial write-offs will follow. In any industry, the realization that the company has overpaid for a large acquisition can result in public criticism.

Quantify and qualify

Just as companies need to disaggregate the sources of value in big projects, they must also differentiate among sources of risk. Often their approach is desultory, leaning heavily on oversimplified quantitative approaches. Even for large decisions, many executives limit their calculations to high, medium, and low cases for cash flow, based on fairly arbitrary sensitivities. It's also not uncommon for them to reflect the added risk of

Companies across capital-intensive industries are starting to recognize the prevalence of decision biases and their potential impact on investment decision making.

less secure regions or early-stage projects merely by adjusting the discount rate they use to calculate the cost of capital in their valuation models. Such adjustments are typically made without factual basis—for example, plus or minus 1 percent for no apparent reason. And the approach implicitly assumes that because any given project is but a part of a diversified portfolio of investments, there would be no severe consequences for the company, which is unrealistic given the size and nature of these investments. Such projects are more susceptible to a wider range of market, technology, and regulatory risks, which affect different aspects of a large project differently—with potentially severe consequences in some areas and more mild ones elsewhere. That impact can't be meaningfully captured in a simple percentage adjustment.

Instead, companies with the best decision methodologies we've observed disaggregate different sources of uncertainty and model them separately—often both quantitatively and qualitatively. The type of data itself usually dictates what kind of analysis will work best, but for many large projects, using both quantitative and qualitative data is necessary to offer managers a fuller picture of risk. Managers who restrict themselves to one or the other could miss some key points.

Consider the case of a resource company operating in Africa. Managers evaluating an investment there charted out several scenarios for the development of the country in which the prospective investment would take place. They looked at the fiscal position of the government under each of the scenarios and then calculated what the royalty rate would need to be to allow the country to meet its spending obligations. That analysis provided a more sophisticated perspective on where royalties would go than the typical approach of making an arbitrary assumption that royalties could go up by an average of, say, 10 percent. The team then triangulated the development scenarios against what had actually happened in other resource-rich countries to try to get a sense of the likely shape of evolving regulation. Managers quickly concluded that the country they were interested in would likely face a real near-term cash shortage and that it would increase natural-resource royalties prohibitively in order to balance its budget.

Keep decision biases in check

Companies across capital-intensive industries are starting to recognize the prevalence of decision biases and their potential impact on investment decision making. This is particularly evident in natural-resource companies; we've observed that the duration and uncertainty of investments, as well as the importance of big projects for individual careers, can exacerbate the impact of biases in such companies. As one manager we met admitted, "If you've spent a few years in the desert looking for a resource, you can be biased toward going ahead with an investment so you can be the one running a large operation." Any functional manager trying to build up investment in the multiple projects she oversees might have the same bias, albeit to a lesser degree than the manager in the desert overseeing a single large one.

This topic is far too broad to cover comprehensively here. However, time and again, the executives we've spoken with have agreed that when making decisions about investments of this size, it's essential to include measures in the process that identify and mitigate the effects of bias.[2] Most companies have a policy that lays out who approves investments and on what grounds, but those policies are often inadequate or wrong, and companies seldom track the quality and performance of the process. As a result, as one executive observed, his company's biggest failures occurred when senior managers overrode established processes and methodologies.

Some practical countermeasures can help. One global power company asks all functional heads individually for their perspectives on each proposal; the act of recording the various positions can encourage people to take greater accountability for their decisions. A few companies go further, explicitly identifying which biases they and their managers are vulnerable to—and then investing in techniques to mitigate the effects. For example, one global energy supplier established an independent team of evaluators, separate from the project team, to tackle an optimism bias and misaligned incentives within the project team itself. The evaluators audit the analytical models, stress test the assumptions behind the analysis, and ensure that every relevant stakeholder and functional department has provided comment before proposals are considered by the investment committee. The process culminates with the team submitting an independent assessment of the project to the investment committee.

Elsewhere, a private-equity company insists on as many as 15 to 20 interactions between the investment committee and the team proposing an investment. Compare that with the two or three interactions more typical of a large mining company, where the initial case, a full project review, and a final decision may be the only formal senior interactions. The private-equity company's more thorough review gives the investment committee more than just the choice of accepting an investment despite concerns or forgoing a potential opportunity by allowing it to lapse. Moreover, during each interaction, the investment committee actively tests and shapes the assumptions made in assessing the project—challenging the effect on the project's value if the price were slightly higher or lower, for example, if extraction costs were twice as much, or if the quality of the product were higher or lower. Obviously, that kind of discussion isn't possible for every variable, but it's far more detailed than in most corporations—where the investment committee is typically regarded as much too senior to get so involved, and all assumptions are usually agreed upon long beforehand.

[1] See Martin Pergler and Anders Rasmussen, "Making better decisions about the risks of capital projects," *McKinsey on Finance*, May 2014, mckinsey.com.

[2] For more on the five key groups of biases that affect investment decision making, see Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 2010, mckinsey.com.

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Making trade-offs in corporate portfolio decisions

Managers often want to own good businesses they shouldn't buy—or hold onto businesses they should sell. Here's how some companies have made these tough decisions.

Andrew Campbell and Jo Whitehead

Editors' note: for companies managing a portfolio of businesses, investment decisions are seldom clear-cut—especially when different logical rationales conflict. This excerpt, adapted from the new book Strategy for the Corporate Level: Where to Invest, What to Cut Back and How to Grow Organisations with Multiple Divisions *(Jossey-Bass, June 2014), examines some of the ticklish questions and trade-offs that those harder cases bring up.*

Managers typically make portfolio decisions based on a series of logical justifications. The choice to invest, cut back, buy, or exit is ideally guided by the strength of a business's structural attractiveness (business logic); the potential to improve the business or create synergy with other businesses (added-value logic); and the state of the capital markets—whether they are likely to over- or under-value the business relative to the net present value, or NPV, of its future cash flows (capital-markets logic).

These three logics are each important for making good portfolio decisions. The decision is easy if the three logics all point in the same direction. When they don't, decisions can get complex. For example, if a business is likely to sell for more than it's worth, there is little reason to buy and good reason to sell—unless the business would perform much better under your ownership or it adds something to another business you own. If a business is structurally less attractive because it is in a low-margin industry and has a significant competitive disadvantage, you are likely to want to sell or close it—as long as the price you can get is more than the value of continuing to own it. But you may also want to keep the business if you can improve its competitive position or if it strengthens your position or adds capabilities in a related segment.

The trick is to make informed trade-offs among these different reasons for buying or selling businesses. It is important to give weight to all three logics and avoid letting momentum build up around one so that the others have little influence or are ignored. Too often, we encounter executive teams that decide what to buy first and consider how to add value only as part of the valuation or integration process—or that commit to hold onto an underperforming business without considering whether it might attract enthusiastic buyers. But this article is not about those who fail to use the three logics. It's about tricky cases where the logics suggested different paths forward—and how managers came to the conclusions they did.[1]

You can add value, but the business is structurally less attractive

Most management teams try to avoid businesses with low returns, weak positions, and limited growth prospects, especially those in complex industries. But what if you're good at adding value to these businesses? The default answer is to focus on what you're good at.

Consider the case of Grupo Bimbo, a $14.1 billion[2] Mexican baking giant, the world's largest bread-manufacturing company. It operates in a tough business: bakery products. These products have notoriously low margins, partly because customers are price sensitive. Some competitors, such as Hostess Brands, have gone bankrupt, and others have been in gradual decline. However, Grupo Bimbo's stock price has gone up 700 percent since 2000, and revenues have nearly doubled in the past five years.

Grupo Bimbo's secret is that it adds a lot of value to the bakery businesses it owns. It has a strong focus on operations. For example, it's particularly skilled at managing delivery routes for its trucks. The company makes three to five deliveries per week across more than 52,000 routes to 2.2 million points of sale in national, regional, and local networks. Each truck carries a computer to help the optimization process.[3] It's also skilled at optimizing oven utilization in its 100 plants. And the company has complementary skills. Much of the machinery used in its factories is developed and manufactured in its industrial division. It also produces a significant portion of the plastic packaging used on its products. Finally, the company's focus on operations includes an emphasis on producing high-quality bread in some of the most advanced facilities for baking. Combined, these capabilities allow Grupo Bimbo to adapt to local tastes and needs on a global scale, with operations in 19 countries across four continents. Through organic growth in its core countries and through aggressive acquisitions, including Weston Foods (Sara Lee's American baking operations), sections of Hostess Brands's bread business, and most recently Canada Bread, it is today one of the largest bakers in the world.

Acquiring businesses in complex, low-margin industries is not a strategy to recommend lightly. One risk of buying or holding structurally unattractive businesses is that they typically don't provide a reasonable return on incremental investments. Hence decision makers, like Grupo

Bimbo, must juggle all three logics. How difficult is the industry? Can they add enough value to compensate for the low underlying returns? Can they buy assets at a discount or without paying too large an acquisition premium?

You can't add value, but the business is structurally attractive

Every manager likes an attractive business, one with high margins that has a competitive advantage. But what if you're not good at adding value to this business? The default answer is to learn how to add value, and to do so quickly.

When Rolls-Royce acquired the marine business of Vickers in 1999, it acquired a number of different businesses, one of which was the Ulstein offshore ship business. This small Norwegian business made components and systems for vessels used to supply oil rigs—a technically demanding environment in which ships, in the middle of very heavy seas, have to remain within a few meters of the rig. Rolls-Royce could see that, from the perspective of business logic, this was a structurally attractive business. The value of such a vessel to an oil company is very high, and there were few competitors able to design and build them. Unfortunately, Rolls-Royce would be unlikely to add much value to Ulstein in the short term. Ulstein needed to broaden its products, add niche technology capabilities, and build its capability to sell globally. While Rolls-Royce had some seemingly relevant capabilities, such as global sales in aerospace, a strong balance sheet, talent, and a well-known brand, managers recognized that these might not be appropriate in such a different industry.

Rather than sell Ulstein, Rolls-Royce took care to build some new capabilities that would enable it to add value in the future. The company hired a new head for its marine businesses. Drawing from Ulstein and other marine businesses, both within and without Rolls-Royce, he built a team that could exploit what Rolls-Royce had to offer and do more. The key was to understand the difference between selling systems, such as complete drive systems with electronic controls, and components, such as diesel engines. The team was then able to draw on those capabilities in Rolls-Royce that fit. For example, the team drew on lessons learned in civil aerospace and defense to offer long-term service support to ship operators. The result? Rolls-Royce's marine business grew from about £750 million in revenues in 2000 to more than £2.5 billion in 2010, and today it's a leading competitor in this segment. But to get there it had to develop many of the ownership skills needed to turn the vision into a reality.

It's easy to presume that a company will be able to learn to be a good owner, especially when the business is attractive, but developing new skills at

The trick is to make informed trade-offs among these different reasons for buying or selling businesses, giving weight to all three logics.

the corporate level is not easy. It often requires significant changes in people and a willingness to let go of past habits and processes—and failure to do so is common.

You can add value to a structurally attractive business, but it's overpriced

When you find an attractive business that you can add value to, your instinct is to acquire it or hold onto it. But what if you own a business for which the price in the capital markets is higher than the NPV—for example, if the business is in a hot sector and competitors are vying for a few prizes? Should you sell? If you're considering acquiring, should you withdraw from bidding? The default answer depends on whether you're looking to acquire or whether you already own the business and whether the reason for the overvaluation in the capital markets is likely to be temporary or permanent.

If you're looking to acquire, the default answer is either to change the strategy so that you don't need to buy the business or to wait until the capital markets correct themselves. However, there are tactics that you can employ if you want to be more proactive. A common one is to hedge the risk of overpayment. If both your company and the target are trading at high multiples relative to historic levels (and especially if your multiple is particularly high), you can make the acquisition with equity rather than with cash, or issue new shares and use the cash to buy the acquisition. This results in paying for an overpriced asset with overpriced equity.[4]

Another tactic to cope with high prices is to structure the deal to reduce the risk of overpaying—for example, by using an "earn-out formula." This can work if the seller believes the business is worth more than the buyer does. An earn-out allows both parties to see the deal as attractive due to different assessments of its future prospects. In the event that the business performs to the seller's expectations, both sides are happy. In the event that it performs to the buyer's expectations, at least the buyer is happy.

If you're already a superior owner of a business and are offered a price that is higher than its NPV, the default answer is to hold. You should be wary about allowing your strategy to be buffeted by the vagaries of the capital markets, especially if you believe the overvaluation is not justified by the superior abilities of other companies to add value. Even then, you should still consider selling under some conditions—if the premium offered by the buyer is too big to ignore, for example, or if the cash overcomes a shortage of funding to invest in other parts of your portfolio.

You own a structurally unattractive business and are subtracting value, but buyers are not offering a fair price

Managers with unattractive businesses to which they cannot add value will normally sell. But what if you cannot sell a business at a price that matches the value of retaining it? Many companies will simply keep such a business and wait until they can offload it at a better price. But there are some tactics that sellers can use to increase the price buyers will offer. Which tactic is most appropriate will depend on the reason for the low price—be it a lack of buyers, the nature of those buyers, the information they have about the business, or the deal process.

For example, a mining company wanted to dispose of a combined smelter and cast house (a facility in which the metal from the smelter is cast into semifinished products). Few buyers were interested in the combined offer—in part because the smelter had committed to buying electricity at a fixed high price from the local power utility for a 20-year period. To solve the problem, the company unbundled the business into three separate parts, turning it into a more saleable proposition and improving overall NPV. The cast house could now be sold to a company that wanted to use its own metal as an input. The power contract for the smelter was bought back from the utility. And the smelter was left as an independent asset that could be sold or, if the reserve price was not met, shut down.

Another way to increase price is to redesign the deal process. For example, when Tesco divested its Japanese operation to Aeon, it divided the deal process into two stages. In the first stage, it paid Aeon to take 50 percent of the business off its hands. The remaining 50 percent will be sold off at a later date. This allowed the buyer and seller, which had different views about the value of the business, to reach an agreement. If the business performs well, Tesco will be able to get a better price for the remaining 50 percent share.

What to do also depends on the risks of subtracted value. If the current owner neither adds nor subtracts much value, the business is "ballast." Retaining it awhile is unlikely to reduce its value so the sale process needn't be rushed. For example, a natural-resources company owned an aluminum business—for which it was not a particularly good owner. Aluminum, at the time, was also not an attractive business due to global overcapacity, and better parent companies had their own challenges, so the business

could not be sold at a sufficiently attractive price. Fortunately, the business was part of a joint venture, operated by the company's partner, which also acted as the parent company. That left little chance that the natural-resources company would subtract value, so it decided to hold on to its share and look for an opportunity to offload the investment in the future.

If the current owner is already subtracting value, the pressure for an urgent disposal is high. Retaining the business means it will sell for less in the future and it will demand attention from parent-company managers that distracts them from more productive work. Getting rid of it speedily—using whatever tactics available—is likely to be the least bad solution.

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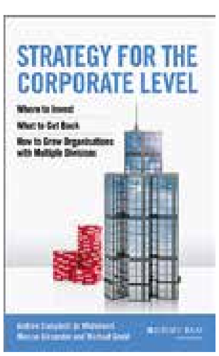
In each of these cases, leaders were able to make wise choices only by using all three logics together. By facing up to the conflicts among the logics, they were able to find tactics that enabled them to succeed. Financial analysis is an important aid to this process. It can help managers define how big a premium a company can afford to pay or how much value needs to be added to turn an unattractive business into one that offers good returns. But financial analysis cannot substitute for strategic judgments about the attractiveness of the business, the ability to add value, and the reasons for over- or undervaluations in the capital markets. It's these judgments that are critical to making good portfolio decisions.

1 There are 27 potential combinations of the three logics; we focus on a handful of the common ones here. Those interested in a more comprehensive description of how to deal with all different situations can visit corporatelevelstrategy.info.

2 As of June 11, 2014.

3 *HBR Blog Network*, "How the world's largest bakery puts execution before strategy," blog entry by Esteban García-Canal and Mauro F. Guillén, October 2, 2012, blogs.hbr.org.

4 Ming Dong et al., "Does investor misvaluation drive the takeover market?," *Journal of Finance*, April 2006, Volume 61, Number 2, pp. 725–62.



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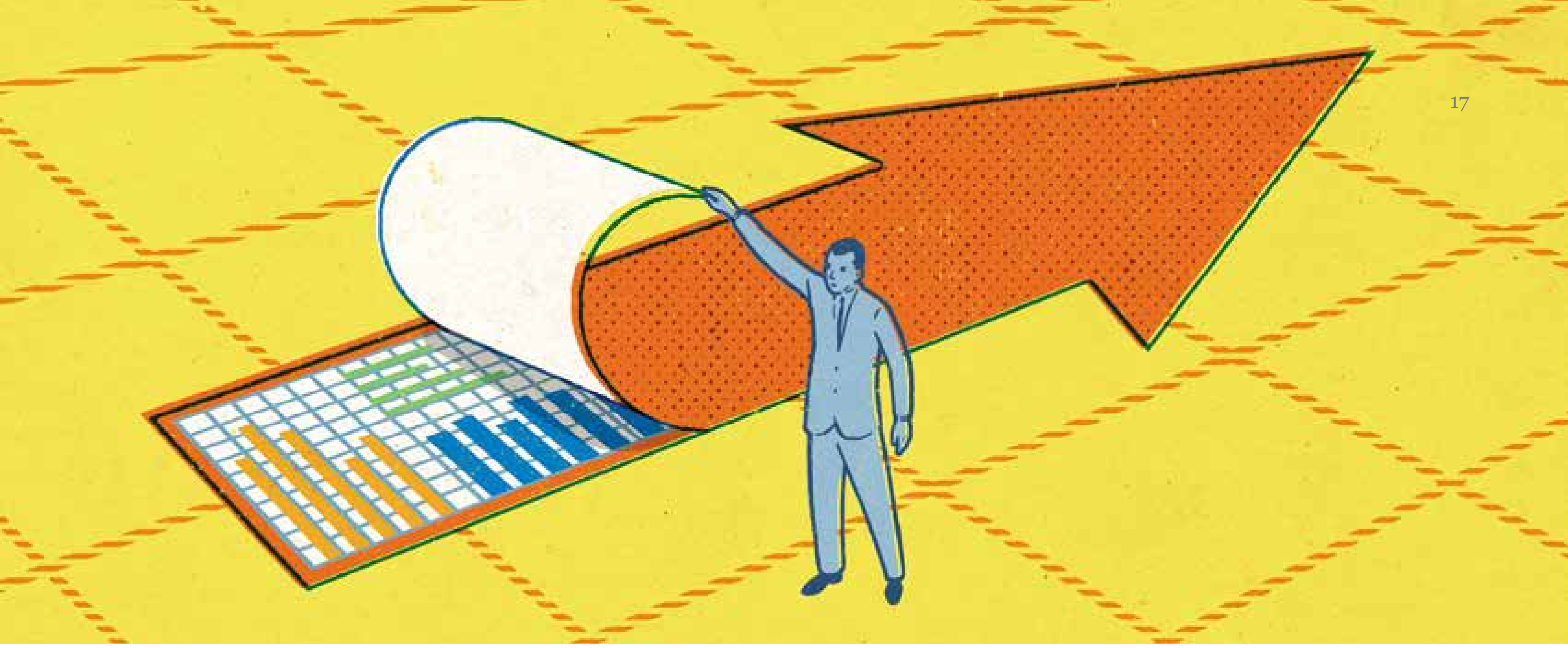


Uncovering cash and insights from working capital

Improving a company's management of working capital can generate cash and improve performance far beyond the finance department. Here's how.

Ryan Davies and David Merin

Managing a company's working capital[1] isn't the sexiest task. It's often painstakingly technical. It's hard to know how well a company is doing, even relative to peers; published financial data are too high level for precise benchmarking. And because working capital doesn't appear on the income statement, it doesn't directly affect earnings or operating profit—the measures that most commonly influence compensation. Although working capital management has long been a business-school staple, our research shows that performance is surprisingly variable, even among companies in the same industry (exhibit).

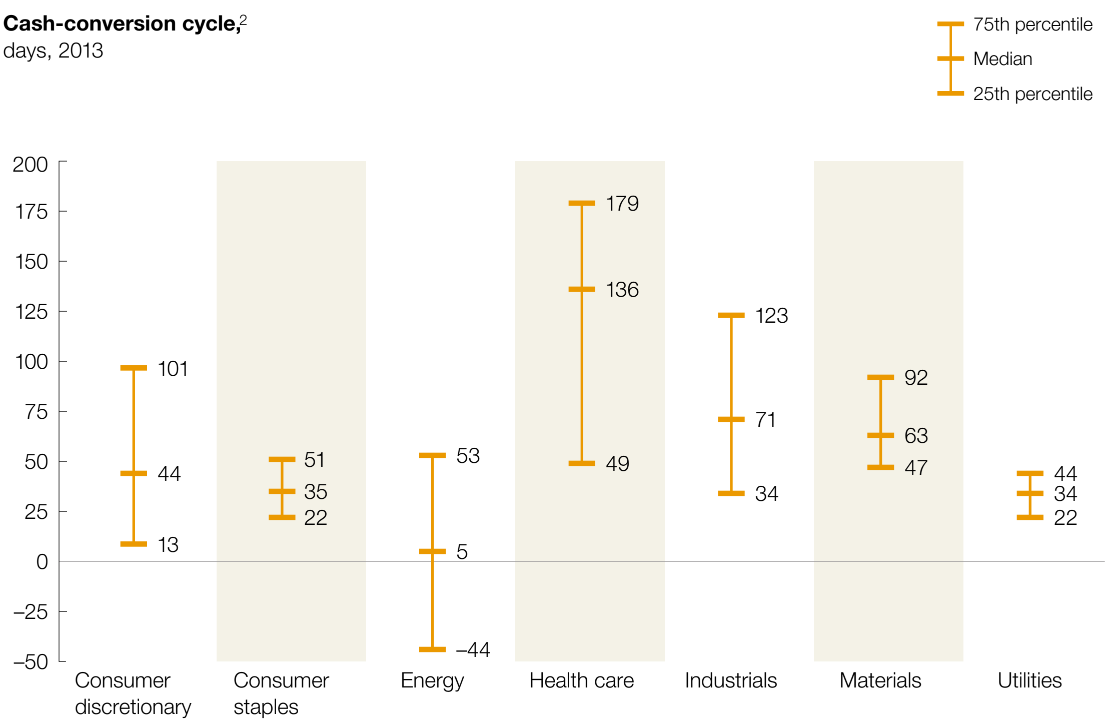
That's quite a missed opportunity—and it has implications beyond the finance department. Working capital can amount to as much as several months' worth of revenues, which isn't trivial. Improving its management can be a quick way to free up cash. We routinely see companies generate tens or even hundreds of millions of dollars of cash impact within 60 to 90 days, without increasing sales or cutting costs. And the rewards for persistence and dedication to continuous improvement can be lucrative. The global aluminum company Alcoa made working capital a priority in 2009 in response to the financial crisis and global economic downturn, and it recently celebrated its 17th straight quarter of year-on-year reduction in net working capital. Over that time, the company has reduced its net working capital cycle—the amount of time it takes to turn assets and liabilities into cash—by 23 days and unlocked $1.4 billion in cash.[2] For distressed companies, that kind of improvement can be a lifeline. For healthy companies, the windfall can often be reinvested in ways that more directly affect value creation, such as growth initiatives or increased balance-sheet flexibility. Moreover, the process of improving working capital can also highlight opportunities in other areas, such as operations, supply-chain management, procurement, sales, and finance.

Of course, not all reductions in working capital are beneficial. Too little inventory can disrupt operations. Stretching supplier payment terms can leak back in the form of higher prices, if not negotiated carefully, or unwittingly send a signal of distress to the market. But managers who are mindful of such pitfalls can still improve working capital by setting incentives that ensure visibility, collecting the right data, defining meaningful targets, and managing ongoing performance.

Exhibit

Needs of working capital differ by industry, but even within sectors performance varies widely.[1]

Cash-conversion cycle,[2]
days, 2013



[1] We also see significant variation within subsectors.
[2] The cash conversion cycle (CCC) measures the time—in days—that it takes for a company to convert resource inputs into cash flows. In other words, the CCC reflects the length of time it takes a company to sell inventory, collect receivables, and pay its bills.

Modify metrics to elevate visibility

Working capital is often undermanaged simply because of lack of awareness or attention. It may not be tracked or published in a way that is transparent and relevant to employees, or it may not be communicated as a priority. In particular, working capital is often underemphasized when the performance of a business—and of its managers—is evaluated primarily on income-statement measures such as earnings before interest, taxes, depreciation, and amortization (EBITDA) or earnings per share, which don't reflect changes in working capital.

What actions should managers take, beyond communicating that working capital is important? In our experience, the selection of metrics to manage the business and measure performance is especially important, because different metrics will lead to different outcomes. For one manufacturing company, switching from EBITDA to free cash flow as a primary measure of performance had an immediate effect; managers began to measure cash flow at the plant level and then distributed inventory metrics to frontline supervisors. As a result, inventories quickly fell as managers, for the first time, identified and debated issues such as the right level of stocks and coordination among plants.

A disadvantage of free cash flow as a metric is that it may promote shortsighted decisions or excessive risk taking, such as reducing inventory to dangerously low levels to hit an end-of-period target. Tracking capital charges instead offers a more balanced incentive.[3] For example, one engineering-services company added a capital charge for outstanding accounts receivable to the measure of account profitability it used to determine compensation levels for its sales force. That enabled account managers to better understand the real cost of working capital and see the rewards for what were sometimes painful calls to customers to collect late payments.

Collect the data

Many companies don't systematically track or report granular data on working capital. That almost always indicates an opportunity to improve. For example, if managers at a manufacturing company can't quickly determine how many days their current inventory will last at each location and stage of production—raw materials, work in progress, and finished goods—then they can't be managing it well. If they don't have readily available data on how much they spend with each supplier and their respective payment terms, then they aren't managing accounts payable closely. Moreover, without such data, they may also be making erroneous decisions elsewhere. For example, after an audit of accounts payable at one company uncovered missing items and duplications, managers realized that different parts of the organization had been contracting the same suppliers without coordinating the process centrally through the procurement function. As a result, procurement managers had underestimated how much the company overall was spending with some suppliers by as much as 90 percent and thus had missed an opportunity to negotiate better volume discounts and payment terms.

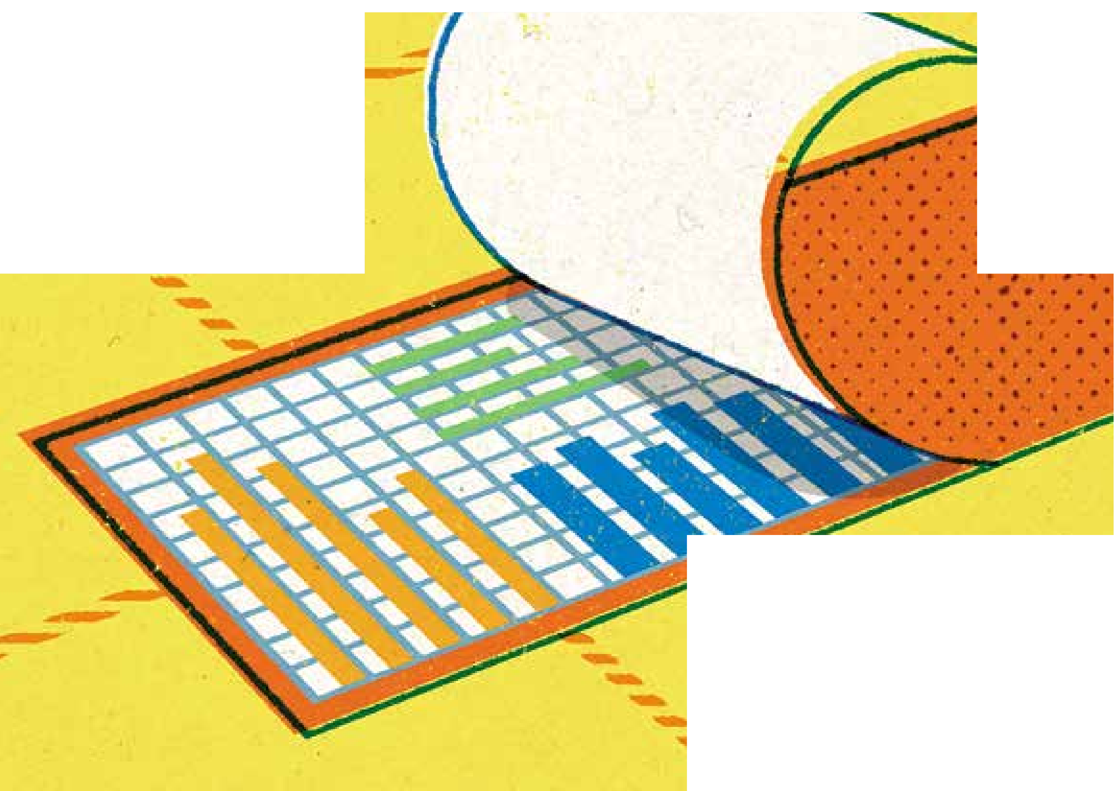
Getting such data into a consistent and usable format the first time can be tedious, drawing from multiple legacy systems or breaking inventory down by production stage. Repeating that process manually isn't practical—indeed, we've seen more than one company's efforts to improve working capital falter when the process of gathering the data was too demanding to execute on an ongoing basis. Ideally, managers should build data collection into their core IT processes. Those who can draw on a single integrated system to automate the process will have an easier time of it. But managers who clearly identify the kind of data they need and where to get it can do quite well with a standardized template built into an Excel spreadsheet, which takes much less work to fill in as the process becomes routine.

Set more meaningful targets

Even when data are available, managers often set performance targets that affect working capital in a less-than-analytical way. We've seen many inventory managers, for instance, create target levels based on gut feel rather than calculating stocks based on observed variability. And we commonly observe companies setting incremental goals for improvement—by a few days or a few percentage points over their previous year's performance.

More successful managers of working capital start by re-creating business processes as if there were no constraints and explicitly testing their assumptions—a so-called clean-sheet approach. For example, managers at a global manufacturing company had long held an average of 60 days' inventory of a critical raw material at a certain plant to ensure that disruptions to supply wouldn't affect production. When asked to improve that performance, they set an initial goal of cutting supply back to 50 days, a back-of-the-envelope improvement target arbitrarily based on their best performance in the past; they viewed this as quite aggressive.

In this case, that approach still would have left the company with unnecessarily high inventory levels, but without solid analysis, it could just as easily have been too aggressive. Fortunately, managers decided to test their assumptions using a clean-sheet approach. They calculated how



Insights from analysis of working capital can also be used to improve performance across a broad range of functions other than finance.

much inventory they would need in a perfect world if there were no variability in the process. Then they added a buffer based on actual variability they had observed in demand and supply. In the end, they determined that they only needed to keep 30 days' inventory. The 20-day gap between the incremental target and the clean-sheet target was worth tens of millions of dollars annually.

It's important to note that the finance function should not set these targets on its own. Rather, it should involve operations managers, who can also take the lead on improvement initiatives. In many cases, excess inventory is driven by specific operational issues—for example, low reliability in one stage of a multistep manufacturing process. Target setting should also be a collaborative process that involves procurement (for accounts payable) and sales (for accounts receivable); those functions typically bear most of the burden of implementing improvements to working capital that are related to payment terms and collection.

While the full range of specific analytical tools is beyond the scope of this article, managers can make considerable headway by focusing on those areas of working capital with the largest dollar values, estimating clean-sheet targets, and then focusing on those places with the largest gap between incremental and clean-sheet targets. Areas of opportunity will differ by business, but in our experience, many companies find value in each: inventory, accounts payable, and accounts receivable.

Maintain momentum

Once companies have the basic incentives, data, and targets in place, they can turn to more advanced techniques for working capital management, such as supplier financing (particularly when a company's cost of capital is lower than its suppliers') and vendor-managed inventory.
But many companies can wrest much of the value of working capital management just by maintaining the momentum of their baseline programs—to prevent them from eroding as time passes.
One pharmaceutical company, for example, substantially improved performance in this area in 2009 and 2010 but by 2013 saw it creep back to precrisis levels as other business priorities diverted attention. In our experience, just paying attention can prevent backsliding. Are the incentives having the desired effect? Is the focus on continuously improving? Can performance targets be even more aggressive? A periodic audit of inventory and accounts is also useful, especially for new accounts, where managers may have made policy exceptions to payment terms to attract customers or to inventory to earn discounts from suppliers.

Insights from analysis of working capital can also be used to improve performance across a broad range of functions other than finance. Inconsistent customer terms and conditions brought to light by programs to improve the management of working capital, for instance, could signal an even bigger opportunity in pricing. The supply-chain data needed to manage working capital can reveal waste and inefficiency. For example, once they were reviewing data from accounts payable, managers at one company realized they could combine cargoes of raw materials in a way that reduced shipping costs and allowed a smaller network of warehouses. Additionally, the process of calculating safety stocks can uncover underappreciated supply-chain risks and lead to the development of diversified supply options and other contingency plans.

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Working capital is important and often undermanaged. Improving its performance can generate cash to fund value-creating opportunities and reveal insights that improve other aspects of business performance.

[1] Defined as the cash companies have tied up between what they've purchased (inventory and accounts payable) and what they've sold (accounts receivable).

[2] For a summary of Alcoa's fourth-quarter 2013 investor presentation, see "Alcoa reports strong full-year 2013 profit up from 2012, excluding special items; Alcoa addresses legacy matters," January 9, 2014, alcoa.com.

[3] A capital charge would multiply working capital (for example, inventory or accounts receivable) by the company's cost of capital and be subtracted from operating profit. This is also known as economic profit. See Chris Bradley, Angus Dawson, and Sven Smit, "The strategic yardstick you can't afford to ignore," *McKinsey Quarterly*, October 2013, mckinsey.com.

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Business, society, and the future of capitalism

Unilever chief executive Paul Polman explains why capitalism must evolve, his company's efforts to change, and how business leaders are critical to solving intractable problems.

Paul Polman

Capitalism has served us enormously well. Yet while it has helped to reduce global poverty and expand access to health care and education, it has come at an enormous cost: unsustainable levels of public and private debt, excessive consumerism, and, frankly, too many people who are left behind. Any system that prevents large numbers of people from fully participating or excludes them altogether will ultimately be rejected. And that's what you see happening. People are asking, "What are we doing here? The amount of resources we currently use is 1.5 times the world's resource capacity. Is that sustainable? A billion people still go to bed hungry. Is that sustainable? The richest 85 people have the same wealth as the bottom 3.5 billion. Is that sustainable?" Digitization and the Internet have given consumers many different ways to connect and aggregate their voices. Power is dispersed, but wealth is concentrated. Further development and population growth will put a lot more pressure on our planet.

Capitalism needs to evolve, and that requires different types of leaders from what we've had before. Not better leaders, because every period has its own challenges, but leaders who are able to cope with today's challenges. Most of the leadership skills we talk about—integrity, humility, intelligence, hard work—will always be there. But some skills are becoming more important, such as the ability to focus on the long term, to be purpose driven, to think systemically, and to work much more transparently and effectively in partnerships. There are enormous challenges, but business leaders thrive on them and are well placed to solve them, as they also offer enormous opportunities. I often say it's too late to be a pessimist.

The new corporation

Business is here to serve society. We need to find a way to do so in a sustainable and more equitable way not only with resources but also with business models that are sustainable and generate reasonable returns. Take the issues of smallhold farming, food security, and deforestation. They often require ten-year plans to address. But if you're in a company like ours and you don't tackle these issues, you'll end up not being in business. We need to be part of the solution. Business simply can't be a bystander in a system that gives it life in the first place. We have to take responsibility, and that requires more long-term thinking about our business model.

In our effort to achieve that at Unilever, we first looked inward. We actually had a ten-year period of no growth, and that forces you to make your numbers or you're under pressure from your shareholders. You end up underinvesting in IT systems and training your people; your capital base erodes. And bit by bit, you become internally focused, think in the shorter term, and undertake activities that don't create long-term value. So how do you change that?

The first thing is mind-set. When I became chief executive, in 2009, I said, "We're going to double our turnover." People hadn't heard that message for a long time, and it helped them get back what I call their growth mind-set. You simply cannot save your way to prosperity. The second thing was about the way we should grow. We made it very clear that we needed to think differently about the use of resources and to develop a more inclusive growth model. So we created the Unilever Sustainable Living Plan, which basically says that we will double our turnover, reduce our absolute environmental impact, and increase our positive social impact.

Because it takes a longer-term model to address these issues, I decided we wouldn't give guidance anymore and would stop full reporting on a quarterly basis; we needed to remove the temptation to work only toward the next set of numbers. Our share price went down 8 percent when we announced the ending of guidance,

We have a unique opportunity to create a world that can eradicate poverty in a more sustainable and equitable way.

as many saw this as a precursor to more bad news. But that didn't bother me too much; my stance was that in the longer term, the company's true performance would be reflected in the share price anyway. Our final internal change was to alter the compensation system to bring in some incentives related to the long term. Ultimately, a year or so was needed to make it very clear internally that we were focused on the long term, on sustainable growth. To reinforce that message externally we focused our effort more on attracting the right longer-term shareholders to our share register.

The benefits of long-term thinking

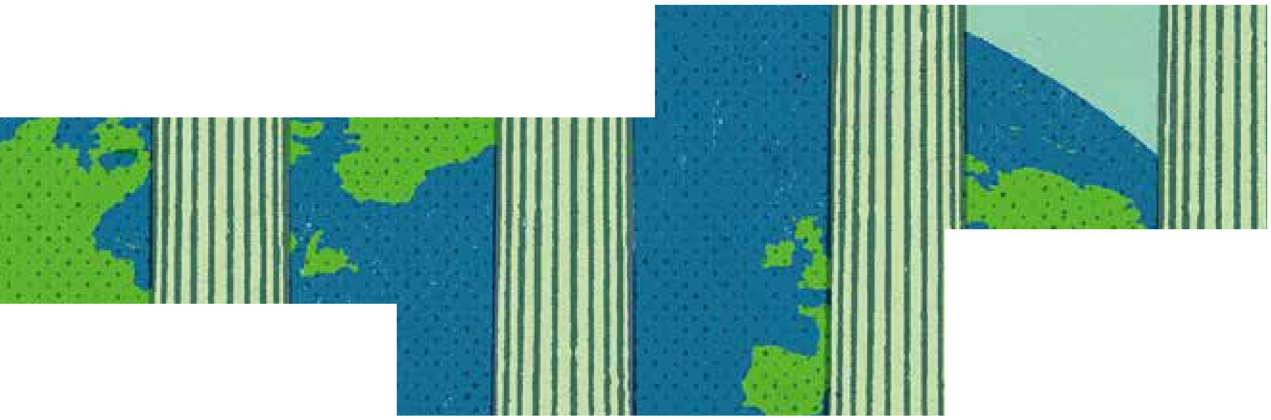
Thinking in the long term has removed enormous shackles from our organization. I really believe that's part of the strong success we've seen over the past five years. Better decisions are being made. We don't have discussions about whether to postpone the launch of a brand by a month or two or not to invest capital, even if investing is the right thing to do, because of quarterly commitments. We have moved to a more mature dialogue with our investor base about what strategic actions serve Unilever's best interests in the long term versus explaining short-term movements.

That's very motivational for our employees. We may not pay the same salaries as the financial sector, but our employee engagement and motivation have gone up enormously over the past four or five years. People are proud to work on something where they actually make a difference in life, and that is obviously the hallmark of a purpose-driven business model. We're getting more energy out of the organization, and that willingness to go the extra mile often makes the difference between a good company and a great one.

Let me be clear, though: a longer-term growth model doesn't mean underperforming in the short term. It absolutely doesn't need to involve compromises. If I say we have a ten-year plan, that doesn't mean "trust us and come back in ten years." It means delivering proof every year that we're making progress. We still have time-bound targets and hold people strictly accountable for them, but they are longer than quarterly targets. Often they require investments for one or two years before you see any return. For instance, one of our targets is creating new jobs for 500,000 additional small farmers. We had 1.5 million small farmers who directly depended on us, and we've already added about 200,000 more to that group. It's a long-term goal, but we still hold people accountable. The same is true for moving to sustainable sourcing or reaching millions with our efforts to improve their health and well-being. All of this is hardwired to our brands and all our growth drivers.

Convincing investors

When we reported on a quarterly basis, we often saw enormous volatility in our share price, which attracted short-term speculators. By abolishing full quarterly reporting of profit and loss, we took some of the volatility out. But moving to a longer-term focus required spending significant time reaching out to the right shareholders. Any company—certainly a company of our size—has thousands if not millions of shareholders, and they can have different objectives. Some want you to spin off businesses and get a quick return. Some want share buybacks, some want dividend increases, some want you to grow faster. It's very difficult to run a company if you try to meet the needs of all your shareholders. So we spent time identifying those we thought would feel comfortable with our longer-term growth model instead of catering to shorter-term interests.



We have seen our shareholder base shift. That's probably not happening as fast as we would have liked, but we are starting to see change as our results come in more consistently and we can provide more proof: several years of consistent top- and bottom-line progress, many years of consistent dividend increases, and so on. We're starting to attract more longer-term thinkers, who are sufficiently numerous to satisfy our business model. It's the same thing with consumers. Which consumers are you seeking? You cannot appeal to all of them; you decide which ones you want and then target those. Why not apply that same principle to your shareholder base?

It's not only corporate leaders who need to take a longer-term view of capitalism. Pension funds own 75 percent of the capital on US stock exchanges, representing companies like ours. These funds are actually there to guarantee longer-term returns for all of us when we eventually retire. They firmly believe in that mission, but many of them have activity systems that do not support it. They might offer quarterly incentives to their fund managers; they might employ short-term hedge funds and others, disturbing the normal economic process. It is increasingly clear now that a lot of this activity actually destroys more value than it builds.

A fund manager, like a company, needs to think, "How can I stimulate the right behavior? How can I have a more mature discussion? How can we look at other drivers so that we see we've got a model for longer-term returns?" I think we will all end up being in a better position than we otherwise would. At Unilever, we've looked at our own pension fund, with $17 billion of assets, and questioned whether it was invested according to our views on long-term capitalism. We are seeking to adhere to the responsible-investment principles that the UN Global Compact is championing. We have also issued our first "green bond" in consumer goods to galvanize change in the financial markets. We are talking to the growing group of high-net-worth individuals about putting their money to good use. More people are becoming more amenable to the argument than would have in the past.

A new business model

In the coming 15 years, we need to align on the new Millennium Development Goals.[1] We have a unique opportunity to create a world that can eradicate poverty in a more sustainable and equitable way. That is very motivational. Business needs to be part of it. Corporate social responsibility and philanthropy are very important, and I certainly don't want to belittle them. But if you want to exist as a company in the future, you have to go beyond that. You actually have to make a positive contribution. Business needs to step up to the plate.

Although some people might not like business or fail to understand that it needs to make a profit, they do understand that it has to play a key role in driving solutions. In the next ten years, I think you are going to see many more initiatives undertaken by groups of businesses to protect their long-term interests and the long-term interests of society. Governments will join these initiatives if they see business is committed. It is, however, becoming more difficult for governments to initiate such projects in the current political environment as long as we don't adjust our outdated governance model.

The Tropical Forest Alliance[2] is a good example of what can be done. If we keep going with deforestation, which accounts for 15 percent of global warming, our business model and, frankly, our whole society are at risk. On top of that, the consumer is saying, "I'm not going to buy products anymore created through deforestation." So industry got together and said that businesses need to use combined scale and impact to create a tipping point. The Consumer Goods Forum (representing $3 trillion in retail sales), which we helped to create, is one of these coalitions of the biggest manufacturers and retailers. When it said, "By 2020, we're not going to sell any more products from illegal deforestation, whether soy, beef, pulp, paper, or palm oil," that sent an enormous signal across the total value chain and generated action on the supplier side. Governments are now joining. We're actually close to a tipping point to address these issues. That is the new world we have to learn to live in.

[1] A set of eight goals adopted by world leaders at the United Nations' Millennium Summit in 2000, with the aim of addressing major global issues, such as poverty, sustainability, and education. Leaders agreed on set targets to be met for each priority as early as 2015.

[2] A public–private partnership created by the US government and The Consumer Goods Forum to decrease tropical deforestation undertaken to source commodities, such as palm oil and soy. The alliance now consists of multiple nongovernmental organizations and national governments, including those of the Netherlands, Norway, and the United Kingdom.

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