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The artful synergist, or how to get more value from mergers and acquisitions

Keeping your deal team small ensures confidentiality, but pinpointing synergies requires bringing more people on board. Here's how to strike the right balance.

Jeff Rudnicki, Ryan Thorpe, and Andy West

Making sure that large M&A deals create value is as much about knowing whom to involve—and when—as it is about knowing how to capture synergies.[1] The larger the deal, the more critical the need to ensure confidentiality by keeping the team small during the early stages of planning. Such teams may lack breadth, but they're sufficient to produce a rough valuation that allows planning to move ahead.

As planning progresses, more people eventually have to be involved. But many M&A practitioners make the mistake of clinging to too small a team late into the due-diligence stages of a deal. This overly conservative mind-set creates problems, leaving deal planners to perform their roles in isolation. Without others to challenge assumptions and cognitive biases,[2] the planners' synergy estimates, performance benchmarks, and cost and revenue targets can be off the mark. High-priority issues and complex integration challenges can get lumped together indiscriminately with lower-priority and simply managed ones—creating an adversarial, political, and highly emotional working environment. Business managers complain that their synergy targets are too high—when in fact, they often prove to be too low. And companies lose precious time as those tasked with implementing a deal try to reconstruct the expectations of those who planned it. That often squanders internal goodwill, organizational buy-in, and even hard cash.

A more inclusive approach to estimating synergies can create more value and promote a culture of shared accountability and buy-in. But pulling more people into the process requires an artful balance of often-contradictory objectives. Managers must promote both transparency and confidentiality, as well as embrace both skepticism and a shared vision, all while keeping a ruthless focus on efficiency.

A more inclusive approach to estimating synergies

As smart as many executives are about keeping their M&A teams small in the beginning,[3] they make the wrong trade-off as they get deeper into the diligence process. As a result, they lay out a framework for integration and develop synergy estimates based on the insights of a small, isolated team—without the buy-in they need from critical stakeholders. These include not just the executives who will carry the heaviest burden of integration execution but also the full complement of a CEO's direct reports.

In our experience, the diligence process can't happen in a vacuum. Synergies vary from deal to deal. Even a straightforward synergy target for general and administrative costs can vary significantly depending on the current state, the assumptions, and the appetite for change. Some functions, such as IT systems or human resources, can enable, delay, or completely prevent other functions from integrating, which renders synergy estimates meaningless. And functional leaders are often wary of committing to performance and budget targets they haven't seen before. Imagine the pushback from a manager at one acquirer when he learned he'd be expected to absorb a 40 percent cut in staffing—instead of adding people, as he had expected, given the complexity of the transaction.

Involving functional-group managers on a deal-specific basis can help, especially when framing the cost and revenue assumptions behind the valuation model for due diligence. These managers can help articulate the risks of cutting too deeply or too quickly, for example, or identify opportunities to build on an existing transformation program. And getting their input early on can create a shared understanding of the final synergy targets—even setting a higher cognitive anchor for them.

Such dialogue needn't take a lot of time. A few targeted conversations and a straightforward information request made over the course of a few short days can dramatically increase the level of insight. That was the case for one acquirer when it sought to buy a business in a deal that included transitional service agreements with its former parent. The acquiring company's CIO helped the M&A diligence team review the transition timelines, which shed important light on the associated costs and risks of the service agreements. Bringing the CIO into the process allowed her to get a head start on integration planning, which is critical for systems that enable synergies elsewhere. It also helped her accept the final synergy targets, even though they were higher than for other functions. Moreover, the dialogue between the CIO and the team revealed that the baseline costs of the transitional service agreements were unreasonably high—and the synergies could be higher if the business quickly transitioned to the acquirer's systems.

Many managers we've talked with find such dialogue so successful that they use it for all large deals, bringing most, if not all, top leaders into parts of the diligence discussion. Even for smaller deals, the company typically includes some subset of top

We have found it is possible to be both transparent and confidential.

leadership to validate costs and deal assumptions and to pressure-test risks.

Balancing competing objectives

The advantages of a more inclusive team doesn't mean extending an invitation to a cast of thousands. But it does come with risks—especially for larger deals. Not only is maintaining confidentiality more difficult, but larger teams also tend to move more slowly and are more likely to include skeptics who challenge a deal's strategic rationale. Balancing these interests tests managers' cleverness in finding the overlap between seemingly exclusive objectives.

Transparency and confidentiality

We have found it is possible to be both transparent and confidential. For example, the CEO of one serial acquirer balanced the two interests this way. First, she expressed a very clear perspective on the importance of large deals and the appropriate role of executives in evaluating those deals—creating a time and place for open dialogue and promoting explicit challenges to a deal's rationale. But then she made it clear that once a decision was made, everyone was expected to champion it.

As a result, the members of the executive team understood and respected their roles. They knew they would be engaged, and when, and they didn't second-guess the process. This engendered a sense of trust that they would be aware of all important M&A efforts and would have a chance to react to potential deals before any became final. Their trust was affirmed over time, with each potential deal forming the basis for confidential discourse. Finally, the CEO herself stressed confidentiality. She chose a core M&A team she trusted. But she also established explicit repercussions for leaking. In one instance, a senior executive was let go after it became clear he was disclosing information about potential deals in the works to people throughout the organization.

Skepticism within a shared vision

In our experience, few deals ever achieve a shared vision among the executive team. But proceeding without one can be destructive. Three months after the close of one recent deal, one senior executive launched an attack on his synergy target while explaining a shortfall in planned savings. Such exchanges were commonplace across the executive team. Later, the executive explained that the deal should never have been done in the first place and that he was worried about his career prospects after being involved in such a bungled deal.

For large deals, it is the CEO's job alone to ensure that his or her executive team has a shared vision for the deal. This sounds simple, but in most deals, we have observed at least several direct reports to the CEO remaining skeptical throughout. The CEO must sell his or her direct reports on the strategic merits of a deal, through conversation—often one-on-one—and through participation. There is no other way to form a productive team that will capture all the value possible from a deal. For smaller deals, similar obligations fall to division and business-unit heads.

Productive teams will challenge aspects of the deal, such as strategic fit and synergies. But they do so with a mind-set of trying to make the deal work and creating the best possible outcome. With that mind-set, even the most stubborn skeptics can actually help bring about a better outcome.
We have observed a sort of peer pressure at play in these situations, in which dedicated leaders help reinforce commitment among one another and among lower layers in the organization. CEOs can encourage this mind-set by surrounding themselves with those with diverse business backgrounds and by promoting contrarian thinking and risk taking, often leading by example.

Building efficient M&A processes

The best acquisitions aren't the ones that close the fastest, but rather those in which the leadership team comes together to create the greatest amount of value. That takes time. To allow that time, a company must have ruthlessly efficient M&A processes.

To be efficient, companies must have a robust finance function with a transparent view into its own cost structure, the better to quickly interpret and categorize a target's costs. In one recent merger, for example, financial planning was led by two capable and respected executives, who in only three weeks managed to build a comprehensive and detailed combined baseline of performance across the two companies. Because they worked with executives across both companies to make sure they agreed with the baseline, the acquiring CFO was able to present synergy and financial targets for a dozen or so areas of the company less than a month into integration planning, three months before the deal closed.

This proactive approach allowed the leaders of each organization to apply their energies toward creating the leanest and most efficient organization they could, rather than iterating and debating the fact base and targets. The result was a process that was among the most efficient we have ever seen and that encouraged collaborative work across both organizations. We ultimately credit the acquiring CFO, who decided to invest in the right finance professionals to lead this effort.

Efficient M&A teams should also be able to learn from each deal. No set of best practices will ever replace the feel that great executives have for getting a deal done and getting value from it. This means an executive team must come together and review *how* past deals were done, not just *how much* they earned. And they must learn what others involved in the deal did, once that information can be shared freely.

■ ■ ■

Taking a more inclusive approach to deal making won't eliminate tension from your company's large M&A deals, and it won't turn a bad acquisition into a good one. What it will do is create the conditions in which your management team can artfully build a good deal into a great one. ■

[1] Our focus is on large deals (more than 30 percent of the acquirer's size by revenues or market cap). Smaller deals are often different because they don't affect most areas of the business, are often focused entirely—or not at all— on cost cutting, and lack the leadership and organizational challenges of large deals.
[2] See, for example, Tim Koller, Dan Lovallo, and Zane Williams, "Overcoming a bias against risk," August 2012, McKinsey.com.
[3] Patrick Beitel and Werner Rehm, "M&A teams: When small is beautiful," January 2010, McKinsey.com.

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M&A 2016:
Deal makers catch their breath

In a year marked by smaller acquisitions and higher prices, cash deals came out on top.

Cristina Ferrer and Andy West

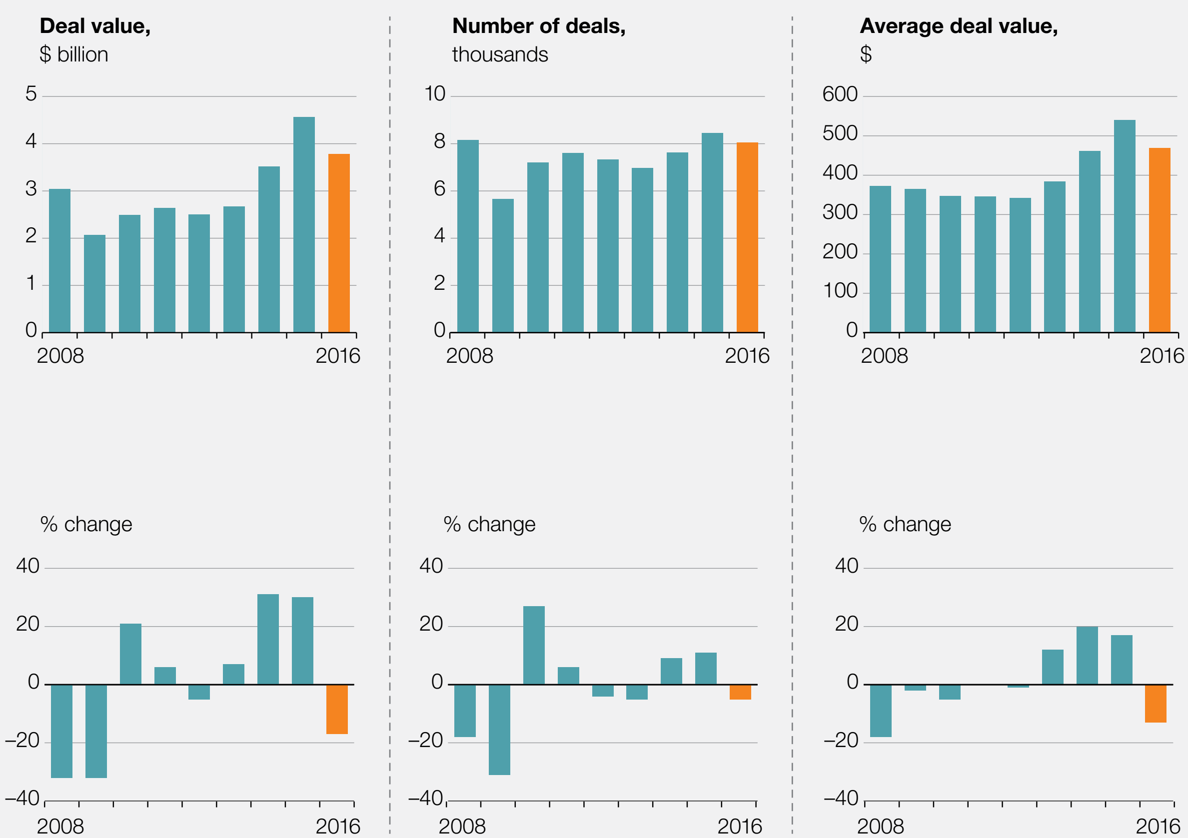
Deal activity slowed in 2016, after four years of rapid growth, as companies retreated to smaller deals. At the same time, excess cash and pressure for growth pushed deal prices higher, even as economic and political uncertainty grew. The contribution of megadeals—which had pushed the market to new highs in recent years[1]—declined by 40 percent.

Those are the highlights of deal making in 2016, according to our analysis of 8,057 deals announced[2] globally and valued at more than $25 million (Exhibit 1). Specifically, the absolute number of deals fell in 2016, by around 5 percent below the year before. But the total value of deals fell by more than 17 percent from the year before—falling below the 20-year average as a percent of global market capitalization. Much of that decline can be attributed to a sharp reversal in the combined value of megadeals—those valued at more than $10 billion. Their share of global M&A activity fell by 40 percent, from around a third in 2015 to less than a quarter in 2016. It is important to note, however, that despite this drop, deal making in 2016 remained at one of its highest levels of the past ten years.

One bright spot of deal activity was cross-regional M&A, which went up by nearly 20 percent even as cross-border and domestic activity fell by 28 percent and 24 percent, respectively. Most of the increase in cross-regional M&A came from investors in Asia acquiring companies in Europe, up 111 percent when measured by deal value, and in the United States, up nearly 80 percent (Exhibit 2). By industry, the largest two sectors—industrials and telecom, media, and technology—represented a third of activity for the year. Healthcare dropped from the second-busiest sector in 2015 to the sixtieth busiest in 2016, with a 60 percent decline in combined deal value. The only two sectors that grew in absolute terms were transportation and logistics, up from $285 billion in 2015 to $368 billion in 2016, and energy and utilities, up from $217 billion to $272 billion.

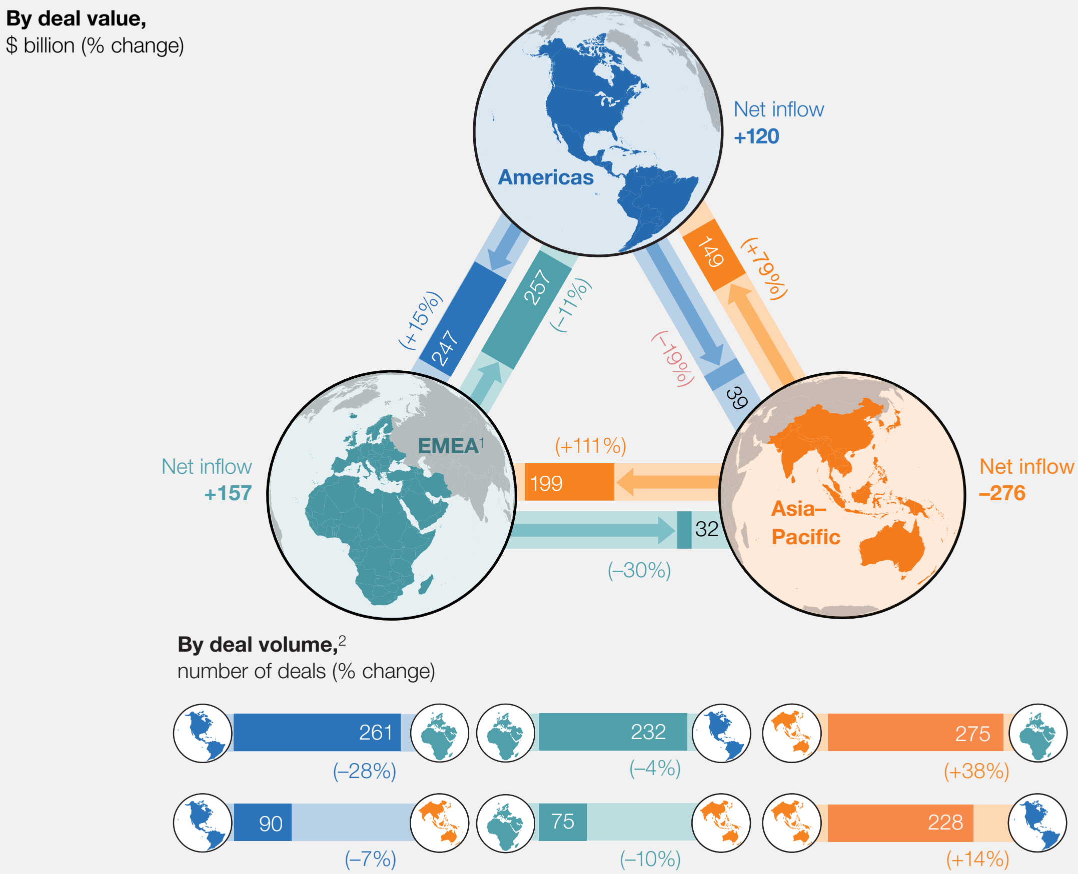
Finally, investors appear to be losing the enthusiasm that had pushed deal value into the double digits in the early years of the decade.[3] After hovering above 12 percent from 2010 to 2014, our deal-value-added[4] (DVA) index dropped below 10 percent in 2015, and again to around 8 percent in 2016. That's still well above the long-term average (Exhibit 3), and consistent with a second year of increased deal premiums (Exhibit 4). Pure stock deals were especially affected, with the average DVA dropping from 3.6 percent in 2015

Exhibit 1 **Global M&A activity in announced deals declined overall in 2016.**



Note: Includes deals >$25 million in deal value only.
Source: Dealogic

Exhibit 2 **Most of the increase in cross-regional M&A came from investors in Asia acquiring companies in Europe and the United States.**



[1] Europe, Middle East, and Africa.
[2] Includes deals >$25 million in deal value only.

Source: Dealogic

to –0.9 percent in 2016. The DVA for all-cash deals remained strong, falling only slightly during 2015, from 18.3 percent to 17.4 percent. ■

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[1] Werner Rehm and Andy West, "M&A 2015: New highs, and a new tone," December 2015, McKinsey.com.
[2] Excluding deals that were subsequently withdrawn.
[3] David Cogman and Carsten Buch Siversten, "A return to deal making in 2010," January 2011, McKinsey.com.
[4] For M&A involving publicly traded companies; defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from two days prior to two days after announcement, as percent of transaction value.

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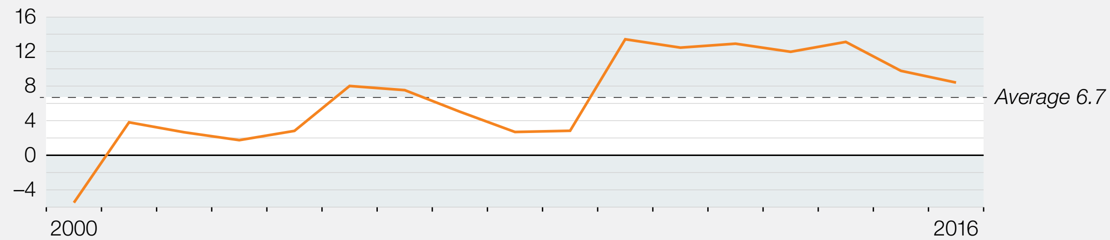
Exhibit 3 **Deal value for deals greater than $25 million fell again in 2016.**

Average deal value added (DVA),[1] index, %

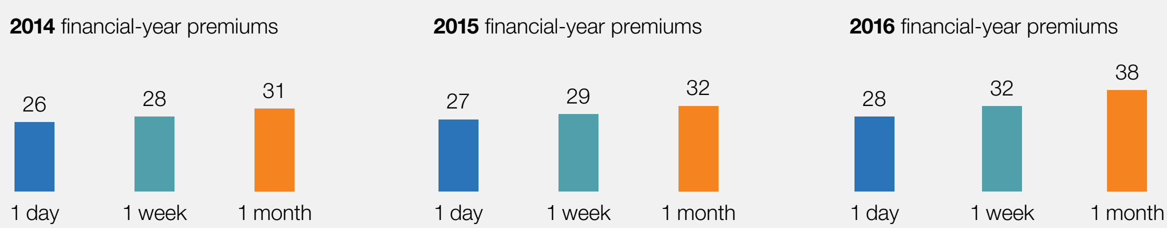


[1] For M&A involving publicly traded companies; defined as combined (acquirer and target) change in market capitalization, adjusted for market movements, from 2 days prior to 2 days after announcement, as % of transaction value. Includes only deals valued >$500 million and at least 5% of the acquiring company's market capitalization.

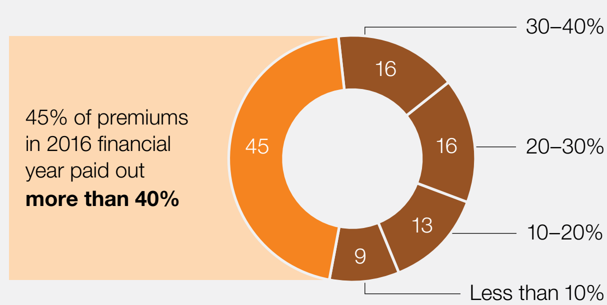
Source: Datastream; Dealogic; McKinsey analysis

Exhibit 4 **Acquisition premiums increased relative to the past two years.**

Median premium paid in 2014–16, %

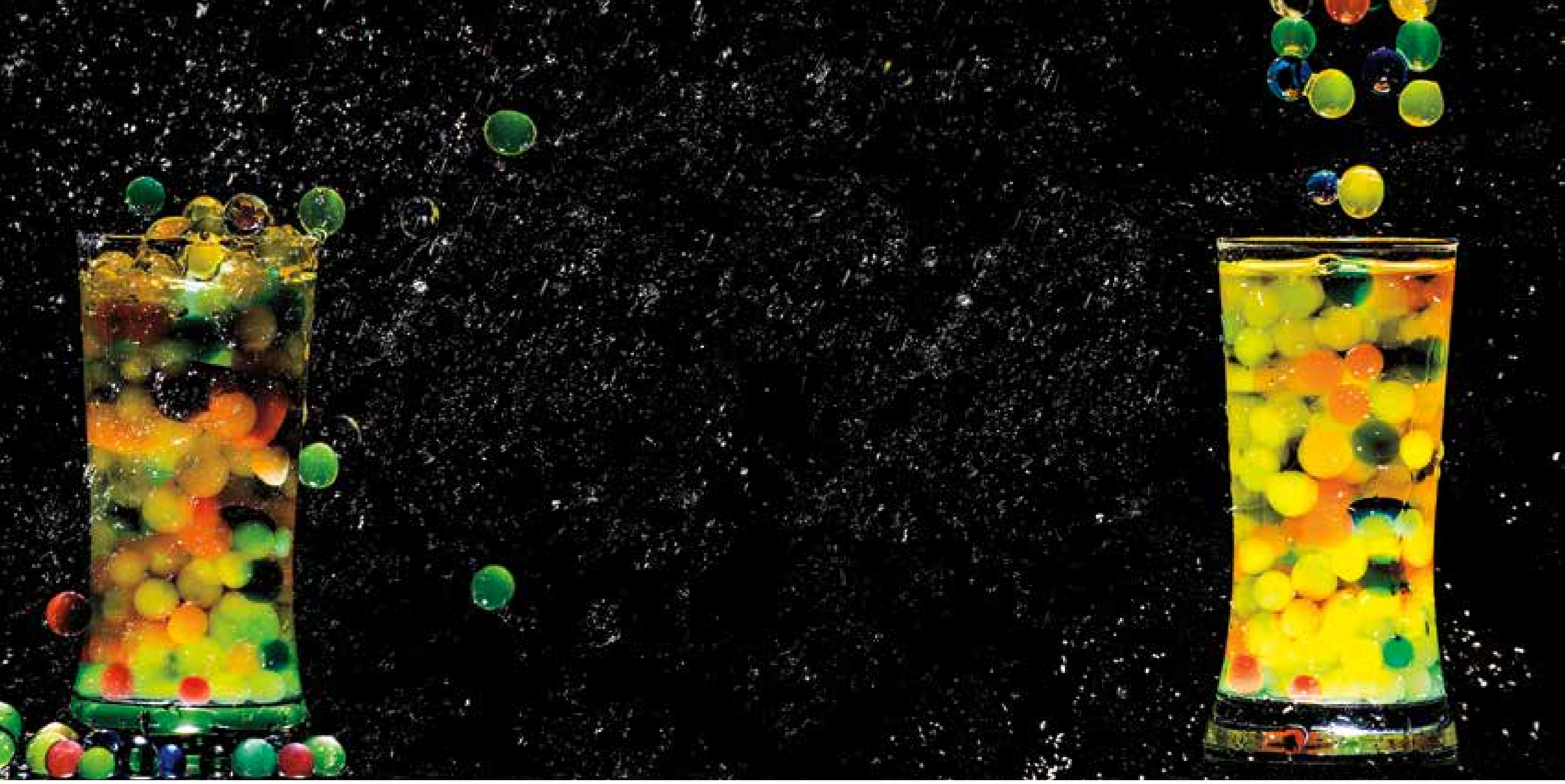


Distribution of 1-month premiums for 2016 financial year, %



Note: Based on selected deals announced in 2016, n = 371. Only includes 100% acquisitions, excludes negative premiums and deals where target price was clearly affected by rumors, etc.

Source: Dealogic



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The finer points of linking resource allocation to value creation

According to new survey results, exploring the more subjective side of investment decision making yields five elements that correlate closely with outperformance.

Tim Koller, Dan Lovallo, and Zane Williams

The way companies allocate resources and make investment decisions is critical to their ability to create shareholder value. Our past work has focused on the pervasive problems of biases and inertia in resource allocation—and found that when these challenges are overcome, companies can see a lot of value as a result.[1] But there has been far less investigation of the more practical side of investment decision making: the very tactical practices companies use to reach their decisions, such as the steps they take to provide decision makers with the information they need and how they sequence their strategic-planning activities.

A recent McKinsey Global Survey set out to explore these issues.[2] When we asked executives about their companies' decision-making processes and their performance relative to peers, the results led us to identify four practices that correlate closely with outperformance: tying budgets to corporate strategy, making evidence-based decisions, setting bottom-up performance goals, and formally ranking investments. We also found a correlation between portfolio composition and performance: specifically, the companies where business units have similar financial characteristics (such as growth and return on capital) tend to outperform companies where business units have different traits. What's more, executives who say all five elements are at work in their companies are as much as four times likelier than others to report outperforming their competitors.[3]

Tying budgets to strategic plans

For all the time managers spend developing their companies' strategic plans, they don't always succeed at reflecting those strategic priorities in subsequent budgeting decisions. For example, a company's strategic plan may call for increasing or reallocating R&D spending. But when management puts together an annual budget, it may cut back on the R&D spending to meet a short-term earnings target. Among respondents, only about 30 percent say their current budgets in various areas—capital expenditures, product development, product launches, geographic expansion, and spending on sales and marketing—are similar or very similar to their companies' most recent strategic plans.

In our analysis of allocation practices that link to outperformance, tying budgets to strategic plans correlates more closely with higher growth and profitability than any of the other practices we identified. Respondents with a 75th-percentile score for tying budgets to strategy are 53 percent more likely than those in the 25th percentile to say their companies are growing faster than competitors. In addition, they are 29 percent more likely to describe their companies as more profitable than competitors.

Evidence-based decision making

When deliberating over investment and other strategic decisions, managers have many practices at their disposal to ensure sound decision making: presentation of information that contradicts leaders' views, for example, and explicit discussions of the range of potential outcomes. Only 60 percent of respondents agree that decision makers explicitly discuss uncertainties when making resource-allocation decisions. And only 41 percent agree that their companies consider a range of potential outcomes or scenarios for a given investment.

When asked which specific techniques their companies' managers use to improve decision making, the largest share of respondents, 59 percent, cite scenario analysis. But no more than one-third cite any of 12 other commonly referenced checks on biases, such as pre-mortems, postmortems, and explicit meeting rules.[4]

Nevertheless, the results suggest that the use of such techniques can lead to better performance. Respondents whose companies make the most use of evidence-based decision making are 36 percent likelier than their peers whose companies don't use these techniques to report growing faster than competitors. And they are 22 percent more likely to say their companies are more profitable.

Setting bottom-up performance goals

How executives characterize their companies' approaches to setting performance targets, either top down or bottom up, may be a matter of interpretation. Compared with their C-level peers, business-unit heads are likelier to report that their company-wide targets are set from the top down. The results also indicate that larger companies tend to use more top-down target setting than smaller ones do—which we found surprising, given the complexity and diversity of larger companies. But it may be that large companies are more top down oriented to simplify their target-setting processes.

Contrary to what larger companies tend to do, we found that bottom-up target setting is the approach that correlates more closely with strong performance. Respondents whose companies do more bottom-up target setting are 26 percent likelier than those struggling with it to agree that their companies are growing faster than competitors. They're also 18 percent more likely than their peers to say their companies have a reputation for attracting world-class talent.

Formally ranking investments

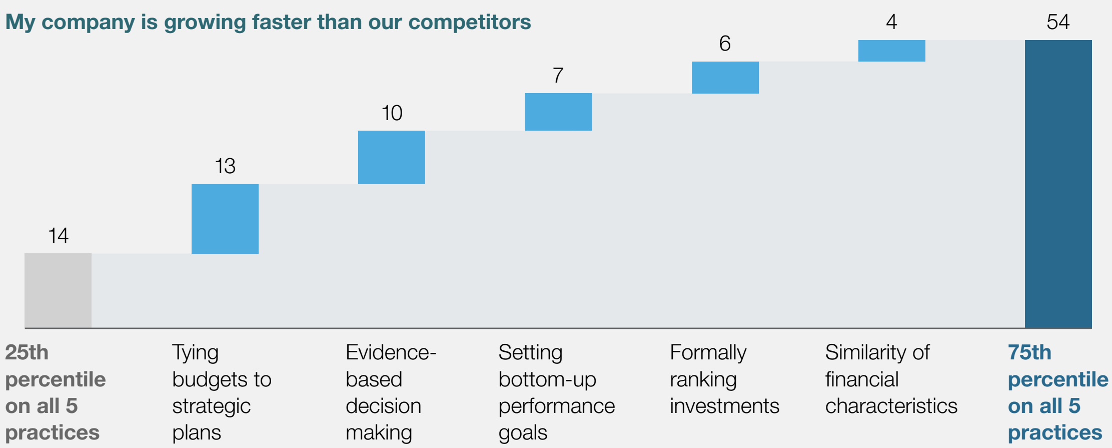
When evaluating which opportunities most warrant an investment of resources, many executives report that their companies formally or explicitly rank potential investments—another marker of strong performance. Nearly two-thirds report company-wide rankings of capital expenditures, and more than half say the same for product-development and sales-and-marketing investments.

Exhibit

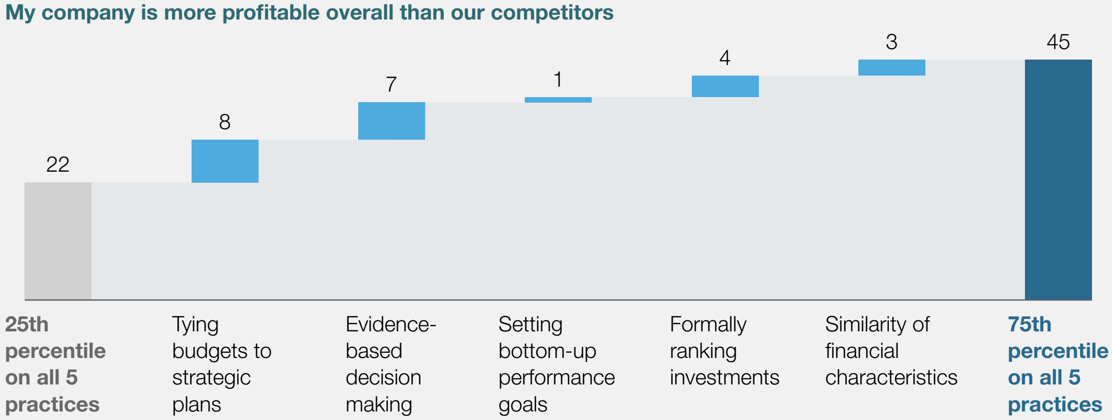
The cumulative effect of five key allocation practices exceeds each one's individual impact.

% increase in likelihood of respondents agreeing or strongly agreeing with each statement, comparing bottom- and top-quartile companies for given practice[1]

My company is growing faster than our competitors



My company is more profitable overall than our competitors



[1] Respondents who answered "somewhat agree," "neutral," "somewhat disagree," "disagree," "strongly disagree," or "don't know" when asked to rate their companies' performance were not included in this analysis.

At companies that rank highest at setting priorities for high-value investments, respondents are 20 percent likelier than their peers who rank the lowest to report faster growth than competitors.

It is notable that responses vary by a company's level of complexity. About two-thirds of respondents in the least complex companies (that is, those with three or fewer business units) say their companies rank their marketing investments. By contrast, only 36 percent of those at the most complex companies (those with more than 15 business units) say the same.

Similarity of financial characteristics

Finally, a company is likelier to outperform when its business units share characteristics of financial performance, such as similar revenue levels, profit margins, and returns on either capital or equity. Companies tend to have a harder time managing businesses that are growing at different speeds or levels within the same portfolio.

Indeed, respondents at companies in the top quartile of our similar-characteristics factor are more likely than those in the bottom quartile to agree that their companies are growing faster and seeing greater profitability than competitors. In addition to similar financial characteristics, we also tested for the degree of relatedness—that is, similar customers, distribution systems, technology, and manufacturing—across divisions' assets. Relatedness emerged as a factor in its own right, but it had only a marginal effect on performance when a company doesn't also have similar financial characteristics in place.

The five factors' cumulative effects

Individually, each of the five factors—the four practices and the similarity of business-unit performance—has a significant impact on profitability and growth. When combined, the factors are even more powerful (exhibit). At the companies ranking low on all five factors, only 14 percent of respondents say their companies are growing faster than competitors; at the companies that rank high for all five, 54 percent report higher growth. The results are similar for profitability: 22 percent of executives at companies ranking low on the factors say their profits exceed competitors', compared with 45 percent who say the same at companies ranking high on all five.

Looking ahead

The survey results themselves clearly suggest how managers and their companies might improve their resource allocation and investment decision making. And while managers should take steps to implement all five factors that contribute to overall value, the following may be the easiest to implement in the short term:

- *Collaborate to set performance targets.* Although bottom-up target setting correlates with stronger performance in the survey, we suspect that the best practice lies at neither of the extremes. Top-down targets can be arbitrary because they sometimes don't take into consideration the market conditions that each unit faces. Targets set using a purely bottom-up approach are susceptible to sandbagging by the business units. Ideally, executives at headquarters (or the corporate center) will have enough information on an individual unit's prospects to work with its leaders and tailor each unit's performance targets. To get there, some companies need to strengthen the capabilities of their corporate centers, so their executives can work more thoughtfully with business units on target setting and ensure that it's a collaborative process.

- *Ensure comparable project valuation.* Although managers often already rank investment opportunities across their entire companies, too many do not. This is often true when business units use different assumptions when valuing their projects, when they neglect to consider the network effects of valuation under different scenarios, or when project proposals overstate the expected internal rate of return in order to ensure funding. The more that companies ensure comparable valuation, the more likely—and able—they are to meaningfully rank opportunities and allocate resources to those with the highest potential payoff.

- *Explicitly review financial characteristics.* We know from prior research that companies that reallocate resources typically outperform companies with more static resource allocation. One characteristic that is often overlooked as companies examine their portfolio of businesses is the similarity of financial performance—which our survey identified as critical. Companies should add this to the variables they consider when shaping their portfolios of businesses. ■

[1] Tim Koller, Dan Lovallo, and Zane Williams, "A bias against investment?," September 2011, McKinsey.com; Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," March 2012, McKinsey.com; and Yuval Atsmon, "How nimble resource allocation can double your company's value," August 2016, McKinsey.com.

[2] The online survey was in the field from April 12 to April 22, 2016, and received responses from 1,271 executives representing the full range of regions, industries, company sizes, and functional specialties. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[3] We asked respondents a series of questions about their companies' decision-making processes, such as whether they set financial targets bottom up or top down, and assessments of their companies' performance relative to peers. We then used a statistical technique called factor analysis to identify groups of variables that drove performance. All differences noted between responses from 25th-percentile companies and 75th-percentile companies are statistically significant.

[4] We define "pre-mortems" as an analysis of what can go wrong or right before the project is under way and "postmortems" as an analysis of what went wrong or right after the project was completed. "Explicit rules for meetings" could include getting all ideas onto the table before discussing and/or the CEO expressing his or her opinion after everyone else on the management team or group has done so.

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Taking conservation finance to scale

Environmental projects are woefully underfunded. Improving their risk-return profiles and structuring larger investment products could unlock private capital to narrow the gap.

Ryan Davies, Hauke Engel, Jürg Käppeli, and Todd Wintner

Environmental-conservation projects face a dramatic shortage of funds. Estimates indicate that $300 billion to $400 billion is needed each year to preserve and restore ecosystems but that conservation projects receive just $52 billion, mostly from public and philanthropic sources.[1] Some asset managers and conservation experts have suggested that private investors could close more than half the gap by profitably funding enterprises or projects in areas such as sustainable food and fiber production, habitat protection, and water quality and conservation.[2]

This is an attractive prospect—except that conservation can be a slow and risky business. It can take decades to realize, verify, and capitalize on conservation benefits; only the most patient investors will wait that long. Some projects are derived from compelling but unproven concepts that investors are understandably reluctant to back. Many more are based on proven concepts yet still operate in challenging circumstances and generate unreliable revenues. We routinely hear about conservation projects for which the investment risks and expected returns are misaligned: imagine an equity investment for which the level of risk is comparable to venture capital but the returns are closer to those of a stake in a successful, established company.

These conditions make it hard for project developers and fund managers to attract private capital. The good news, though, is that developers and fund managers have techniques at their disposal for creating projects with the size, stability, and potential that mainstream investors seek. Here we look at some problems that discourage private investment in conservation and offer our ideas for how to overcome them.

Acknowledging the challenges in conservation

Conservation finance faces certain problems that affect the wider impact-investing market, of which it is a segment. These problems include a lack of widely accepted standards for measuring impact, a shortage of financial-management experience among project developers, the high transaction costs of investing in small projects, and an abundance of early-stage project concepts that are too speculative to interest all but the most risk-tolerant investors.

Three big challenges have more to do with the specific traits of conservation. The first of these challenges is generating sizable cash flows shortly after a project begins. Some projects only start producing cash flows after years of investment. Others have benefits that are hard to monetize, such as the economic gains that come from preserving biodiversity or from mitigating the risk of future losses. Preserving and rebuilding coastal wetlands, barrier islands, and oyster reefs, for example, can reduce damage from storms. When many parties benefit from a restoration project, though, it can be hard to get some of them to fund the project up front or to pay for the services it provides.

The second challenge is the inherent complexity and unpredictability of natural systems. Even with sophisticated scientific knowledge, it can be difficult to predict the conservation outcomes from managing a natural system in a particular way. This matters because natural systems impose variability on business activities, such as food and fiber production, that depend on those systems. As a result, revenues from conservation projects can be uncertain, whether those revenues are linked to conservation outcomes or to sales of goods and services.

The third challenge is the multifaceted nature of many questions related to land use, particularly its objectives and its governance. Settling these questions requires relevant specialists—ecologists, project managers, lawyers, public-policy analysts, government officials—to agree on the conservation principles for a project. This can be difficult. Most conservation projects depend on certain uses of land or water, which are scarce resources that might be used in multiple ways. Pursuing optimal conservation outcomes can be politically unpopular, preclude other socially beneficial uses of the land, or generate less profit than other uses (for instance, agriculture, resource extraction, or real-estate development practiced with conservation as a low priority).

Many projects are subject to further risks because many stakeholders (government at multiple levels, local communities, and private-land owners, to name a few) impose constraints that can overlap or even conflict. In some countries, national, regional, and local authorities each have jurisdiction over different aspects of how a piece of land is used. And if a project depends on policy mechanisms such as carbon prices to generate income, the possibility that those policy mechanisms will change creates more risk.

How conservation can attract more private investment

Project developers and fund managers can take the lead on several actions that will help attract private capital for conservation projects, first from impact-oriented investors and then, increasingly, from mainstream investors as well. Impact-oriented investors can also support the conservation-finance sector using their knowledge, relationships, and resources other than capital.

Elevate the dialogue on project risk and return to be more open, objective, and structured. Because many risks can affect conservation projects, developers must start by identifying risks comprehensively. This often requires consultation with a range of stakeholders. The Water Funder Initiative, for example, has collected ideas from policy makers, scientists, industry executives, conservationists, and others about the risks and opportunities associated with investing in water solutions.[3]

Developers should also approach investors with a realistic and well-structured assessment of risks and returns and how these translate to financial measures. We often see conservation projects that have commercially unattractive risk-return profiles because their risks are high relative to their expected cash flows. Sometimes such projects are pitched as market-rate investments, which diminishes their credibility. Fund managers and financial intermediaries can help developers structure multiple options for investing in a project, including options that are more likely to interest investors who seek market-level returns in addition to conservation impact. Financial professionals can also help identify investors who are qualified to evaluate the risks and returns associated with complicated investments such as conservation projects.

Exhibit

Common risk-mitigation strategies can reduce the default rates and investment costs of conservation investment products.

Risk-mitigation strategy		Key aspects
Operational assistance		Assistance with technical, legal, and financial matters can improve project quality and success rates Typically provided by development finance institutions (DFIs) or foundations
Staged risk tranches	Debt	Fungible, liquid collateral can mitigate credit risk Underlying problems (eg, uncertain land rights) can sometimes be addressed
Staged risk tranches	Equity	Demonstrating stable, predictable cash flows can mitigate risk Works especially well in established sectors such as forestry
Insurance/hedging	Private insurance	Insurance against catastrophic losses can be expensive for new projects or those without established risk models
Insurance/hedging	Futures/ forward trades	Can be used to hedge against volatile commodity prices in liquid markets Can be expensive or challenging if timing of cash flows is unclear
Guarantees		Can take the form of loss guarantees that assure investors they will receive a % of their principal in cases of default Can be provided by DFIs, foundations, or governments

Source: Credit Suisse; McKinsey analysis

Mitigate risks and boost returns. Project developers and fund managers can use various methods to improve a project's expected risk-adjusted returns (exhibit). Management and operational risks, for instance, can be mitigated by assembling a team with all the necessary skills in science, business, regulatory policy, cultural affairs, and other areas.

One nascent but promising concept for improving risk-return profiles to suit private investors is blended finance. This involves carving out investment tranches with less favorable risk-return profiles so they can be funded by so-called concessional capital from public or philanthropic sources. Other tranches can then have risk-return profiles that fit private investors' expectations, making it possible to raise funding for projects whose overall risk-return profiles might otherwise hold little appeal.

Fund managers continue to explore old and new models for blended finance.[4] Examples include the following:

- *Early-stage grant making* by nongovernmental organizations can fund the development of conservation projects. This not only reduces the amount of capital needed from subsequent investors but also lowers the investment risk. Grants from NatureVest, for instance, were essential to the development of the Stormwater Retention Credit Trading Program in Washington, DC.

- *Donor-funded guarantees* are an established mechanism exemplified by the US Agency for International Development's commitment to guarantee 50 percent of the losses on up to $133.8 million of loans by Althelia Ecosphere's Althelia Climate Fund.

- *Junior debt or equity* has a lower-priority claim to assets and earnings than other loans or securities. With this model, the Global Environment Facility used $175 million to mobilize more than $1 billion of private capital for climate- and environment-related projects.

Structure lower-cost, large-scale investment products. High financing and project costs cut into the returns from conservation enterprises, making them less attractive to private investors. But fund managers and project developers can lower their costs in several ways. One is establishing routine processes. A good due-diligence checklist for evaluating projects can help fund managers remove impractical ones from their pipelines early on so they can devote more time and money to better ones. Project templates, such as Encourage Capital's blueprints for investing in sustainable fisheries or California's conservation-easement template, can accelerate the process of developing and structuring projects while helping investors avoid high-risk concepts.[5]

Structuring larger investment products could also help fund managers tap more private capital while spreading out the costs of creating, marketing, and distributing a fund. One approach is to bundle relatively small projects of a similar type into an ordinary investment vehicle, using a common deal template to bring down costs. The Forestland Group, for example, has set up several real-estate investment trusts for sustainably managed timberland. Fund managers might also aggregate different but related projects—such as forestry, agriculture, and ecotourism projects in the same national park—into a single diversified product.

Another scaling approach is to create investment products with familiar, widely used structures. For example, a private equity–style conservation fund could direct as much as $200 million toward 10 to 20 projects in established markets such as sustainable agriculture, ecotourism, and sustainable forestry. Sovereign institutions could issue bonds covering a large ecosystem, use the proceeds to finance conservation there, and repay the debt with revenues from park-access fees and other sources.

Incubate new conservation concepts. As proven conservation models are being standardized and applied on a large scale, project developers also need to create new models that will generate investment opportunities in the future. Entrepreneurs working on novel conservation approaches often need more than money to get projects up and running. Assistance with technical and operational matters can be at least as valuable. To support innovative work in conservation, foundations, non-governmental organizations, and investors could establish incubators to help start-ups get both the financing and the knowledge they need.

Incubators could perform a matchmaking role as well, connecting investors with projects that suit their appetites for risk and their expectations for financial returns and environmental impact. Such incubators could also serve as a proving ground for new financing ideas such as conservation-impact bonds, which are analogous to social-impact bonds, or insurance products that monetize the risk-mitigation benefits of conservation projects.

■ ■ ■

Factors such as low interest rates, falling returns on equity investments, and burgeoning demand for environmentally friendly goods and services favor an increase in conservation finance. Conservation experts and fund managers must now win the confidence of mainstream investors by enhancing their management and financing methods. Their success could catalyze significant growth in conservation finance, allowing investors to improve their returns and mobilizing more private capital to protect ecosystems around the world. ■

[1] Fabian Huwyler et al., *Conservation finance: Moving beyond donor funding toward an investor-driven approach*, a joint report from Credit Suisse, World Wildlife Fund, and McKinsey & Company, 2014.

[2] *Investing in conservation—A landscape assessment of an emerging market*, a joint report from EKO Asset Management Partners and NatureVest, November 2014, naturevesttnc.org.

[3] *Toward water sustainability: A blueprint for philanthropy*, Water Funder Initiative, March 2016, waterfunder.org.

[4] *Blended finance vol. 1: A primer for development finance and philanthropic funders*, a joint report from the Organisation for Economic Co-operation and Development and World Economic Forum, September 2015, weforum.org; and *GEF innovations in blended finance: A summary,* Global Environment Facility, 2015, thegef.org.

[5] Alex Markham, Trip O'Shea, and Kelly Wachowicz, *Investing for sustainable global fisheries*, Encourage Capital, January 2016, investinvibrantoceans.org.

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When sustainability becomes a factor in valuation

Sustainability efforts are material to investors only to the extent that they affect cash flows. What matters depends on the industry.

Investors and other stakeholders seeking to understand companies' risks and opportunities increasingly demand to know more about their performance related to sustainability concerns—or more specifically, environmental, social, and governance issues. Companies generally disclose variables that have a material effect on their value, according to financial accounting standards. But a one-size-fits-all approach to disclosure misses meaningful differences among industries.

In this December 2016 interview, excerpted from a conversation at the inaugural symposium of the Sustainability Accounting Standards Board (SASB), McKinsey's Tim Koller joined alumnus Jonathan Bailey to discuss how accepted principles of valuation apply. Koller, an author of *Valuation: Measuring and Managing the Value of Companies*,[1] has argued that "creating shareholder value is not the same as maximizing short-term profits—and companies that confuse the two often put both shareholder value and stakeholder interests at risk."[2] In this conversation, Bailey and Koller dig into the issues related to how sustainability affects value, the asymmetry of information between companies and their investors, and how companies communicate about that information.

Jonathan Bailey: How does your thinking about valuation reflect today's focus by many stake-holders on sustainability and how it's changed over time?

Tim Koller: I think we have to separate the mechanics of valuation from what managers should be doing to maximize a company's value and how investors react to the whole thing. For hundreds of years, the value of a company has ultimately come down to the cash flows it generated. That's what you can spend as an owner, whether you're a private owner or whether you're a shareholder in a large company.

Now, there have been periods of time when people said, "Oh, the rules are changing." For example, during the dot-com bubble, all of a sudden, people said, "Traditional methods of valuation don't make sense anymore—look at all these companies with high valuations that have nothing to do with cash flow." Well, ultimately, it was the lack of cash flow that brought those companies' valuations back down.

Sustainability issues aren't any different from other things management has to worry about. If the forces in the world that relate to sustainability are going to be material to a business, it's management's job to take a longer view and figure out what to do about them. Because eventually, these things will affect cash flows. And what's good about SASB's approach is its focus on how different sustainability factors might materially affect the cash flows of companies in 79 different industries.

From the perspective of how investors react, one thing we find is that managers have a lot more information than investors—and long before investors have it. So sometimes the markets lag behind in their valuations because some important factor is too vague or unclear for investors to see how it might affect a company's cash flows. When it does become clear, the markets do react. If you look at the way oil and gas companies are valued, for example, people say, "There will be all these stranded assets out there. Some oil reserves won't be produced because of the growth of alternative energy sources." When you look closely, the market's already discounting those concerns. Investors are assuming that there's not much value beyond a certain period of time, which isn't too far into the future.

Jonathan Bailey: That requires managers to be able to think about the long-term horizon, internal budget processes, and capital-allocation decisions with materiality in mind. In my experience with corporate clients, there are often dynamics in the way that people think about creating value within a business that seem to be a little less than efficient.

From your perspective, thinking about it more in terms of corporate finance, what would you say are some of the things we need to overcome in order to help managers do a better job of integrating these longer-term goals, like sustainability?

Tim Koller: When managers make decisions, they always work off some baseline of performance. One trap they fall into is ignoring what really would happen, relative to the baseline, if they *didn't* do something. For example, what are the consequences of not doing an acquisition? Maybe they won't be able to achieve their base case. Or, for another example, if they don't invest in safety, the effect on the baseline isn't that safety would increase their cash flow—but rather that it reduces the probability of having lower cash flows.

So one thing managers need to be more thoughtful about is which elements actually create value in and of themselves. With regard to sustainability, if a company can do things that make customers more likely to buy from it than from a competitor, because it has better credentials, those things are all going to be positive. But what are the consequences, relative to the baseline, of not doing

> “With regard to sustainability, if a company can do things that make customers more likely to buy from it than from a competitor ... those things are all going to be positive. But what are the consequences ... of not doing something?”

something? What if a company doesn’t invest in safety, for example? Or if it doesn’t invest in environmental mitigation? Or if it builds a plant in such a way that it can’t be operated under future regulations as opposed to today’s? That’s really the challenge for managers. If they don’t do these things, what’s likely to happen? And it’s not going to be business as usual.

Jonathan Bailey: I know some of the work you’ve been doing recently has been on communication between managers and investors. Given the information asymmetry you mentioned, what do the best companies do to communicate how they’ll create value in a way that investors should care about—in the context of sustainability issues?

Tim Koller: I think we’re still in a very infant stage with regard to this. Some of the reporting by companies is still boilerplate. But there are some good examples. For instance, some of the consumer-apparel companies have become very conscious about their overseas sourcing. They’re becoming more proactive about describing what they do to make sure that suppliers are upholding certain standards. You can also see it in extraction or energy-related industries, where they’re worried about sustainability issues. You can see it in healthcare, where they’re ultimately concerned about product safety.

Unfortunately, communication often doesn’t happen until after there’s been a blowup somewhere in the industry—situations where, all of a sudden, something happens that gets everyone’s attention, and people start to worry about it.

Jonathan Bailey: Another trend we’ve seen is in the growth of information available to investors. Whether it’s from what they learn from company disclosures, from data providers (which may not be from disclosure), from trawling news media, or from building input-output models that compile a view of what’s happening inside a business on sustainability characteristics.

From an investor perspective, do you feel that this is really just a trend toward more data or is it really important to focus on better data?

Tim Koller: I think it’s about the better data. There are investors who look at a Bloomberg screen to make investment decisions, and having sustainability factors available there provides a lot of visibility to the issues. But the investors who drive the market are typically much deeper than that. They’re going to spend a month doing their research before they decide to make an investment in a company. They’re going to follow it for a long period of time. They’re going to be more interested in what material factors may drive the company’s value.

What ultimately matters, we’ve learned from sophisticated long-term investors, is the importance of management credibility.[3] It’s not so much about the amount of data. It's that managers, when facing those investors one on one, are able to talk about what's really going to matter, what's going to drive the cash flows, and what's being done about it.

So the disclosures are good because they get the conversation going. But whether or not they're mandated or audited, what really matters to those investors is, when they're face to face with management, whether they have a sense that management really knows what they're talking about and what they're doing about it.

Jonathan Bailey: That's an interesting point, because you'll often hear CEOs say, "Look, I never get questions from sell-side analysts about these sorts of topics." But it's probably the case that those conversations are happening in a different forum. They're not happening on a quarterly earnings call—they're happening in those one-on-one meetings with a value-based investor who has a much more active focus.

So if you're sitting there as a CEO trying proactively to have that conversation, do you think that management teams are doing the best they can to structure the right conversations? Or do you think, on the whole, managers are basically waiting for people to come to them, and the loudest voices will be the ones that shape the discussion?

Tim Koller: It's a combination of the two, because there are two worlds going on. There are the quarterly earnings and the sell-side analysts, and then there are the actual investors, who tend to have private conversations with managers. And those worlds don't intersect for the most part.

When executives sit down with what we call intrinsic investors, the conversation is much deeper, and it does focus on what's material, whether it's sustainability or other things that are affecting the industry. They talk about, "What's going on there? How is management reacting?"—getting a sense of whether management knows what they're doing. That's a sharp contrast from the quarterly calls, where usually only the sell-side asks questions.

I was talking to one investor-relations professional who's been in the business for decades who said that only once did a buy-side investor actually ask to join a quarterly call. There are ways to improve that. When we talk to long-term investors, they would like management to be more proactive in those quarterly calls. They say, "Tell us what you really think is important. Don't try to guess what the sell-side analysts want to know. Tell us about the results in the context of what you're doing longer term. And then find a way to make sure that the most important questions about the long term get raised. Take charge of investor communications and focus on what's really important." ■

1 Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, 2015.
2 Marc Goedhart, Tim Koller, and David Wessels, "The real business of business," March 2015, McKinsey.com.
3 Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," January 2017, McKinsey.com.

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