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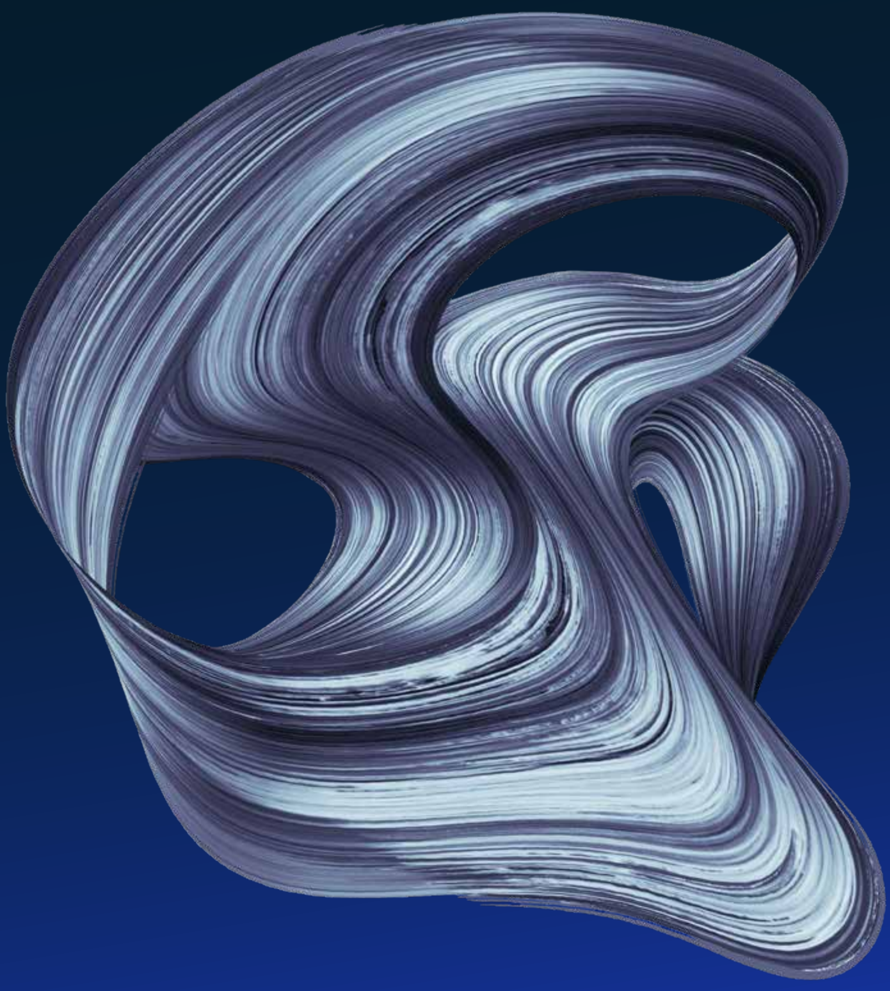

Managing through COVID-19

Inside: The role of the CFO in navigating the crisis, advice from long-term investors and board directors, a look at how planning and forecasting processes must change, plus a blueprint for M&A success

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Editorial Contact:
McKinsey_on_Finance@McKinsey.com

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Table of contents

Editor's note

Over the past several months, leaders in McKinsey's Strategy and Corporate Finance Practice have developed a range of perspectives intended to help companies navigate the public-health and economic impacts of the global COVID-19 pandemic. We've collected some of those insights in this special themed issue of *McKinsey on Finance*. Several pieces outline the skills and capabilities that have been required to manage the initial response to and the near-term consequences of the novel coronavirus. Others consider what it will take to survive and thrive in the next normal—for instance, what role should M&A play in encouraging business recovery and growth? We hope the articles give finance leaders the ballast they need to steer through these tumultuous times.

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The CFO’s role in helping companies navigate the coronavirus crisis

Strong, steady leadership from the finance organization is critical for addressing immediate concerns about safety and survival, stabilizing the business in the near term, and positioning it for recovery.

by Ankur Agrawal, Kevin Carmody, Kevin Laczkowski, and Ishaan Seth

The spread of the novel coronavirus has created a worldwide humanitarian and economic crisis. The events we are living through are in many ways unprecedented, with large-scale quarantines, border closings, school closings, and physical distancing. Governments and communities have been jolted into action to "flatten the curve."

Organizations, too, have needed to accelerate their actions to protect employees, customers, suppliers, and financial results. The challenges are many and varied: with some companies losing up to 75 percent of their revenues in a single quarter, cash isn't just king—it's now critical for survival. While always important, digital connectivity is now fundamental to the continuity of business operations, as remote work becomes the norm across much of the globe. The need for frequent, transparent communication with colleagues and investors has only ramped up in importance as business conditions, epidemiological forecasts, and rules of conduct change daily, if not hourly.

Amid all this uncertainty, the CFO can play a strong, central role, alongside executive peers, in stabilizing the business and positioning it to thrive when conditions improve. The CFO is the leader, after all, who day to day most directly contributes to a company's financial health and organizational resilience. In this article, we offer lessons about the actions that CFOs should take in the wake of the pandemic to put their companies on a sound financial footing and help reduce some of the fear and uncertainty. We outline the critical steps CFOs and finance organizations can take across three horizons: immediate safety and survival, near-term stabilization of the business in anticipation of "the next normal," and longer-term preparations for the company to make bold moves during recovery.[1] Our guidance is based partly on empirical research McKinsey has conducted on companies that outperformed competitors coming out of previous crisis points and recessions.[2]

Resolve and resilience: Addressing the immediate crisis

Economically, the COVID-19 crisis is most immediately one of liquidity and resulting financial stress. The finance leader's top priority, then, has to be optimizing cash reserves, as the magnitude and duration of the crisis remain unclear. Specifically, the CFO should focus on assessing the company's liquidity, launching a centralized cash war room, developing different scenarios based on potential paths of the virus's spread, and rolling out an internal and external communications plan.

Launch a cash war room

Most CFOs are already moving quickly to quantify their companies' cash on hand as well as any incremental capital they can access. Finance leaders will need to forecast cash collections associated with the latest sales projections. With many customers delaying payments, however, some companies may need to double down on collections to remain solvent. When working capital is no longer sufficient, CFOs should consider tapping lines of credit and other options while reviewing opportunities to raise capital, such as through divestitures or joint ventures. If necessary, they should also seek relief on debt covenants as early as possible to strengthen the balance sheet before doing so becomes a matter of survival. In such times of crisis, when a cash shortage is a distinct possibility and conditions are changing constantly, setting up a cash war room can help CFOs implement aggressive curbs on spending throughout the organization. Additionally, CFOs can use various tools or mechanisms—what some would call a "spend control tower"—to prioritize payments and impose clear reporting metrics that track liquidity in real time.

Develop scenarios

Amid this period of heightened uncertainty, finance and strategy teams will need to rely on a range of scenarios rather than on individual time-horizon-

[1] For regularly updated articles on the business implications of the coronavirus pandemic and how organizations can respond, see McKinsey's collection "Coronavirus: Leading through the crisis," on McKinsey.com.
[2] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com.

based frameworks.[3] The finance leader should develop a point of view about two or three integrated scenarios that encompass multiple eventualities—for instance, which paths might the pandemic take, and which geographies or industries are poised for faster recovery than others? The CFO should also articulate clear thresholds or trigger points that suggest what financial actions the company will take and when. The financial planning and analysis (FP&A) group is uniquely positioned to help in this regard, as it works closely with the business units and can help project the effects of the pandemic on various aspects of demand and supply. Rolling forecasts should incorporate both macroeconomic and company-specific data to identify major areas of EBITDA risk. The forecasts should also identify second-order impacts, such as geographical supply-chain disruption and employee dislocation, as well as likely sources of cash leakage and customer-liquidity projections.

Once all this is in place, the CFO should guide the creation of a framework that a small executive team can use to make business decisions (to rationalize projects, for example) and monitor conditions (for triggers that might cause various scenarios to unfold, for instance). The CFO will need to track in real time the effect that cash decisions are having on the company's ability to ride out the downturn and resume business operations once demand begins to bounce back.

Institute a communications plan

The CFO must take a lead role in the financial and strategic aspects of crisis management. As mentioned previously, the company's primary finance focus during this period will be on implementing a "cash culture"—that is, preserving cash and deploying it dynamically. The CFO must communicate this priority throughout the organization and help establish incentives to reinforce it so that all departments and business units understand "why this matters now" and what their specific role is in helping optimize cash.

It is equally critical to communicate proactively with boards of directors and investors. The message to both should focus on the crisis's actual and projected effects on the company, the actions being taken to protect the business, the liquidity situation, and any changes to earlier earnings commitments. In addition, the CFO would be wise to increase the frequency of investor communications after the first few months of upheaval, particularly when new information is available. Such connections are essential for demonstrating that executives are taking fast and resolute action based on their best understanding of the situation.[4]

The CFO should guide the creation of a framework that a small executive team can use to make business decisions and monitor conditions.

[3] "Economic Conditions Snapshot, March 2020: McKinsey Global Survey results," May 2020, McKinsey.com.
[4] For more on communicating with investors during this crisis, see Tom Kolaja and Tim Koller, "When investors call: How your business should talk about coronavirus," March 2020, McKinsey.com.

Return: Stabilizing the business

Once concerns about cash preservation have been addressed, the CFO needs to ensure that the company is positioned to operate effectively in the next normal. The finance leader's critical tasks here will include making operational improvements to bolster productivity, reevaluating the investment portfolio, and investing in the finance function's capabilities.

Bolster productivity

Our research shows that, during the last economic crisis, a small subset of leading companies (we call them "resilients") pursued productivity improvements more often and more frequently than others, creating the capacity for growth during recovery.[5] As a result, they outperformed competitors, doubling their generation of TRS over the subsequent decade. What's more, when compared with peers, the resilient companies reduced their operating costs by three times as much—and they made the moves to do so 12 to 24 months earlier than peers did.

The CFO and the finance organization can make several operational moves to support near-term performance improvements. For instance, to shore up revenues, the CFO can promote the development of new products and services that will assist customers who are experiencing financial difficulties, thereby promoting loyalty from valuable customer cohorts. The CFO can actively reallocate resources to businesses with strong existing revenue streams and optimize the company's use of alternative sales and delivery channels, such as e-commerce.

With much of the world in lockdown and demand falling, it will be necessary for finance leaders to take decisive actions for reducing operating costs, but it will also be critical for CFOs to maintain some flexibility and to balance those reductions against the eventual need to scale operations back up as the economy recovers. In the meantime, the CFO and finance team can also bring some rigor to spending management by implementing rapid zero-based budgeting for all discretionary expenditures, such as indirect procurement.

Reevaluate investments and strengthen the balance sheet

CFOs should use this period of crisis as an opportunity to perform a deep diagnostic on the balance sheet—for instance, reviewing goodwill impairments; refinancing debt; reducing inventory, accounts-payable, and accounts-receivable terms; and so on. This sort of balance-sheet cleanup can extend the company's financial flexibility while keeping everyone focused on key metrics at a chaotic time. Additionally, CFOs should guide peer executives in a review of major R&D, IT, and capital allocations and use the opportunity to optimize the company's investment portfolio. It is very likely that business units' initial projected returns on investments will have changed significantly as a result of the pandemic. Finance leaders will need to quickly shift human and financial resources to higher-yielding projects and the initiatives most valuable to the company's future.

Turbocharge the role of financial planning and analysis

Under crisis conditions, the FP&A team must accelerate its budgeting and forecasting work, providing continually updated business information that the CFO and the finance organization can then incorporate into an integrated forecast. The FP&A team should use collaborative tools to monitor and manage key performance indicators; in a crisis period, issues with data latency will not be acceptable. And the team's updates need to become a true rolling forecast, supported by a "decision cockpit"—a real-time dashboard business leaders can use to focus on the seven to ten key metrics that will guide the organization's operations through the coming months.

Some finance organizations may lack executives with the skills necessary to elevate the FP&A team into such a role; those with analytics and

[5] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," McKinsey Quarterly, May 2019, McKinsey.com.

business backgrounds may be in particularly short supply. To build up the finance bench, the CFO will need to scout for dynamic, proactive individuals, explicitly recognize their performance, and support their experiments with new tasks and new roles on the fly. Additionally, with the likely sudden and dramatic rates of unemployment in many sectors (such as hospitality and travel), finance organizations may be able to recruit top talent with some combination of the digital, finance, and business expertise required but that had previously been harder to find.

Reimagine and reform: Thriving in the next normal

Once the crisis abates, senior management will want to move forward. To enable the company's pursuit of bold strategic moves, the CFO and peer executives should convene a small group of talented executives whose mandate is to focus on strategic planning, with oversight and support from senior management and the board. The team will set the game plan for investments, portfolio shifts, and major productivity initiatives that will position the company to win after the pandemic.

There are five big moves that our research shows have the greatest impact on a company's ability to significantly outperform the market: dynamic resource reallocation, programmatic M&A, strong capital expenditure, productivity breakthroughs, and differentiation improvement.[6] All are important, but in the current crisis, reallocating resources for future growth, realigning the portfolio through acquisitions and divestitures, and boosting productivity are the most critical.

Adopt a transformation mindset when reallocating resources

Crises are often opportune times to restructure parts of the business that require transformation (and to take the related charges). This one is no different. The CFO and finance organization would be well served to adopt a transformation mindset when they are setting targets, managing performance, constructing budgets, or challenging their business on growth or expense actions. The finance team should launch a review of the portfolio, with a focus on achieving the full potential of each business unit. This is a time to shelve incremental thinking and seek out transformational plans that could boost revenues or reduce costs—not by 5 to 10 percent but by 30 to 40 percent.

Consider how M&A and divestitures could improve the portfolio

Roiled markets and plummeting valuations can create a ripe environment for M&A. CFOs should be a leading voice in determining how to use M&A as a tool to manage the crisis (through divestitures, for instance) and to reallocate capital toward high-priority needs (through product, geography, or supply-chain acquisitions, for instance). A programmatic approach to M&A—where companies pursue frequent small and medium-size acquisitions—may hold some promise during this disruptive period.[7] Consider that during the last financial crisis, companies that maintained a programmatic approach to M&A outperformed through the downturn and maintained excess TRS through the recovery. In fact, the top-performing companies through the downturn (those with top-quartile TRS) had the highest average volume of annual transactions during that time period and returned roughly six times that of the bottom-quartile performers. Similarly, resilient companies divested assets 1.5 times more than their nonresilient peers.

Boost productivity through digitization

This is the first economic disruption that requires a large part of the global workforce to perform their duties remotely, making digital-collaboration tools necessary to keep the business functioning. But the finance team's use of digitization to help the company manage the crisis should not be considered a onetime event. Digital initiatives that once seemed out of reach—from automated closings to real-time forecasts—are now business critical. The CFO and finance team should take a leadership position in advocating for the use of

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[6] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[7] Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com.

digitization across the organization, long after the crisis has passed. The CFO and finance team can codify the solutions they have developed—the cash war room, rolling forecasts, and collaborative dashboards, for instance—and help scale them throughout the organization. This active, informed embrace of digitization will be invaluable for ensuring accurate reporting, informed decision making, and business continuity in any future crises.

Meanwhile, much attention has been paid to the massive disruptions to global supply chains. These disruptions have changed business leaders' ROI calculus overnight—from being solely focused on efficiency to now accounting for resilience and stability. Consider how business-process-outsourcing centers worldwide are reeling from lockdowns and limited bandwidth in their own countries (India and the Philippines, for instance), and think about the degree to which many of the critical processes they support have been disrupted. CFOs will need to do the hard of work of digitizing and automating core business processes to reduce their exposure to exogenous shocks and to create resilience.

In the coming days, weeks, and months, as employees are struggling with anxiety about their health, their future, and their loved ones, finance leaders must demonstrate empathy—but also bounded optimism that the organization and its people will find a way through the crisis.

The CFO can back up this view with clear actions and decisions. Regular communication is critical: the CFO must be forthcoming about the "knowns" and the "unknowns." This will help ease misgivings, decrease distraction, and keep people motivated. Also critical is empowering others in the finance organization to direct aspects of the crisis response while establishing a financial decision-making framework that will help executive peers make necessary trade-offs.

No one knows how long the pandemic will last, but in time, business and daily life will find a new equilibrium. CFOs are key to ensuring that their organizations not only survive the current crisis but thrive in the next normal.

Ankur Agrawal (Ankur_Agrawal@McKinsey.com) is a partner in McKinsey's New York office, where **Ishaan Seth** (Ishaan_Seth@McKinsey.com) is a senior partner; **Kevin Carmody** (Kevin_Carmody@McKinsey.com) and **Kevin Laczkowski** (Kevin_Laczkowski@McKinsey.com) are senior partners in the Chicago office.

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Navigating COVID-19: Advice from long-term investors

Look after employees, customers, and suppliers; adopt a through-cycle mindset; and communicate transparently. Profits and dividends will come later if you make the right moves now.

by Tim Koller and Sarah Keohane Williamson

The global COVID-19 pandemic has presented executives with the most challenging times in their careers. The social impact of their decisions is under the spotlight as they try to balance the needs of all key stakeholders—customers, partners, suppliers, and society in general.

The good news is that executives' most important investors, long-term shareholders, believe that doing the right thing for all stakeholders in the near term will benefit investors in the longer term.

To put executives' challenges into perspective and cut through the swarm of messages they are getting from bankers, sell-side analysts, short-term investors, and media pundits, FCLTGlobal and McKinsey conducted interviews with ten long-term investors in early to mid-April 2020 (see sidebar, "Our panel of investors"). We asked them a simple question: What advice would you give to executives during this difficult time?

The investors all acknowledged that executives are making decisions in an extremely uncertain environment. "Cash is king" in times of crisis, and every company is facing its own liquidity challenges. Some are fighting for survival and doing whatever they can to stay afloat for as long as possible. Some have more leeway in the actions and decisions they are taking, because their cash flows have been less severely affected. Many companies likely fall somewhere in between the two extremes.

Several common-sense themes emerged in our conversations, however, including the advantages of using a through-cycle approach when making decisions about investments and operations and the need to communicate transparently during the crisis period. The investors' primary piece of advice? Look after employees first, followed by customers and suppliers. It will pay off in the long run, as each group will certainly remember how you treated them during this difficult time. The profits and dividends will come later if you make the right decisions and moves now.

Protect employees, customers, suppliers, and the community

Most of the investors we interviewed immediately focused on the importance of taking good care of current employees, assuming a company has enough liquidity to be a going concern. The emphasis should be on keeping employees working if possible, but only under the safest possible conditions. Protecting employees' health is not just the humane thing to do; it can also help a business ramp back up more quickly when the risks subside. It can also engender greater loyalty among employees—a benefit that can easily be underrated. One of the investors we spoke with cited a retailer that put employees at risk by keeping its stores open longer than was probably prudent. The investor viewed this negatively; the company's emphasis on quarterly sales will likely come with a cost in the future.

The investors we interviewed also note the importance of protecting customers and suppliers. Executives' reflexive reaction to the pandemic has been to try to conserve cash where they can—for instance, holding off on payments to suppliers and squeezing suppliers on price. These actions make sense for those companies that might not survive otherwise, investors acknowledge, but companies with some liquidity should consider using it to help smaller, weaker customers and suppliers. A quick recovery for customers means increased demand for goods and services. But if suppliers don't recover quickly (or at all), companies won't be able to ramp up production to meet this increased demand and may lose share to competitors.

Stakeholder and sustainability issues were already at the forefront of public discussions prior to the COVID-19 crisis. Some of the investors we spoke with say companies should remain cognizant of environmental issues, even now. One investor pointed to a company that made a quick decision to begin to diversify its supply chain geographically. It failed, however, to realize that, as a result of climate

Our panel of investors

The following long-term investors were interviewed by FCLTGlobal and McKinsey:

- Thomas B. Bastian, retired managing director, Invesco
- Christine Chow, director of EOS, Federated Hermes
- Benjamin Colton, global cohead of asset stewardship, State Street Global Advisors
- Tracey Flaherty, global head of diversity and inclusion and public affairs, Natixis Investment Managers
- Steven M. Galbraith, managing member, Kindred Capital
- John P. Goetz, co–chief investment officer, Pzena Investment Management
- Michael J. Mauboussin, head of consilient research, Counterpoint Global
- Guy Moszkowski, retired cofounder and former director of research, Autonomous Research US
- Sally Pope Davis, managing director and co–lead portfolio manager, Goldman Sachs Small Cap Value Strategies
- Barnaby Wiener, equity portfolio manager and head of sustainability and stewardship, MFS Investment Management

change, hurricane activity was likely to increase in its preferred location. The company would simply be swapping risks rather than reducing them. It remains a good time to think about how to remove waste from processes, which can reduce costs and benefit the environment.

Take a through-cycle approach to investments and operations

The investors we spoke with believe that strong companies with good liquidity should continue to pursue their most-promising business opportunities and use the crisis to strengthen their long-term competitive position. Joint research from FCLTGlobal and the McKinsey Global Institute supports that position: companies that invested through previous downturns emerged stronger and were able to generate higher returns than competitors once the crisis was over.[1]

Companies operating in a downturn as a result of the COVID-19 pandemic may similarly want to look for new opportunities—for instance, bringing ideas to market faster or acquiring intellectual property from unexpected sources. The investors in our panel note that it is particularly important to maintain momentum with R&D so that companies can retain top talent and scale up more quickly during recovery. Regarding talent, it may also be a good time to look for ways to bring in new faces. Several investors cite the opportunity to attract people from weaker companies or without competition from companies that have frozen their hiring—not just technical talent but sales, marketing, product-innovation, and general-management experts.

The same through-cycle mindset applies to capital expenditures. Stronger companies may be able to build capacity more cheaply or purchase assets at reasonable prices from weaker companies. During this period, well-capitalized companies can aggressively pursue M&A at attractive valuations. During the 2008–09 crisis, a strong bank gained significant share in certain critical markets by buying up some small, weaker companies with good

[1] Dominic Barton, James Manyika, and Sarah Keohane Williamson, “Finally, evidence that managing for the long term pays off,” *Harvard Business Review*, February 9, 2017, hbr.org.

talent and client relationships. It has retained its leadership position in several important product areas, while some of its competitors still haven't recovered more than a decade later.

The long-term investors we spoke with stress the importance of planning carefully for the eventual easing of the crisis. One investor pointed to a retailer with a strong balance sheet that is continuing to invest in its winter lineup now, potentially gaining an advantage over competitors next fall.

They also note that now is also a good time for executives to rethink aspects of their company's operating model. For instance, some companies are reconsidering their real-estate requirements in the wake of the pandemic. More employees may be working from home even after the peak of COVID-19, and companies now have a wealth of evidence about the effectiveness of videoconferencing.

Build for future shareholder value; deemphasize dividends and repurchases

The investors we spoke with acknowledge that many companies have cut their dividends and share repurchases as a matter of survival, especially those companies that are facing large layoffs. The decision about what to do with dividends becomes more difficult, however, for those companies that can still afford to pay them.

The investors support short-term dividend cuts in those instances where short-term uncertainty is high and cutting dividends is the prudent thing to do. But if a company has enough liquidity to pay its regular dividend under all stress scenarios, it should continue to pay the dividend. Doing so will send a positive signal to investors about the company's financial health and can provide much-needed cash to retail investors and income funds.

Investors' overarching advice to companies about share repurchases is to "proceed with caution." Stronger companies may be tempted to repurchase their stock at low prices, but the current political environment and the potential for continued economic disruption could lead them to regret that decision. One investor mentioned using a special dividend to distribute cash to shareholders and signal financial strength without incurring the political blowback associated with share repurchases. But most of the investors note that a strong balance sheet in a crisis is to be protected—and likely rewarded.

Communicate short-term execution of long-term plans—not short-term guidance

Every piece of communication from a company during a crisis will be heavily scrutinized by all stakeholders, each with their own agenda. Short-term investors may press the company for clues

Investors' overarching advice to companies about share repurchases is to "proceed with caution."

about trading opportunities. By contrast, long-term investors are looking for evidence of resilience: How will the company withstand the crisis, and how strong will it be in the long term, considering its competitive position, growth potential, and returns on capital?

The investors in our panel tell us they need a clear understanding of companies' liquidity and cash position. If companies are stressed, investors want to hear more frequently from them about how they are managing liquidity in the short term: a detailed view of these companies' sources and uses of cash (preferably on a month-by-month basis) would be helpful. For those companies that are clearly going concerns, investors want to understand how employees are doing and the steps companies are taking to ensure employees' safety and well-being. Some visibility into how these companies might adjust the size of their workforces under various scenarios can be helpful, as can an overview of the key economic drivers of their businesses.

Long-term investors say they are looking for honesty and transparency about the pandemic's effects on companies under various if-then scenarios. Such transparency is especially important when different parts of the business (regions and individual business units) are being affected unevenly. Investors understand that companies cannot predict the future. But they do expect that companies will share enough information about the pandemic's effect on their businesses that investors can make their own assessments of how the companies will fare through the crisis and beyond.

On quarterly calls and in other communications, companies should share the most current information, not just numbers from the previous quarter. Historical information is much less important in times like these.

And finally, the investors we spoke with recognize the folly of quarterly guidance in good times, let alone during a crisis. Most of them say they prefer companies to provide guidance based on long-term key performance indicators of value rather than short-term earnings per share. The COVID-19 crisis presents a good opportunity for companies to stop providing investors with short-term guidance—now and after the crisis passes.

Long-term shareholders and companies' interests are aligned. Both will succeed if companies navigate the COVID-19 crisis without liquidity issues and can build for long-term value, ultimately emerging from the crisis in a stronger position relative to competitors.

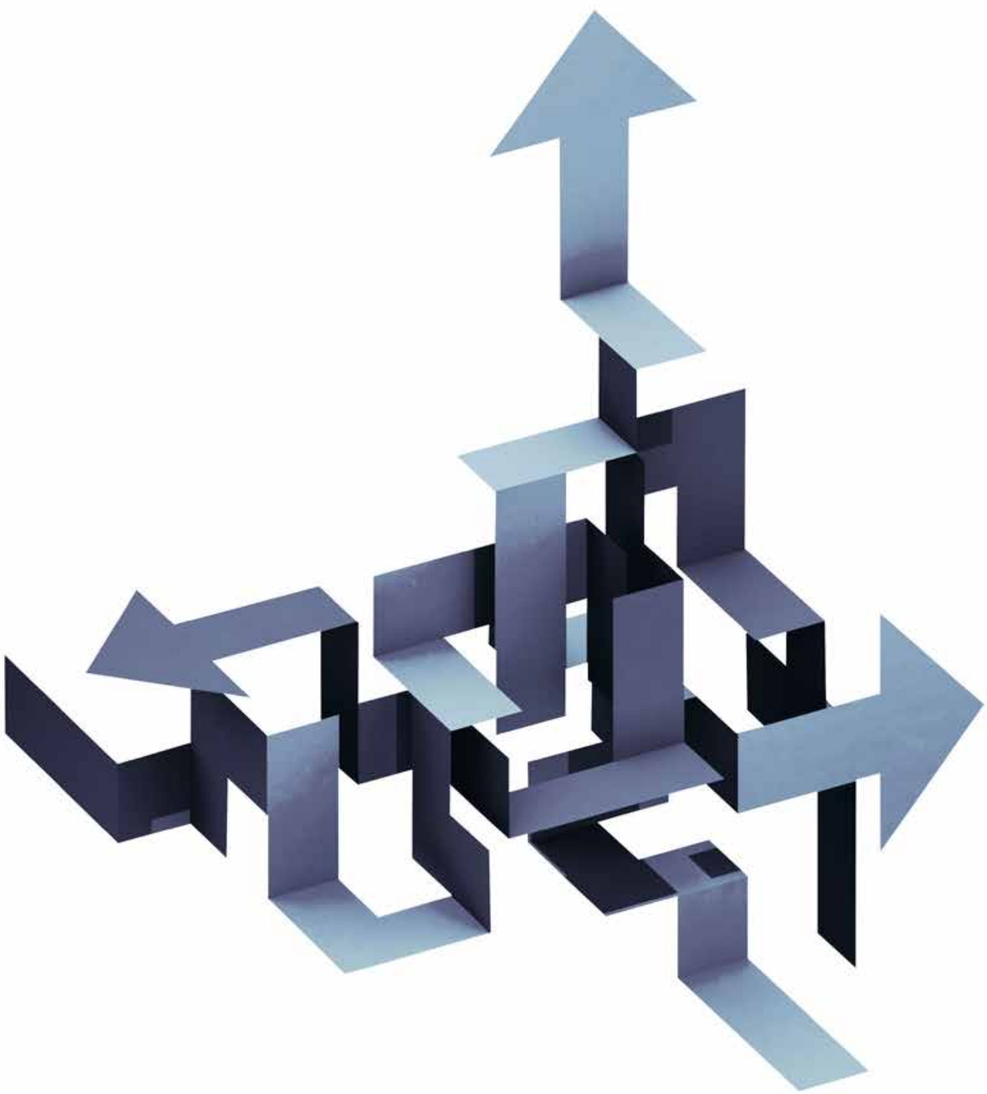
Tim Koller (Tim_Koller@McKinsey.com) is a partner in McKinsey's Stamford office; **Sarah Keohane Williamson**, an alumna of the Boston office, is the CEO of FCLTGlobal.

The authors wish to thank Prateek Gakhar, Ross Parker, and Zane Williams for their contributions to this article.

Planning for uncertainty: Performance management under COVID-19

Companies need a new approach to financial planning and performance management—one that informs rapid realignment of plans and actions and ensures organizational resilience.

by Ankur Agrawal, Kapil Chandra, Matthew Maloney, and Michele Tam



Planning has never been a particularly easy task, but the spread of COVID-19 has made it even more difficult. Finance professionals are used to accuracy, consistency, and relatively predictable planning cycles, not the unclear economic conditions and time horizons of a global pandemic. As one executive told us: "The five-year plan that we would be sending to the board right now is completely out the window. How do we plan in this environment when we don't know what is going to happen?"

Clearly, companies' existing plans and assumptions will need to be revised in light of the rapidly changing global health situation, which is creating uneven economic effects across all industries (exhibit).

In normal times, financial-planning teams generally use a range of driver-based models for budgeting, forecasting, and root-cause analysis. Over the years, they have likely cultivated their own standard reports and preferred views of information. Few

Exhibit

The economic impact of COVID-19 varies by industry and sector.

Preliminary views of hardest-hit sectors (as of April 3, 2020)

	Average stock-price change,[1] %	Industry-specific context
Commercial aerospace	–46	Preexisting conditions, challenges with airlines' balance-sheet resilience, and high fixed costs cause **near-term cash-flow issues and uncertainty about long-term growth.** It may take years to recover from production and supply-chain stoppages: critical vendors are in areas affected by the virus, and tier-3 suppliers are particularly susceptible to liquidity challenges.
Air and travel	–44	There is an immediate effect on demand, some 5 or 6 times greater than that of Sept 11, 2001; about 70–80% **near-term demand erosion** is due to international travel bans and quarantines. Bookings for summer travel season in the northern hemisphere are being affected by the public's fears about the duration of the virus. Faster recovery expected for **domestic travel** (about 2 or 3 quarters); slower recovery for **long-haul and international travel** (6+ quarters).
Oil and gas	–42	**Steep drop in oil prices** is driven by the virus's impact on short-term demand as well as the surplus resulting from OPEC+ decision to increase production. **Oversupply expected to remain in the market even after demand recovers**, and post-2020, unless OPEC+ decides to cut production.
Automotive	–29	**Existing vulnerabilities** (such as trade tensions, declining sales) **are amplified by acute decline in global demand**; Mar 26 survey of US auto consumers indicates 70% are deferring purchases by about 6 months or no longer intend to purchase. Despite ongoing Chinese economic restart, there is **continued supply-chain and production disruption** as majority of EU and US OEMs have temporarily closed plants and Hubei manufacturing remains at about 50% capacity.
Insurance carriers	–29	**Reduced interest rates** and investment performance are **affecting returns—especially for longer-tail lines**. **Disruptions are expected in new business and underwriting processes** due to dependence on paper applications and medical underwriting.

[1] In the past 30 days, for selected sector indexes.

Source: IHS Markit; S&CF Insights; S&P Capital IQ; Corporate Performance Analytics by McKinsey; McKinsey Global Institute analysis have probably encountered the degrees of uncertainty they're experiencing now or have been asked to conjure up a crystal ball in a matter of days to make the most important decisions their companies have ever faced.

Financial planning and performance management under this unprecedented period of turmoil requires a new, systematic approach, one that will allow the CFO and finance team to quickly alert the company to options emerging as a result of the coronavirus.

Specifically, the financial-planning team should focus on the following five steps: get a clear view of the company's starting position; build a fact base and use it to develop a range of scenarios; align on a financial plan with the "direction of travel"; determine best actions and moves; and, finally, identify the "trigger points" that will prompt the business to adjust and adapt forecasts and financial plans with alacrity.

In this period of pandemic, companies are at wildly different levels of liquidity and risk tolerance. Regardless of their starting points, all of them can use all or various aspects of this five-step planning process to cut through the uncertainty and make the best possible decisions.

The financial-planning team's primary responsibility is to help guide the organization through the worst of the crisis—as opposed to the mandate for the plan-ahead team, which is to look beyond the day-to-day of the crisis and develop a view of how the future may unfold. Once the worst has passed, however, there is also an opportunity for the CFO and the finance team to use the crisis as a starting point for deep discussions with business-unit leaders about how the overall planning process may need to change in the next normal.

Get a clear view of the company's starting position

The company needs a clear view of its starting position in the wake of the pandemic. To get this, it should convene a COVID-19 financial-planning team, supported by a range of cross-functional experts (for instance, in sales and in supply chains). Together, the financial-planning team and cross-functional experts can build a solid fact base, one that tells a comprehensive story about historical and current market and financial trends, as well as potential future indicators. The financial plan that the company rolled out in January 2020 can be a good anchor point for this exercise, as it can help to establish any assumptions that will need to change as a result of the pandemic.

The team should build a driver-based model from revenue to cash, looking monthly (or weekly if liquidity is at stake). It should compare the latest trends and the key operational drivers of the business (those inputs that have the most impact) prior to the crisis with the key drivers of the business since the crisis started. What has changed? What specific liquidity risks have emerged? How sensitive are these drivers to current uncertainties in the market? It is also important to look at business drivers within the industry (vendors, customers, and geographies) and how those have changed pre- and postpandemic. The outcome from all this will be a baseline set of facts to compare against emerging scenarios. These scenarios will become the new "true north" for the financial-planning team and the anchor points of the financial plan for the next 18 months.

Develop a range of scenarios

With a reliable fact base in hand, the financial-planning team should be able to quickly model three or four scenarios for how the pandemic might play out within its industry: a best case (optimistic), a worst case (pessimistic), a momentum case (continue on the current trajectory), and a most-likely case. In this way, the team can ensure that a breadth of outcomes are being explored; the organization cannot simply pick the middle scenario as the most likely case.

Each scenario must be assessed along three dimensions: depth of the decline, duration of the decline, and the time required to ramp back up. Each scenario must also accurately reflect the company's starting point: A company experiencing a slight decline in sales as a result of COVID-19 (grocery, for example) may only need to plan for small, nonstructural changes to ensure that it successfully weathers the

The financial-planning team may want to revisit performance plans—emphasizing the implementation of initiatives rather than aggregated financial results.

crisis. By contrast, a company that has lost half of its sales as a result of the pandemic (hospitality, for instance) may need to plan for a revamp of its entire cost structure and even its entire business model. Hence the “best” and “worst” cases will look different for different companies, even in the same industry.

The financial-planning team should build financial forecasts that exclude any investments or upside from any strategic initiatives—essentially, the momentum cases for each scenario. The team should then stress-test forecasts and initial business assumptions against its scenarios. It will need to take time horizons into account—looking three months out, initially, but eventually extending that to 12 to 18 months. Throughout this modeling exercise, it is important for the financial-planning team to use conservative estimates and assumptions without trying to be overly precise.

It can then build a view of capital and capacity constraints due to COVID-19: Given near-term and midterm considerations, which strategic initiatives might be accelerated, slowed, deferred, or canceled outright? A company in a strong cash position may accelerate opportunities to shore up its supply chain—buying more raw materials or making advance payments to ensure access to resources. By contrast, a company facing liquidity issues may need to pursue the extension of payment terms with suppliers and defer some initiatives until the crisis abates.

Establish the ‘direction of travel’

Once the fact base and scenarios have been created and pressure-tested, the financial-planning team, with input from the executive leadership team, will need to decide which scenarios make the most sense to pursue and then build a detailed financial plan around them.

Depending on the level of disruption the company faces, the direction of travel might focus on sustaining the existing business and restoring operations as quickly as possible, or restructuring the company to match the changing demand environment, or shifting the business model to meet radically different customer behaviors, or shaping a whole new business.

In all these cases, the financial-planning team will need to clarify the company’s cash-conservation approach in a COVID-19 world, including a near- and midterm evaluation of cash flow. This approach should be applied and communicated to each functional and geographic area; everyone should understand what will be spent on operations, sales, marketing, and other critical areas. The emphasis, in times of immediate crisis, should be on what will maximize cash flow to sustain the company, not on overall company size or revenues.

Internally, the financial-planning team may also want to revisit performance plans—emphasizing the implementation of initiatives rather than aggregated financial results. This may be necessary for two reasons. First, previous compensation rewards may be linked to targets that no longer apply, given the economic effects of COVID-19. And second, the context has changed so dramatically that any new initiatives may require employees to take on a completely different mindset and embrace new activities—for instance, asking a brewer to shift production resources from a traditional task (making beer) toward a new COVID-19-related one (using runoff alcohol to make hand sanitizer). It may also be necessary to consult tax experts, given the degree to which the public-policy landscape and stimulus bills may vary by industry and geography.

Determine best actions and moves

With scenarios in hand and a direction of travel agreed upon, the financial-planning team must work with senior leadership to identify a coherent set of initiatives, determine how to execute on them, and track their performance across multiple time horizons. They will need to find the right combination of no-regrets moves, big bets, and real options. Typically, such moves will fall into one of three categories: initiatives that were built into the financial plan as of January 2020, initiatives that had been considered during the planning process but that were not included in the financial plan, and initiatives that may be required now as a result of the crisis.

Based on the financial-planning team's mapping scenarios, for instance, leaders at a midsize industrial company decided to shift resources away from those products that had seen a radical drop in sales due to the spread of the virus and toward products that were holding steady. The company also decided to invest in the conversion of some production lines so it could make personal protective equipment, urgently needed during the pandemic.

Meanwhile, senior leaders at a retail company that was in distress worked with the financial-planning team to build a list of priority initiatives and to map all potential levers required to carry them out successfully—cost, working capital, capital expenditures, and so on. It performed a deep-dive analysis of the products and services associated with these initiatives, as well as sales expected in the near and long term, to ensure that resources and priorities could be appropriately lined up. With this information in hand, senior leaders revised their list of priorities, deferring several initiatives and canceling a few initiatives outright.

Identify 'trigger points'

Particularly in times of crisis, the financial-planning team must closely monitor the company's liquidity and earnings performance and any changes in the market. In our experience, senior leaders can fall into the trap of wanting to track multiple key performance indicators (KPIs) when only about ten variables matter. The financial-planning team should formally identify the most relevant indicators (or "trigger points") among all the business and operational drivers reviewed throughout the process. For many, this will include cash and sales figures but could also encompass customer-retention rates and sales-pipeline metrics. At one grocery retailer, for instance, it was critical to monitor inventory to avoid stock-out situations.

The team can then build a dashboard, which can be reviewed daily by the financial team and monitored for what has changed and any interventions required as a result of these changes—whether that means pulling different levers to achieve desired outcomes or modeling new scenarios. Initially, the dashboards created by the financial-planning team are likely to be "bootstrapped" using Excel and other common software. Ideally, they would be updated as often as possible to ensure that decision makers are receiving the most up-to-date, most reliable information.

In addition, the financial-planning team should identify those KPIs that would signal that the company is moving out of the crisis phase and entering the next normal; McKinsey research shows that companies' early recovery from downturns usually results in outsize gains in the market.[1]

Institutionalize new ways of working

By following the approach outlined in this article, financial-planning teams will inevitably begin to establish a range of new capabilities within the

[1] Martin Hirt, Kevin Laczkowski, Mihir Mysore, "Bubbles pop, downturns stop," May 2019, McKinsey.com.

Playing catch-up: Bolstering FP&A capabilities

The role of financial planning and analysis (FP&A) is heightened in times of crisis, but some companies are finding that—just when they really need these capabilities—they lack the accelerated analytics, business insights, and digitally driven solutions FP&A teams can provide.

In pursuit of various cost efficiencies, some companies have gradually reduced their investment in FP&A capabilities over the years and have inadvertently focused the function's efforts on arduous reporting and planning requirements instead of higher-order translation (from strategy to action) and analytical skills. This focus overlooked the skills most required from FP&A during events such as COVID-19: the ability to clarify quickly for business leaders the underlying drivers of the business, help them identify specific actions and initiatives required to manage through the immediate crisis, and, led by a focused plan-ahead team, anticipate actions for recovery.

There are several ways companies and FP&A organizations can begin to close this gap. In times of crisis, when the finance team is being pulled in many directions at once, the FP&A function should strive to convene agile teams of problem solvers to steer scarce analytical and strategic resources and capabilities to the priorities that matter. When financial acumen is in short supply, the FP&A team should reach out to others within the finance function who possess the relevant skills—and even to leaders in adjacent functions like operations and marketing who may themselves have spent time in FP&A. And given the uncertain labor market, this may be a good time for companies to look outside to find FP&A leaders with the required expertise.

There is no substitute, of course, for ongoing investment in FP&A capabilities. The companies that want to get it right should bump "FP&A talent development" up higher on the list of organizational priorities, and they should measure and monitor the function's progress in this regard. An intentional approach to bolstering FP&A capabilities is the only way to ensure that companies can generate the critical analyses and executive support they need, in both good times and bad.

finance function—for instance, rapid planning and forecasting; cross-functional collaborations; and dynamic dashboards, KPIs, and triggers. In the next normal, companies should consider ways to build on these capabilities and embed them into day-to-day forecasting and performance-management processes.

They may want to shift permanently to shorter planning cycles, more frequent review of KPIs, or the use of zero-based budgeting models. The types of dashboards, nerve centers, and spend-control towers being developed to track finances during COVID-19 could be repurposed postcrisis to vault the company into its period of recovery. Finance organizations could further empower members of the financial-planning and analysis (FP&A) team to act as "sentinels" for recovery and resilience (see sidebar, "Playing catch-up: Bolstering FP&A capabilities").

For those finance functions and FP&A teams that have not explored automation and other time-saving technologies, the crisis may be a jumping off point to do so—freeing up members of the financial-planning team to serve as strategy partners and value managers rather than report generators.

COVID-19 is a global public-health crisis with tragic consequences. It does not have to be an economic disaster as well. Finance executives have a clear role in helping their companies through the pandemic with both a steady hand and a will to succeed. The times demand nothing less.

Ankur Agrawal (Ankur_Agrawal@McKinsey.com) is a partner in McKinsey's New York office, where **Matthew Maloney** (Matthew_Maloney@McKinsey.com) is a consultant; **Kapil Chandra** (Kapil_Chandra@McKinsey.com) is a senior partner in the London office, and **Michele Tam** (Michele_Tam@McKinsey.com) is a senior expert in the Chicago office.

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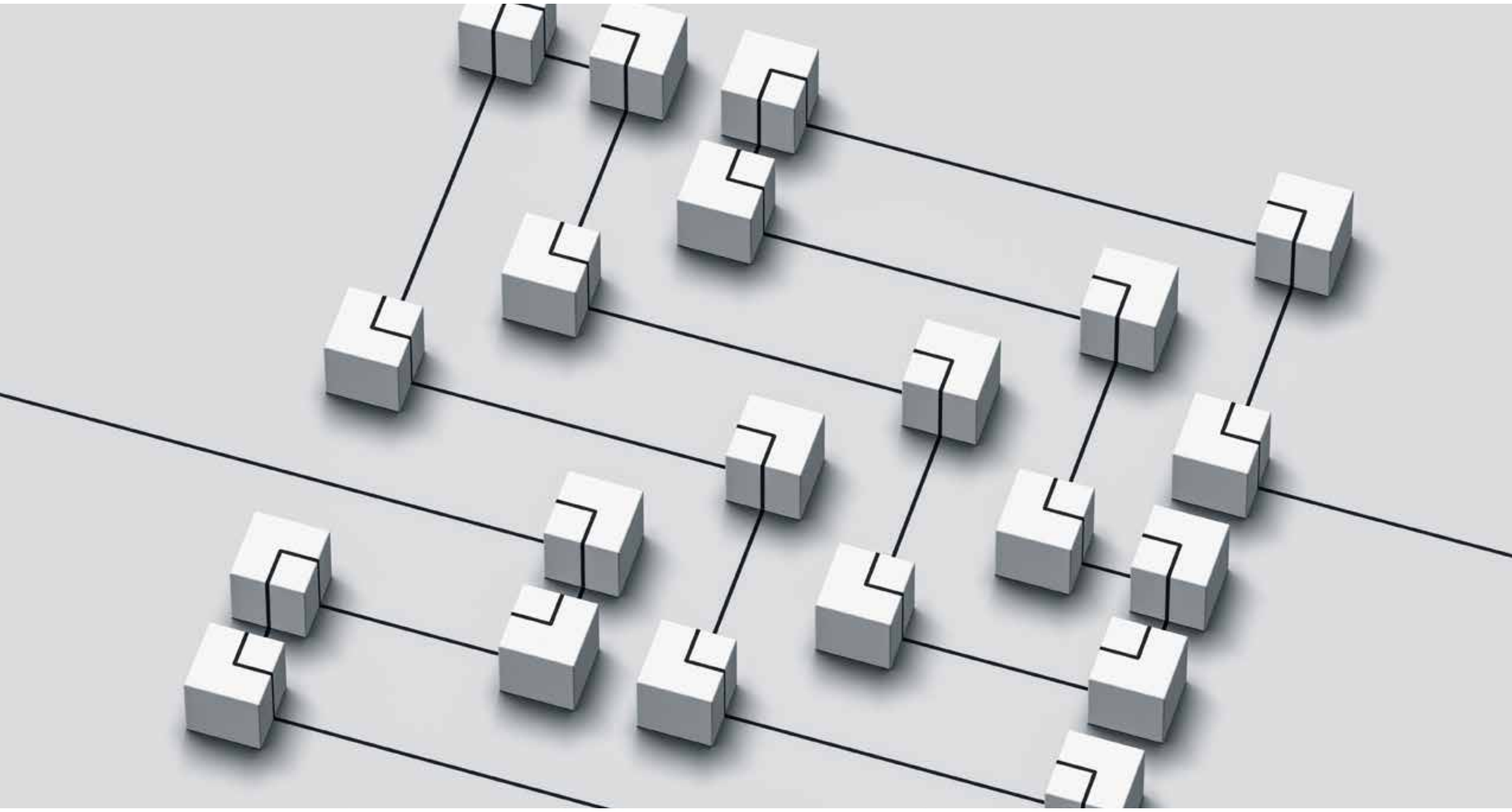
How the CFO enables the board's success—during COVID-19 and beyond

Two board experts explain how in times of crisis or transformation, the CFO can serve as a rock in the boardroom, a critical arbiter of difficult decisions, and a scout for the future.



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Critical business decisions cannot be made unless management teams and boards of directors are on the same page. Transparency, fair and balanced dialogue, and well-structured processes for gaining agreement on strategic plans—these dynamics must be present in every boardroom, in good times and, especially, in bad.[1]

The CFO plays an important role in ensuring that they are.

In crises, such as the global spread of the novel coronavirus,[2] the CFO is best positioned to provide the most relevant and up-to-date facts and figures, which can help boards find clarity amid chaos. In corporate transformations, the pragmatic, data-focused finance leader is the only one who can prompt the board to actively consider all the short- and long-term consequences of proposed strategy decisions.

Rick Haythornthwaite and Barbara Kux, longtime board directors for multiple global organizations, shared these and other board-related insights with McKinsey senior partner Vivian Hunt in a conversation that spanned two occasions: a gathering of CFOs in London some months ago and, more recently, follow-up phone conversations about the COVID-19 pandemic.

These interviews, which have been condensed and edited here, explained the importance of finance leaders in serving both as scouts for the future and as trusted translators of critical market information.

Shaping the COVID-19 crisis response and recovery

Rick Haythornthwaite: The board's most important functions in the wake of COVID-19 are threefold. One is making sure that employees are being treated decently and that the company is taking all the precautions it can. Second is obtaining an objective, insightful understanding of the business and trends. And third is anticipating and preparing for recovery. The key in all three areas is having high-quality data to inform the board's decisions and to share with employees. Of course, getting data from a market in freefall is never easy. This is where you need CFOs to be absolutely on top of their game.

The board needs to know what is *really* happening to the top line, what short-term measures can be taken to preserve and boost cash, and all the actions you have to take during the early stage of such events to buy time. But the board must also have a handle on long-term issues.[3] And now that we're months into this crisis, people are starting to draw lessons from previous ones and bringing some historical data into board discussions. The CFO can use these data to construct hard-edge scenarios that prompt good conversations in the boardroom.

Barbara Kux: An important difference in the role of CFOs today, as compared with their role during the financial crisis in 2008, is that they need to simultaneously manage both short-term responsiveness and future recovery. The CFO must keep the ship floating through rough waters—safeguarding employees' health, securing liquidity, monitoring cash flow and payment terms, ensuring the functioning of the supply chain, assessing effects on P&L and the balance sheet, reviewing customers' and suppliers' situations, and initiating cost-reduction programs. That is all very challenging indeed. But then the CFO must also serve as the ship's scout—watching for key trends that are emerging or that have accelerated as a result of COVID-19, such as digitization and changes in consumer behavior.

The balance between opportunity and risk is being altered substantially for most companies. The CEO could be tempted to profit from immediate demands—"let's make ventilators, let's make disinfectants." The CFO's job, by contrast, is to

[1] Robyn Bew, Linda Liu, and Friso van der Oord, "Building board-management dynamics to withstand a crisis: Addressing the fault lines," September 2019, McKinsey.com.
[2] See "Coronavirus: Leading through the crisis," McKinsey.com.
[3] See Martin Hirt, Celia Huber, Frithjof Lund, and Nina Spielmann, "Boards of directors in the tunnel of the coronavirus crisis," April 2020, McKinsey.com.

Rick Haythornthwaite

Education
Holds a bachelor's degree in geology from the Queen's College, Oxford, and a master's degree from MIT Sloan School of Management

Career highlights
Mastercard
(2006–present)
Global chairman

Globant
(2019–present)
Independent director

Moelis & Co.
(2018–present)
Advisory partner

QIO Technologies
(2014–present)
Cofounder and chairman

Centrica
(2014–19)
Chairman

Invensys
(2001–05)
CEO

Blue Circle Industries
(1999–2001)
CEO

Fast facts
Served on the boards of Cookson, Imperial Chemical Industries, Lafarge, Land Securities, and Premier Oil

Chair of the Creative Industries Federation and former chair of Network Rail, the Southbank Centre, and Almeida Theatre

Barbara Kux

Education
Holds an MBA with distinction from INSEAD

Career highlights
Grosvenor Group
(2019–present)
Nonexecutive director, member of the audit committee

Coaching4Vision
(2017–present)
Leadership coach

Pargesa Holding
(2014–present)
Member of the supervisory board and the audit and remuneration committee

Firmenich SA
(2013–present)
Vice chairman, lead director, and member of the audit committee

Henkel
(2013–present)
Member of the supervisory board

Total
(2011–17)
Member of the board of directors and the governance and strategy committee

Siemens AG
(2008–13)
Member of the management board

Royal Philips
(2003–08)
Member of the group management committee

Ford Motor Company
(1999–2003)
Executive director

Fast facts
Served as a member of the managing board of Siemens, the first woman in the company's 160-year history to hold this position

Appointed director of corporate governance at INSEAD, adviser to the EU Commission, and lecturer at University of St. Gallen

Former McKinsey consultant

“The word ‘crisis’ has two meanings, one being ‘danger’ and the other being ‘chance.’ Today’s CFO must consider both.”

point out the differences between quick-to-market options and long-term post–COVID-19 options. These post–COVID-19 options can be an important factor in motivating and engaging employees during these challenging times.

It is also important for the CFO to present the board with reports and pre-reads that paint the entire picture in an objective way, including potential scenarios for the future. That is the only way boards and senior management can take thoughtful and well-founded decisions—first for the recovery and then for a sustainable future for all stakeholders. The word “crisis” has two meanings, one being “danger” and the other being “chance.” Today’s CFO must consider both.

Shaping the general transformation agenda

Barbara Kux: Outside of crisis periods, studies by INSEAD and McKinsey show, boards spend more than two-thirds of their time on “housekeeping”—financial reporting, compliance, environment, health and safety issues, regulatory issues, and the like.[4] Only about 20 percent is spent on strategy. It is very important for boards to get out of this “compliance cage,” as I call it, and really focus on sustainable value creation. I’m thinking of the board of a leading oil and gas company that did just that. It recognized the importance of sustainable business development early on. The company gained first-mover advantages by diversifying toward a green business, including investing in solar and battery technologies.

At the end of the day, the board is ultimately responsible for the strategy, and the CFO is best positioned to support strategy discussions. The finance leader can serve as a neutral party among the members of the C-suite, synthesizing their transformation ideas, supplementing them with comprehensive quantitative and qualitative data, and then working with the CEO to bring it all back to the board. This is even more important today to respond to COVID-19–related challenges early on.

Rick Haythornthwaite: The biggest challenge for any CEO, CFO, or other senior leader is to institutionalize new ideas without sucking the life out of them. Each C-suite leader plays a different but important role in this regard. The CFO needs to give transformation initiatives structure and rigor, while the CEO is probably better suited to take on the motivational aspects—for instance, the context for change and definitions of success. The whole team creates the strategy map—the markets and products affected, changes in pricing, the execution plan. But the CFO needs to ensure that the financial and operational underpinnings are there. Even if they are not visible to every single part of the organization, the board can see them through the CFO.

[4] See “A time for boards to act: McKinsey Global Survey,” March 2018, McKinsey.com.

‘Scouting for the future’

Barbara Kux: To serve as an effective scout, the CFO should establish nonfinancial KPIs, like net promoter and employee-engagement scores, that are critical for the future health and performance of the organization. CFOs should review the strategy process to see that risks and opportunities are being well-assessed. And they can raise the political antennae of the board—accessing global think tanks, for instance, to understand what’s going on in Washington, China, and other important regions or in the medical community. The CEO often is not the most long-term-focused person in the organization; we know this because our financial markets are still very much short-term oriented. The board *has* to be long-term oriented. The CFO, therefore, must maintain a good balance of both. That might mean introducing a lean-transformation program with a focus on short-term results while, at the same time, contributing to the definition and implementation of a sustainable strategy for the company to emerge strong from the COVID-19 pandemic.

Rick Haythornthwaite: Boards need CEOs who can handle multiple truths, who can be expansive in thinking, and who can live comfortably in the future and bring the company along for the ride. The CFO also needs to be a protagonist in the boardroom, but from a different base: you can’t move to the future until you are anchored in the present. The CFO provides that anchor. Having a balance between future and present, between CEO and CFO, is important. The board wants to feel that there is strategic momentum—but also that the company is not just heading off on a journey of delusion.

Daring to dissent

Barbara Kux: It is important for the CEO and CFO to get on well, but their relationship should not be too close. It is better for the CFO to be objective, even if that sometimes leads to constructive conflicts. At times the CEO defaults to presenting only the positive in the boardroom, which makes it harder for the CFO to play back a more objective story. But that is very much the role of CFOs. They need to raise those early warnings. As a board director, I feel better if the CFO sometimes states, “By the way, we are losing market share here.” It takes a great deal of self-assurance for the CFO to come into the boardroom and say something like that. An independent-minded CFO will always be transparent with the board. A good CEO will always strive to establish an open relationship with the CFO. It is important for the board to motivate this constructive behavior from both executives, so it can truly understand what is going well or not so well.

Leading constructive dialogues

Rick Haythornthwaite: The senior-management team should not be delivering full solutions to the board at the outset; there should be a period of questions and discussion. The boardroom should

> **“An independent-minded CFO will always be transparent with the board. A good CEO will always strive to establish an open relationship with the CFO.”**

be the place for CFOs and boards to engage in the cut and thrust of examination and exploration, with thoughtful planning and framing of dialogues to ensure that decision making is of the highest possible quality.

I'll give you an example. CFOs used to be able to put traditional capital cases in front of the board about things like investments in plant and equipment, and there was typically a well-grooved dialogue. The kinds of actions they are talking about have changed, though. Think about companies' investments in platform technologies, which can involve large sums being paid for targets with very low EBITDA—the idea being that value will ultimately come from the combination of entities rather than from a singular target.

Boards may be unfamiliar with such investment cases, so rather than jumping into quick, instinctive type-one decisions forced by the imposition of inappropriate and probably unnecessary time constraints, they will need an education. The board must take time to understand what, in practice, the acquisition of a platform would look like—how it might be scaled under new ownership, how that scaling would affect the bottom line, any risks involved, and so on. This is fundamentally a type-two decision, requiring time and deliberation. The CFO has an important role to play in making sure that this process happens, that it plays out over several board sessions rather than being squeezed into one meeting, and that conversations are grounded in hard numbers.

In the wake of COVID-19, of course, these dialogues may need to happen virtually; the quality of the conversation will still be good, as people are becoming accustomed to virtual meetings.[5] They are fine for certain pro-forma tasks, where the issues are well understood and processes are well established. But when you're trying to bring in new voices and new ideas, that's when you need to be together in the same room.

Growing into the role of change agent

Barbara Kux: The role of the CFO is so much more expansive than it was even five years ago, including additional responsibility for cyber and digital transformations and for IT initiatives. To get your arms around the role and grow in it, take a step back and look at the company objectively. "What other roles could I play in the company, and how does that overlap with what I am doing now?" "Which initiatives would make the most impact in the company, and how could I realize quick wins in those areas?" Maybe it's a focus on digital or compliance or export control or political intelligence. The CFO's professional response to COVID-19 crisis management could be a springboard for future development. Whatever it is, I would identify it and just start. Take any kind of training you can get; read as many business publications as you can. Train yourself in how to deal with activist investors. Step by step, your hat will become bigger.

Rick Haythornthwaite: Whether you are talking about COVID-19 or digital disruption or any other impact on the business, please remember that the board still wants to sleep at night, and when the details are lost, the board will be much less forgiving of CFOs than of CEOs. Don't forget that part of it. Particularly in this challenging economic environment, it is very important. Chairs and boards? We like to sleep soundly at night.

Vivian Hunt (Vivian_Hunt@McKinsey.com) is a senior partner in McKinsey's London office.

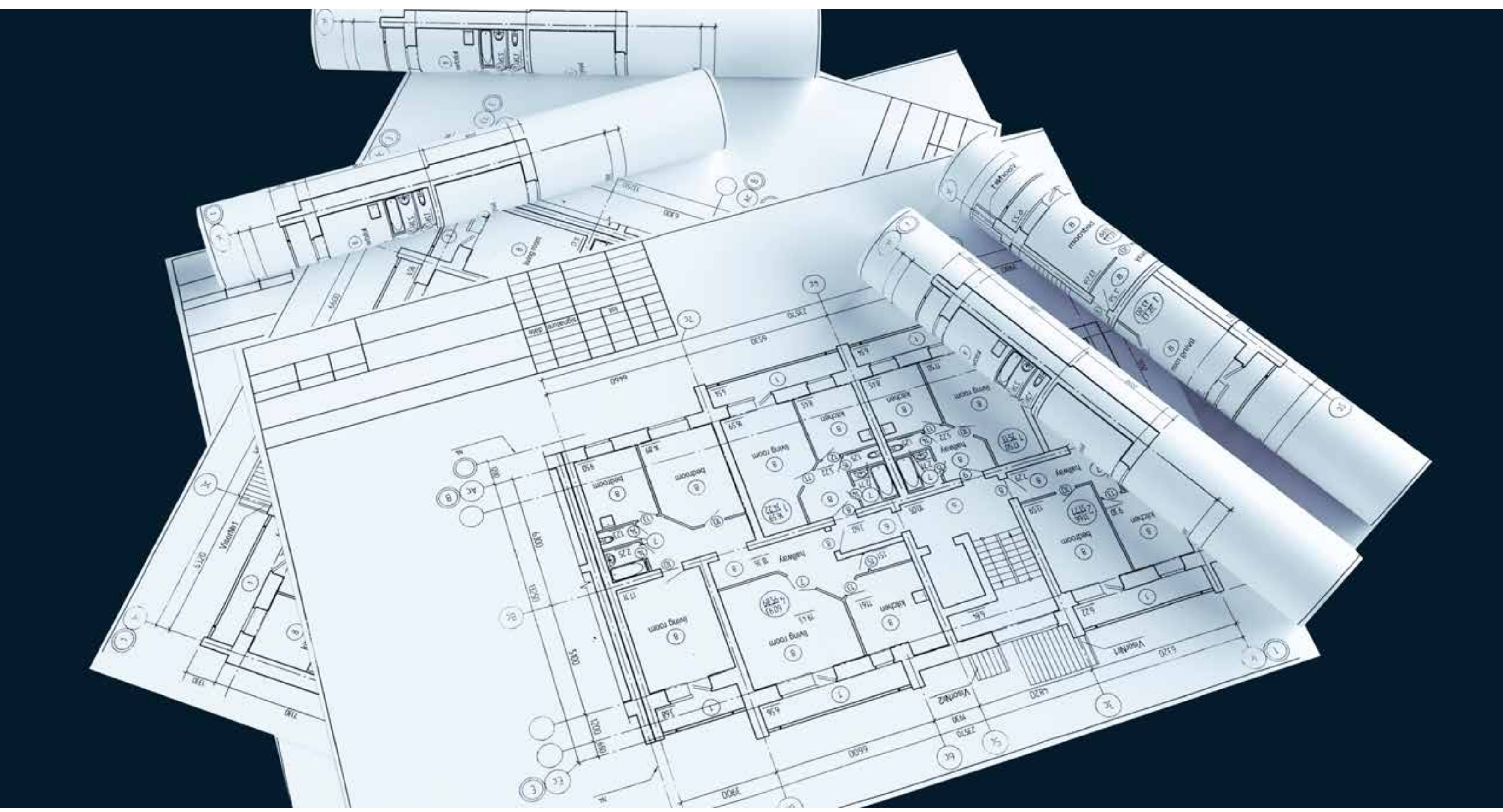
The author wishes to thank Kapil Chandra, Frithjof Lund, Vanessa Palmer, and Nina Spielmann for their contributions to this article.

[5] See Martin Hirt, Celia Huber, Frithjof Lund, and Nina Spielmann, "Boards of directors in the tunnel of the coronavirus crisis," April 2020, McKinsey.com.

A blueprint for M&A success

Programmatic M&A can help companies build resiliency, but this approach to deal making requires a solid game plan—one that will guide proactive deal sourcing and opportunistic deal evaluation.

by Sophie Clarke, Robert Uhlaner, and Liz Wol



Large mergers and acquisitions (M&A) tend to get the biggest headlines, but, as McKinsey research indicates, executives should be paying attention to all the small deals, too. These smaller transactions, when pursued as part of a deliberate and systematic M&A program, tend to yield strong returns over the long run with comparatively low risk.[1] And, based on our research, companies' ability to successfully manage these deals can be a central factor in their ability to withstand economic shocks.[2]

The execution of such a programmatic M&A strategy is not easy, however. Consider the situation at one global cosmetics company (a hypothetical case based on real-world experiences). Enthusiastic executives all had different ideas about which M&A opportunities the company should pursue (exhibit). The CEO was pushing for a big bet on digital, given the company's superior financial position. Some senior leaders proposed expansion in greater China, the fastest-growing market for premium cosmetics. Other business-unit leaders saw potential in the markets for organic products and men's grooming. All had their own agendas (see sidebar, "Undue influences").

Propelled by a healthy dose of FOMO (or fear of missing out) but lacking a clear set of priorities, the M&A team made multiple small bets on a range of businesses—even on some unexpected targets in adjacent markets (such as pet grooming). But the team did not have a clear plan for creating value from these targets nor for integrating them into the current business structure. The result?

Exhibit

When there is no clear connection between M&A strategy and corporate strategy, deals may falter.

Enthusiastic ideas for acquisitions …	Let's leverage our superior financial position (healthy balance sheet) vis-à-vis peers to make a "big bet" on digital channel.	Let's expand our business to greater China. That is the fastest-growing market for premium cosmetics.	Let's acquire an organic beauty company. Consumers want organic, and we have nothing to offer.	Let's enter the men's grooming business. Men need products, too.
… wither due to lack of underlying rationale and integration plans	This digital target could have allowed us to do online sales … it was just too expensive.	We acquired a few exciting, high-growth targets in Asia. Unfortunately, integration took longer than we had hoped, as scaling our existing processes in Asia was very complicated.	I know we weren't planning on buying a pet-grooming company, but it turned out to be a great deal and had a surprising amount of synergy with our business.	Our bank managed to find a ton of targets in all the adjacent businesses we were interested in (organics and men's grooming), and we acquired one of each.

1 Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," July 2019, McKinsey.com.
2 Martin Hirt, Sven Smit, Chris Bradley, Robert Uhlaner, Mihir Mysore, Yuval Atsmon, and Nicholas Northcote, "Getting ahead of the next stage of the coronavirus," April 2020, McKinsey.com.

Undue influences

The hypothetical case of the global cosmetics company points to two common cognitive biases that can emerge when *any* company attempts to pursue programmatic M&A: the shiny-object syndrome and Maslow's hammer.

The shiny-object syndrome—also known as extreme distraction. Companies that continually chase down the next new thing run the risk of pursuing initiatives in the wrong order, skipping foundational tasks, or duplicating efforts and investments.

The M&A team at the cosmetics company, for instance, was reactive. It was swayed by deals sourced by third parties, and it ended up inventing growth strategies around possible, exciting targets without a clear understanding of how they could generate value.

Maslow's hammer. In his 1966 book *The Psychology of Science* (HarperCollins), psychologist Abraham Maslow stated, "I suppose it is tempting, if the only tool you have is a hammer, to treat everything as if it were a nail." This is the approach the cosmetics company favored—establishing a well-organized M&A team but then using it to drive almost *all* growth rather than applying it only to those opportunities best suited to be bought, not built.

Without an M&A blueprint to provide an incontrovertible fact base and action plan, the cosmetics company's efforts to implement programmatic deal making turned into a quixotic, time-wasting effort.

The organization ended up wasting time and resources on deals that were mostly unsuccessful, and its executives unintentionally created an unwieldy portfolio of businesses.

As this example illustrates, success in programmatic M&A requires much more than just executing on a long string of deals. Acquirers must articulate exactly *why* and *where* they need M&A to deliver on specific themes and objectives underlying their overarching corporate strategies. In addition, they must give careful thought as to *how* they plan to pursue programmatic M&A—including constructing a high-level business case and preliminary integration plans for each area in which they want to pursue M&A.

Taken together, these factors combine into what we call an M&A blueprint. In this article we discuss how it can be implemented to help organizations remain unrelentingly focused on their investment thesis throughout the deal process. Having a clear M&A blueprint is even more critical as companies begin to consider how to rebound from COVID-19. Without an M&A blueprint, it will be more difficult for companies to distinguish between through-cycle opportunities that are consistent with their corporate strategy and "low-hanging, distressed asset" deals that are not.

M&A blueprint: The building blocks

The M&A blueprint can help executives answer three main questions: *Why* and *where* should we use programmatic M&A to achieve our corporate strategy? And *how* should we use programmatic M&A to achieve our corporate strategy? Answering these questions will require asking still more clarifying questions about specific organizational strengths and capabilities, resources available, and other inputs to effective deal making.

Understanding 'why' and 'where'

The M&A blueprint prompts business leaders to conduct a thorough self-assessment along with a comprehensive market assessment. The self-assessment helps establish the baseline from which to identify gaps in corporate ambitions as well as the opportunities for M&A to fill these gaps. It involves examining a company's key sources of competitive advantage and testing their scalability to determine whether they would still play to the company's advantage after a transaction. For its part, the market assessment acts as a "sense check" for business leaders, ensuring that the company's M&A strategy capitalizes on the most recent and relevant trends, accounts for potential disruptions, and acknowledges competitors' likely actions and reactions.

An M&A blueprint should also define any boundary conditions, or limits to the company's use of M&A. These conditions, which are typically imposed by the CFO or the board investment committee, provide an important reality check: they define the constraints on certain types or sizes of deals, thereby further narrowing the scope of potential targets. In setting these conditions, business leaders should account for preexisting financial hurdles—for instance, a rule that "deals must be accretive in the first year" likely would not apply to deals targeting growth and might therefore overly constrain M&A activity. Establishing these boundary conditions at the outset—with explicit agreement from the CFO and the board—can help put teeth into investment commitments and align everyone on negotiable and nonnegotiable terms.

Taken together, the self-assessment, market assessment, and review of boundary conditions can help executives understand the circumstances under which the pursuit of M&A makes the most sense, as well as the markets they are best positioned to enter. Indeed, the output of business leaders' discussions about "why and where" will be a set of M&A themes that reflect the company's best value-creation opportunities—those for which the company has the capabilities and resources to achieve intended strategic goals.

What does a good M&A theme entail? For each theme, senior leaders should identify important deal criteria (categorizing potential targets by geography, sales channel, product type, and so on) as well as standard screening metrics like company size, number of employees, revenue growth, product portfolio, ownership, and so on. With this detailed information, organizations and M&A deal teams can continually cultivate potential targets within focused M&A themes while still being opportunistic about deals that present themselves.

Once these themes have been identified, business leaders should test whether the company can execute against them—for instance, are there enough targets available, and do the right targets exist to fill gaps in the company's capabilities? The M&A blueprint will be particularly critical in target-rich environments to help narrow down the list of potentials.

A "gold standard" M&A blueprint is detailed and focused on critical competitive information (value-creation levers, company capabilities, and so on). To understand whether their companies' M&A themes are detailed enough, business leaders should consider whether they would be comfortable broadcasting those themes to competitors. The

The M&A blueprint prompts business leaders to conduct a thorough self-assessment along with a comprehensive market assessment.

answer should be "no." If the answer is "yes," more work on the blueprint will be needed, as it and the related themes are likely not specific enough to be useful to M&A teams.

Understanding 'how'

An M&A blueprint also prompts senior leaders to come up with a plan for "how" they will use M&A to further their overarching corporate strategies. Specifically, the M&A blueprint should delineate the high-level business case and preliminary integration plans associated with each M&A theme.

The business case should explain how the acquiring company plans to add value to the target or targets within a given M&A theme—for instance, the capital and operating expenditures needed (beyond the acquisition price) to integrate and scale the asset or assets. It should also outline the operational changes and capabilities that will be required to integrate the new assets—for instance, the creation of a new business unit or a set of new business processes to manage an acquired digital platform.

One large US healthcare company had committed to a strategy of building scale in its services businesses through M&A. First, it consolidated existing disparate service businesses under a new brand and organized them into three distinct units: pharmacy-care services, diversified health and wellness services, and data-analytics and technology services. These became their three M&A themes. Then, over a ten-year period, this programmatic acquirer closed more than 60 deals, spending well over $20 billion, as it sought to fill out its portfolio along these three themes. The organization knew where it wanted to play and how.

Of course, the business case should include a preliminary integration plan for the acquired asset or assets that is consistent with the deal's value-creation thesis—for instance, all shared services will be absorbed by the acquirer, and the target company's product portfolio will be cross-sold to the acquirer's existing customers.

Through their use of the M&A blueprint, business leaders can stay focused on those parts of the deal that can create the most value—especially important when companies are pursuing multiple deals within the same M&A theme. What's more, they can prepare functional leaders, suppliers, and others well in advance for the actions they may need to take to integrate an asset or multiple assets.

M&A blueprint: Putting it all together

An M&A blueprint cannot and should not be developed based on "gut instinct" by a single executive or defined post hoc to validate the theory behind an exciting deal. An executive or business-unit leader should lead its development but should be supported by corporate-strategy and corporate-development executives. The blueprint itself can take the form of a frequently updated and disseminated written report, or it can be a standing agenda item in every M&A and corporate-strategy meeting. Regardless of format, it can help decision makers assess critical factors relating to deal sourcing, due diligence, and integration planning before making any moves and taking steps to identify targets.

Looking back at the case of the cosmetics company, it becomes clear how an M&A blueprint could have helped the organization prioritize a bunch of scattershot ideas into a comprehensive programmatic M&A strategy.

With its market assessment, for instance, it might have seen that the market for digital cosmetics is projected to grow five times faster than the market for nondigital cosmetics. What's more, market data might have revealed that customers want and expect to buy cosmetics through digital channels, and that there is no clear leader in the space. In its self-assessment, the M&A team might also have seen a gap in the company's product portfolio compared with peers. And a look at boundary conditions might have revealed the time and latitude required to pay off initial acquisition investments, enabling the team to look beyond "base hit" deals with lower acquisition costs.

The M&A blueprint would have led the cosmetics company to a different outcome—perhaps a laser focus on acquiring the set of assets and capabilities needed to build a digital platform for selling cosmetics.

Spending time up front creating an M&A blueprint will pay off over the long term—particularly given the volume of deals associated with a programmatic M&A strategy. With M&A themes and criteria well defined and understood by all, companies can not only be more proactive but also be more opportunistic. The top team will be aligned on strategy and focused on deal must-haves prior to reaching out to potential targets. Negotiations with potential targets can be grounded in the business case. Diligence processes can be accelerated and focused only on the most critical sources of value. Integration planning can begin early, with a focus on realizing the strategic intent of the deal rather than just stabilizing companies, people, and processes in the wake of change. Most important, the M&A blueprint can help executives tell a compelling story (inside and outside the company) about its deal-making strategy and its vision for the future.

Sophie Clarke (Sophie_Clarke@McKinsey.com) is a consultant in McKinsey's New Jersey office, where **Liz Wol** (Liz_Wol@McKinsey.com) is an associate partner; **Robert Uhlaner** (Robert_Uhlaner@McKinsey.com) is a senior partner in the San Francisco office.

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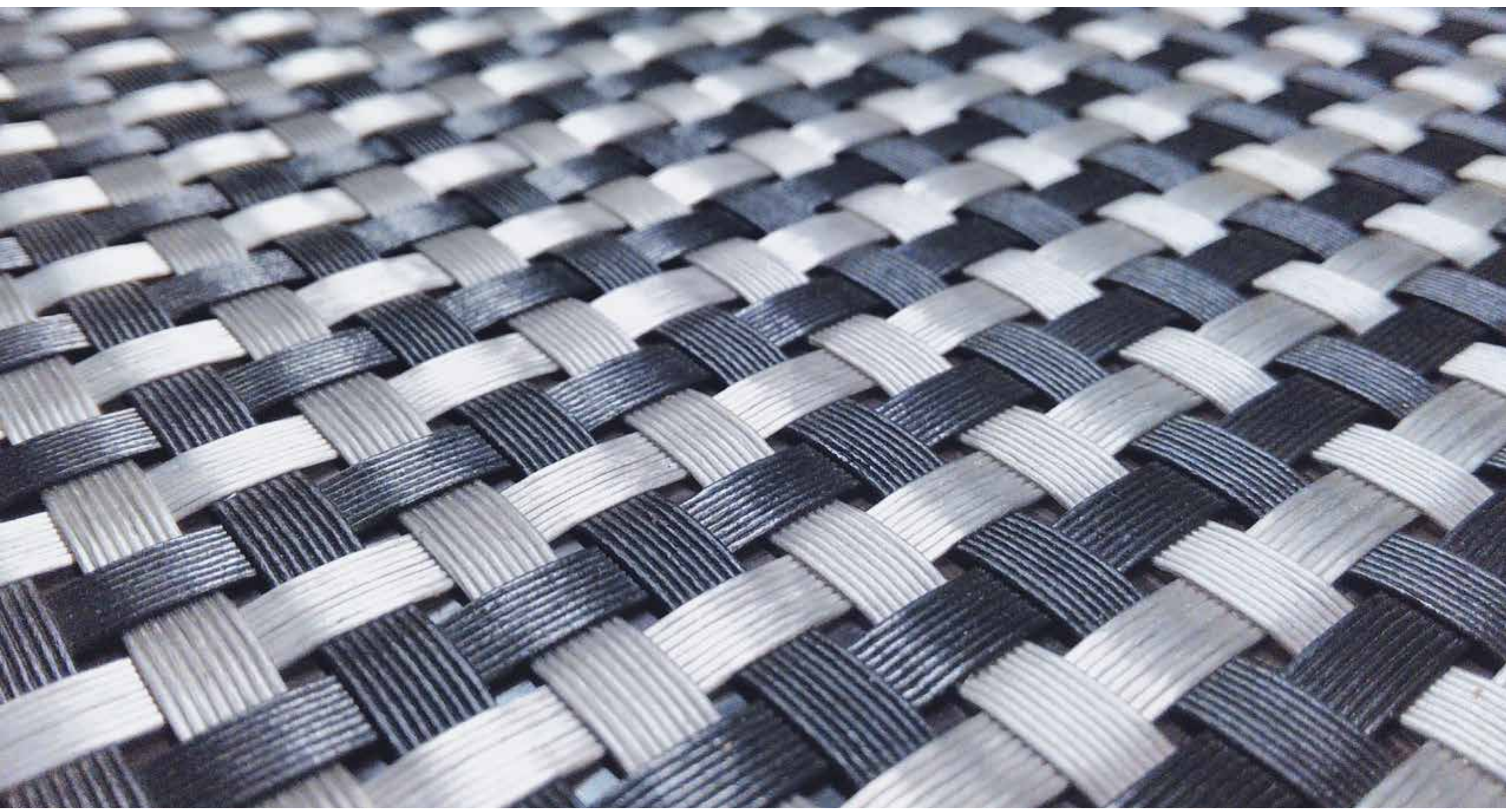
The programmatic acquirer's secret? A commitment to building capabilities

Survey findings highlight the best practices programmatic acquirers use to continually reallocate M&A resources, conduct due diligence, and close on important deals.



Past McKinsey research has found that companies completing many small deals in a year create more value for shareholders than companies completing only the occasional large transaction.[1] But what do these companies, which we call programmatic acquirers, actually do that differentiates them from the rest of the pack?[2]

More recent McKinsey research on companies' M&A capabilities[3] reveals some best practices that programmatic acquirers use in different stages of a typical merger or acquisition—strategy and sourcing, deal execution, integration, and the M&A operating model. They attempt to reallocate M&A capital to the most strategic business units, for instance, tend to have well-defined and well-communicated processes and criteria for conducting due diligence, and aim to align top teams ahead of an integration.

For these companies, programmatic M&A then becomes a virtuous circle: frequent deal making forces companies to build strong, repeatable M&A capabilities, and having those capabilities allows deal teams to seize opportunities as quickly as they emerge.

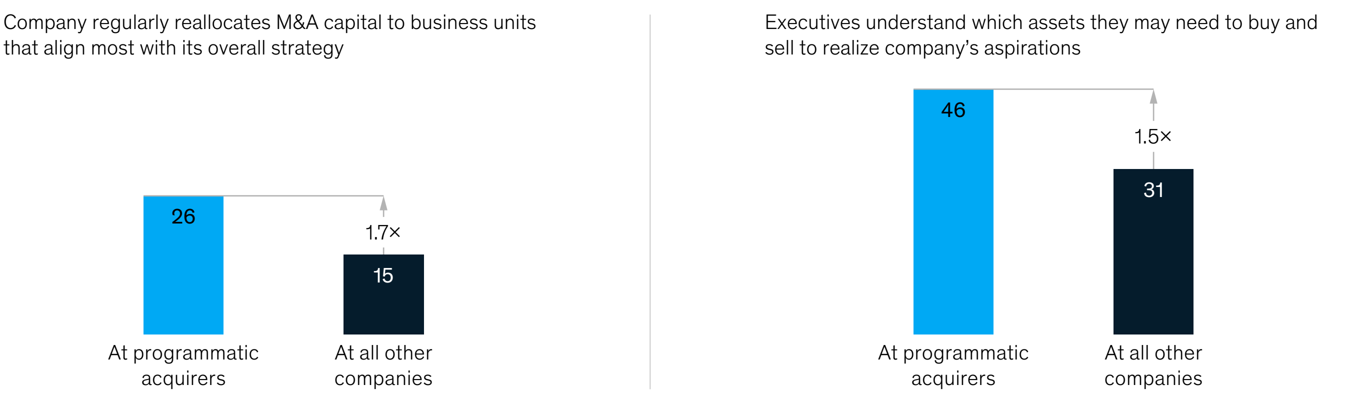
Strategy and sourcing

McKinsey research shows that respondents from those companies that use a programmatic approach to M&A are more likely than peers to strongly agree that their companies take measures to ensure that their M&A strategy and their corporate strategy are aligned. For instance, the programmatic acquirers were almost twice as likely as peers to say that their companies reallocate M&A capital regularly to the business units that map most closely to the company's overall strategy (Exhibit 1).

Exhibit 1

Companies taking a programmatic approach to M&A are likelier than other companies to have M&A strategies aligned with their corporate strategies.

Share of respondents who strongly agree with a given statement, %[1]



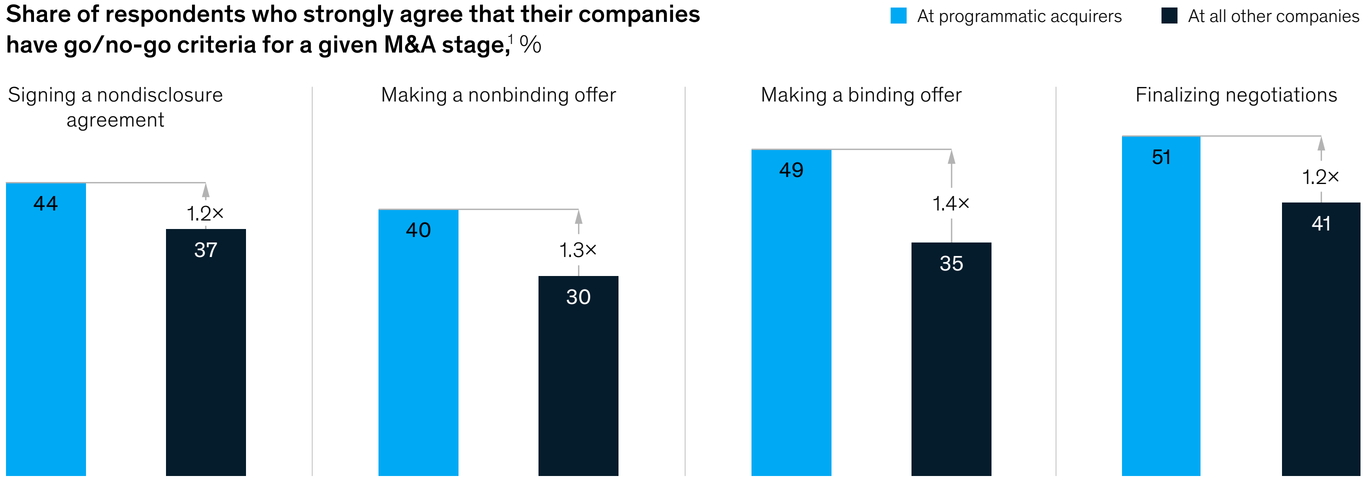
[1] For respondents at programmatic acquirers, n = 321; for all other respondents, n = 961.

[1] Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com.
[2] Programmatic acquirers are companies that have completed an average of two or more deals per year over the past five years; selective acquirers have closed one to two deals on average during that time period; and organic acquirers have completed less than one deal per year, on average, in that time.
[3] The online survey was in the field from August 16 to August 31, 2018, and garnered responses from 1,706 C-level executives and managers representing the full range of regions, industries, company sizes, functional specialties, and tenures. Of them, 1,282 said they are knowledgeable about their companies' M&A activity and answered the full survey. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

Exhibit 2

Companies with a programmatic approach to M&A set go/no-go criteria for each stage of a deal.

Share of respondents who strongly agree that their companies have go/no-go criteria for a given M&A stage,[1] %



[1] For respondents at programmatic acquirers, n = 321; for all other respondents, n = 961.

The programmatic acquirers were also 1.5 times more likely than peers to say that they know which assets to buy *and* sell to realize the company's M&A aspirations. By including divestitures as well as investments in their M&A conversations, these companies can actively shape their portfolios.

Other McKinsey research on investment and decision-making practices shows that companies that actively reallocate resources are simultaneously rigorous and flexible, and they offer managers incentives to move critical resources when and where they're needed.[4] In this way, they can help to cultivate a culture in which reallocation is business as usual.

Due diligence and deal execution

The respondents at companies that follow a programmatic approach to M&A were also more likely than peers to say that they have defined processes for making go and no-go decisions at each stage of a deal (Exhibit 2). Specifically, the programmatic acquirers were 1.3 times more likely to strongly agree that they have such criteria for making a nonbinding offer, and 1.4 times more likely to have criteria for reaching a binding offer.

The programmatic acquirers also reported gathering information about revenue and cost synergies at several points in the M&A process, rather than simply at the outset (Exhibit 3). Having additional clarity about synergies can help these companies make more informed decisions about when to walk away from a potential deal.

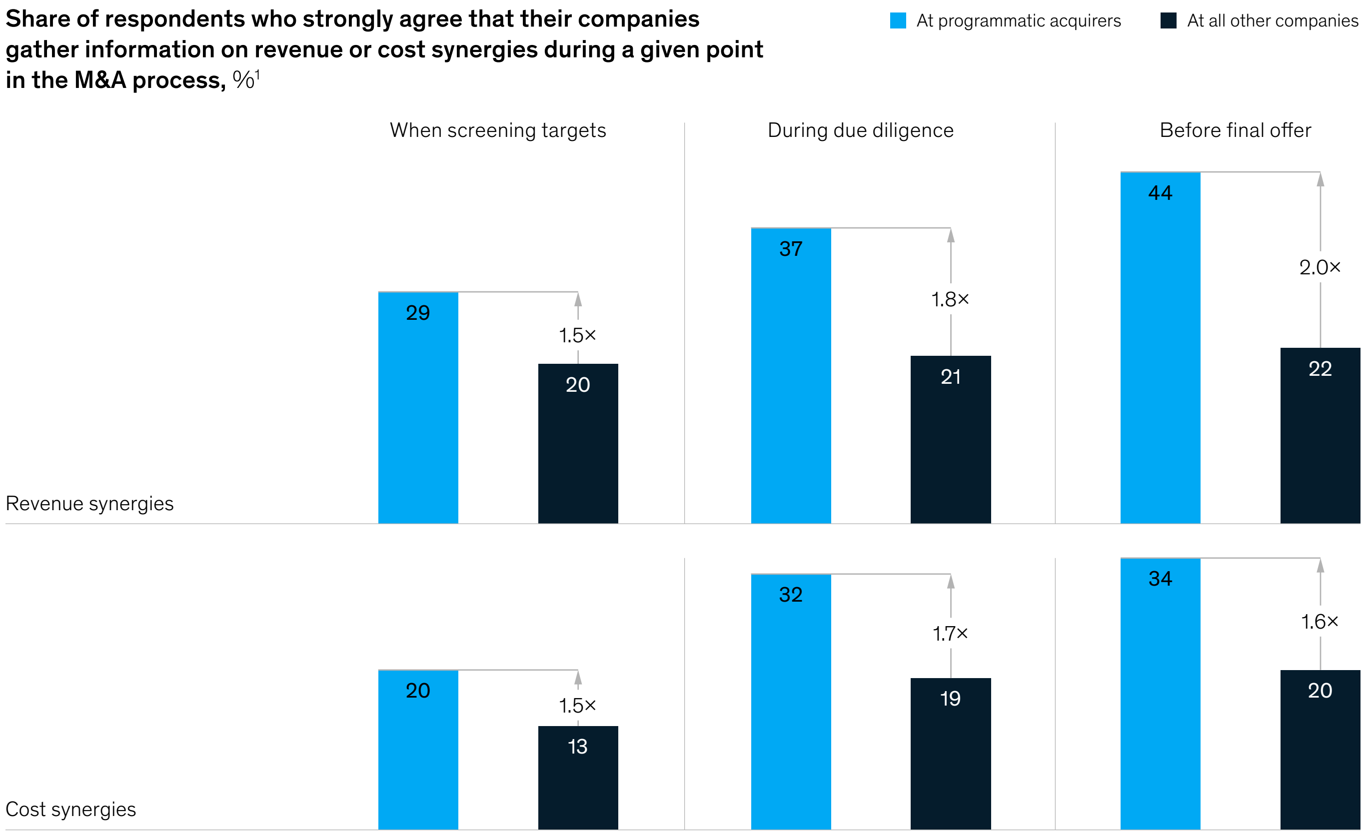
And having this information early in the deal process—when screening potential targets, for example—can help companies get a head start on planning for integration.

[4] Massimo Garbuio, Tim Koller, and Zane Williams, "Admit it, your investments are stuck in neutral," *McKinsey Quarterly*, July 2019, McKinsey.com.

Exhibit 3

Programmatic acquirers tend to gather information about revenue and cost synergies at several points in the M&A process.

Share of respondents who strongly agree that their companies gather information on revenue or cost synergies during a given point in the M&A process, %[1]



[1] For respondents at programmatic acquirers, n = 321; for all other respondents, n = 961.

Integration

The respondents from companies that take a programmatic approach to M&A said that they dedicate significant time during the integration phase of a deal to align senior leaders' interests and identify metrics that reflect the new company's vision. However, only 29 percent of them strongly agree that they spend enough time building trust among the new company's leadership team; 19 percent of other respondents say the same. Bringing these leaders together serves multiple purposes, not the least of which is enabling them to focus on communication. Respondents from programmatic acquirers are almost twice as likely as peers to say they spend enough time effectively disseminating key messages throughout their organizations and gaining buy-in at all levels. Respondents from programmatic acquirers are also 1.3 times more likely than others to say they identify those key performance indicators that will reflect the new companies' vision (Exhibit 4).

M&A operating model

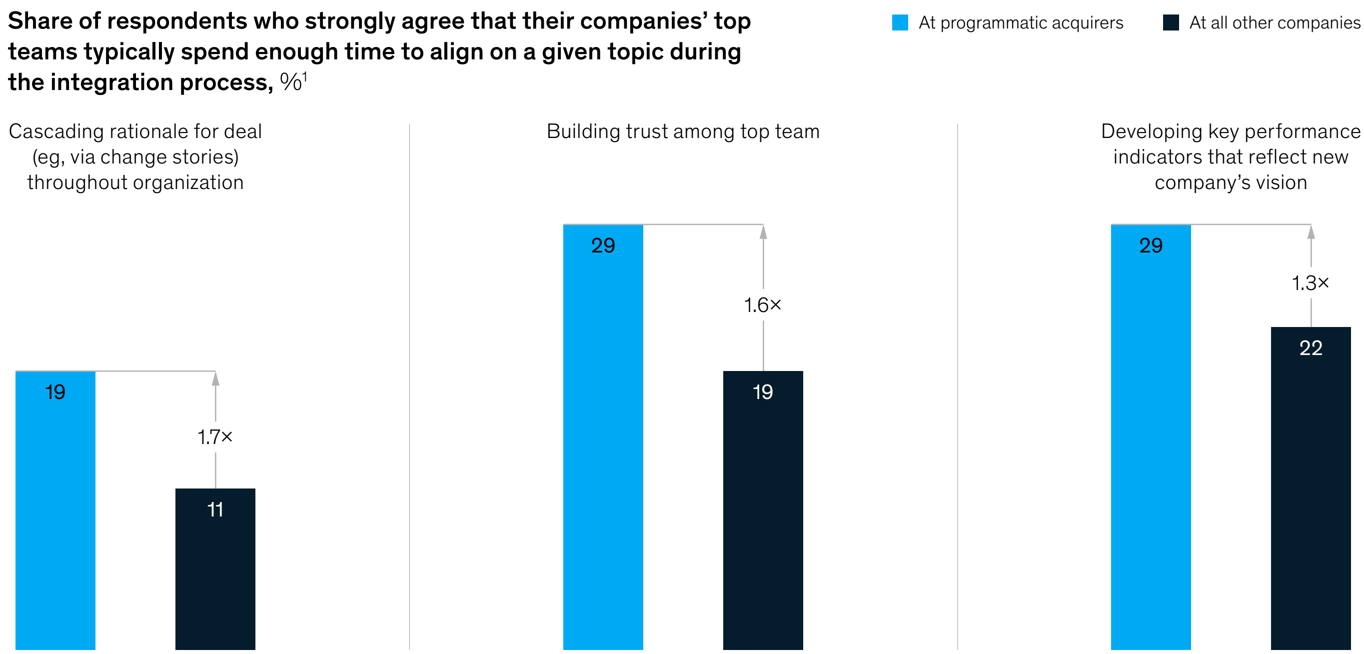
When it comes to the M&A operating model, programmatic acquirers tend to develop ongoing internal structures and processes for M&A rather than treating it as a one-off project. Respondents from these companies indicated that one way they accomplish this is by establishing clear ownership for each phase of M&A, with the owners being dedicated operational or functional professionals whose formal job descriptions include M&A responsibilities. Programmatic acquirers also codify knowledge gained from previous M&A pursuits. Respondents from these companies were more likely than peers to report the use of playbooks in each phase of the deal process, which helps to ensure that best practices are passed along and well defined for future deals.

For some companies, an M&A team owns these playbooks, distributes them as needed to business leaders involved in a given deal, helps the business leaders adhere to the established processes, and revises the playbooks as needed

Exhibit 4

Programmatic acquirers dedicate more time to aligning people, getting buy-in, and developing measurements during an integration.

Share of respondents who strongly agree that their companies' top teams typically spend enough time to align on a given topic during the integration process, %[1]



[1] For respondents at programmatic acquirers, n = 321; for all other respondents, n = 961.

after conducting postmortems. In other companies, the playbooks reside with a central project-management office that uses them as needed when a deal arises. Regardless, the codification of processes and lessons helps ensure that deals create the intended value.

Not everyone can immediately become a programmatic acquirer; M&A strategies are industry dependent; and changing a company's overarching approach to deal making can take many months, even many years. But there is one central lesson all companies can draw from the survey findings: there is no downside to continually enhancing your M&A capabilities as you would your capabilities in other strategic and operational areas.

The survey content and analysis were developed by **Patrick McCurdy** (Patrick_McCurdy@McKinsey.com) and **Jeff Rudnicki** (Jeff_Rudnicki @McKinsey.com), an associate partner and a partner, respectively, in McKinsey's Boston office; **Bernadette Stout** (Bernadette_Stout@McKinsey.com), an associate partner in the Washington, DC, office; and **Andy West** (Andy_West@McKinsey.com), a senior partner in the Madrid office.

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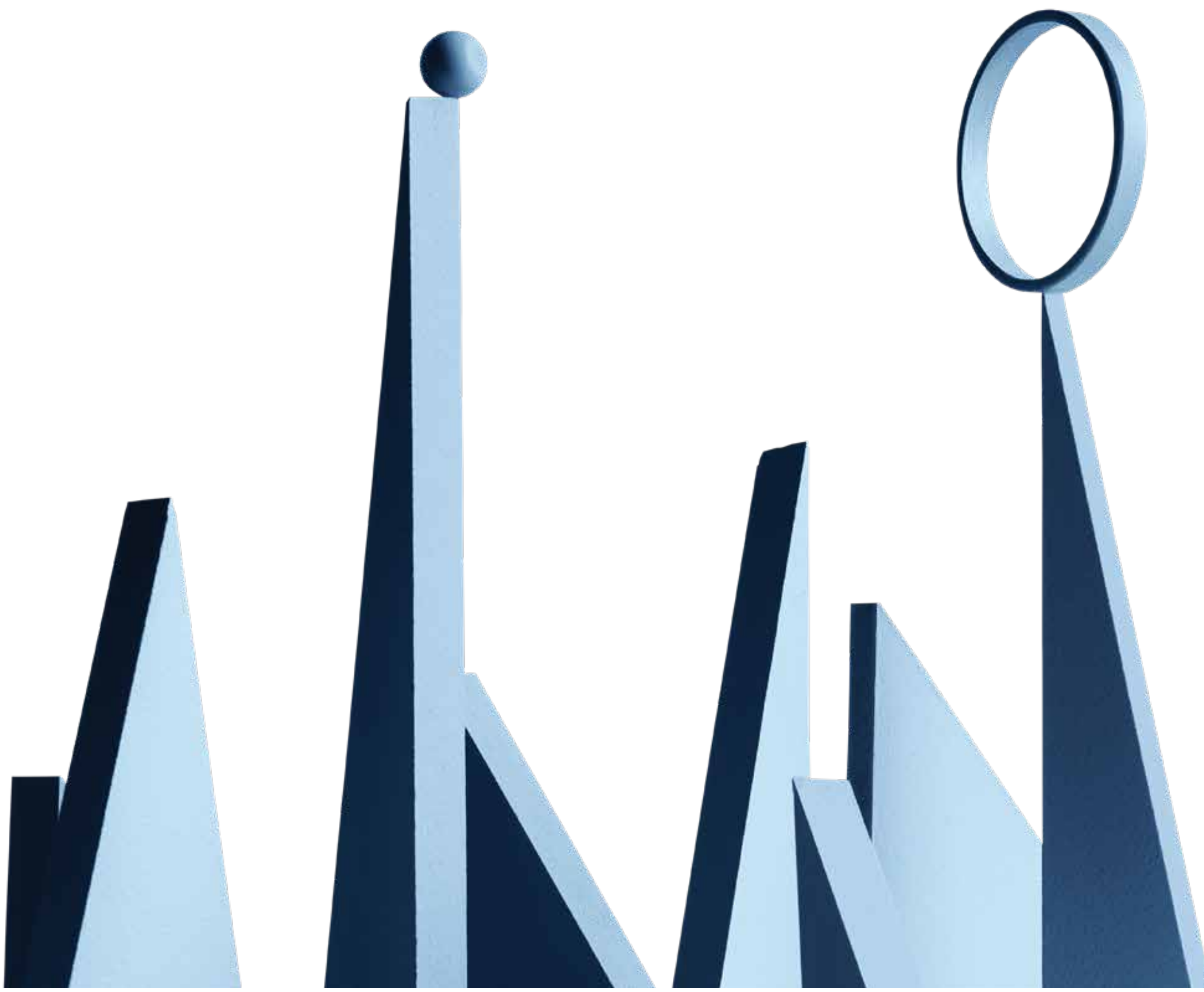
The secret to unlocking hidden value in the balance sheet

For many companies, managing financial resources is a challenge. But combining analytics with a holistic approach to balance-sheet management can help capture the opportunity and improve performance.

by Michael Birshan, Arno Gerken, Stefan Kemmer, Aleksander Petrov, and Yuri Polyakov



Many large companies are supreme revenue generators, reflecting their ability to create excitement around their offerings and consistently meet their customers' needs. When it comes to managing their financial resources, however, they are often less successful. Many struggle to maintain a strong, real-time grip on their finances and, as a result, leave significant value on the table.

Suboptimal financial-resource management is rarely the result of a single policy or decision. Rather it is the by-product of entrenched ways of working that, over time, undermine a company's financial regime. Such suboptimal management usually manifests in one, or several, of five areas of activity: funding and capital structure, liquidity (cash) management, capital productivity, risk management and contingency planning, and, where relevant, commodity-related strategy. Inefficiencies in these areas directly undermine financial performance. In an age of shareholder activism, they also leave executives exposed. Shareholders expect companies to be demonstrably at the cutting edge of financial engineering. When they see a deficit, they are increasingly likely to make their voices heard.

Underperformance in the management of a company's financial resources is a common challenge. However, it is addressable, if leaders prioritize the tools and processes necessary to make a difference. Chief among these are the latest analytical resources, which can enable more consistent modeling, better responsiveness to economic and geopolitical events, closer adherence to key performance indicators, and a sharper view of capital expenditures. Cutting-edge analytics, combined with a holistic approach across the five areas of activity, compose powerful levers to transform financial-resource management into a significant source of opportunity.

CFOs face multiple challenges

Financial-resource management sits alongside a range of responsibilities that fall under CFO remit, including value steering and control, portfolio management, risk management across products and business lines, value communication, activist-threat management, and operational excellence in the finance function. Within financial-resource management, a CFO's charges are balancing priorities and resources across the balance sheet and capital structure, managing liquidity and cash, and optimizing the company's risk position. None of this is easy. A common CFO refrain is that they "always could get something wrong," whether that be insufficient or excessive hedging, matching funding to capital-expenditure priorities, or holding too much cash at a negative carry. There is also a very consistent sense of struggling to meet the demands of competing interests, both internal and external.

In funding and capital structure management, a CFO has the constant challenge of achieving a funding mix that reflects the company's strategy at a particular moment in time while maintaining financial flexibility and keeping the weighted average cost of capital at a reasonable level.[1] There are plenty of theories as to optimal levels, and CFOs often face a challenge in justifying their positions.

With respect to managing liquidity, CFOs must weigh a precautionary attitude based on current resources against the instinct to pursue value creation. Right now, for example, many companies are sitting on cash accumulated through years of profitability and postcrisis caution. Despite rising investment and stock buybacks, the average cash holdings of the world's top 25 nonfinancial companies remained a near-record high of $43.6 billion in 2018, according to Moody's Investors Service. However, it's tough to find the right balance. Activist investors often challenge companies which accumulate excessive case balances without an apparently good reason. On the other hand, there are countless examples of "buccaneering" ventures that end up on the rocks.

Capital allocation that does not take into account the impact of an investment on a company's risk profile and risk management is a significant source of jeopardy.[2] The fact that companies lack

[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] Martin Pergler and Anders Rasmussen, "Making better decisions about the risks of capital projects," May 2014, McKinsey.com.

comprehensive project maps and criteria to evaluate opportunities consistently, leading to a sense of randomness in decision making, often exacerbate exposures.[3] A rush to "get the deal done" can lead to ignoring changes in a company's risk profile over time. This stems from the lack of an integrated view of exposures across business units and inconsistent measurement and reporting of financial risks.

When it comes to foreign-exchange (FX) and interest-rate risk management, hedging programs are often too generic, while alternative approaches, such as natural hedges, are missed. Very few companies effectively align their hedging strategies with definitive levels of risk tolerance. It is common to see rules of thumb applied—for example, hedge a certain percentage of cash flows. These kinds of assumptions can lead to low hedge effectiveness, margin compression or overhedging, and a loss of competitiveness as a result of favorable interest rates, exchange rates, or commodity prices.

Finally, commodity-price and risk management often occur outside the ambit of an end-to-end risk-management approach, particularly among large commodity companies, making commodity hedging less effective.[4] To add to the challenges, the financial aspects of managing companies' carbon footprint are often ignored when funding and risk management decisions are made.

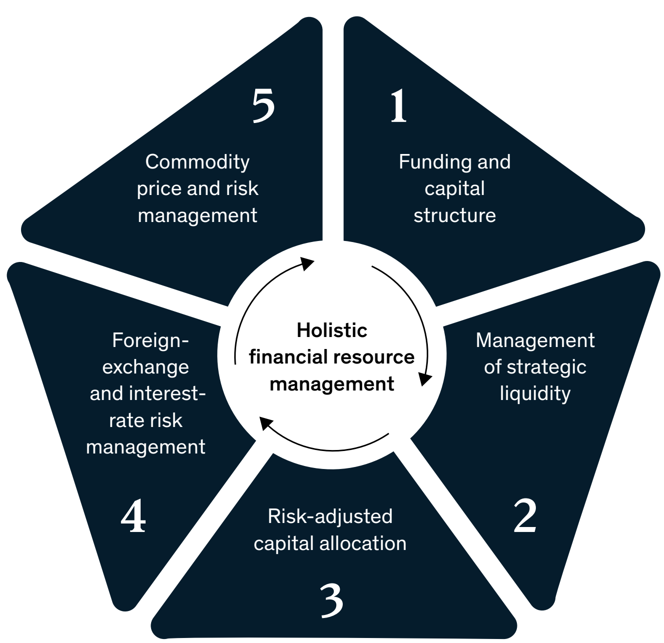
Companies should optimize across five elements

CFOs can create value by optimizing their financial-resource management approaches to the five key areas of activity, represented by the segments of the pentagon in Exhibit 1. However, they can achieve more substantial, or even game-changing, impact

Exhibit 1

CFOs can create value by holistically optimizing their financial resource management approaches across five key areas of activity.

5 key areas of activity



1 Identify best capital structure to minimize weighted average cost of capital while maintaining financial flexibility

2 Quantify cash required to boost resilience and capture opportunity; increase return on invested capital through investment, deleveraging, dividends, and fewer banking charges

3 Increase long-term return on investment by consistently evaluating organic investment opportunities and M&A targets, taking into account impact on overall risk profile

4 Optimize hedging by redefining risk appetite and increasing hedge effectiveness

5 For companies with commodities as primary income-generating assets, improve performance by designing, implementing, and managing risk for profit-generating strategies

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[3] Marc Goedhart and Tim Koller, "The value premium of organic growth," January 2017, McKinsey.com.
[4] Arno Gerken, Olivier Plantefève, and Xavier Veillard, "Managing industrials' commodity-price risk," October 2019, McKinsey.com.

by taking a holistic approach. That means leveraging advanced analytics to generate insights across the segments, or at least the majority of them, and using that information to make cross-cutting decisions.

Companies must make qualitative and quantitative assessments of the state of the play. However, a history-, interview-, or dialogue-based assessment is insufficient. Rather, they must embrace comprehensive modeling that focuses on forward-looking simulations. The simulations should model each relevant element of the pentagon along a large number of scenarios, including stress cases, bearing in mind that changes in one element will invariably affect another. Additional leverage, for example, is likely to modify risk-management policy.[5]

Sophisticated multifactor modeling, applied holistically, can unlock insights that embrace all of a company's financial positions. It can also help improve forecasts and risk-communication protocols, helping CFOs explain and justify financial-management strategies. In areas such as FX, interest-rate, and commodity risk management, this can lead to a more realistic view of underlying exposures. CFOs can then act to take out inefficiencies. In capital management, companies can test their assumptions with respect to target leverage and consider how alternative balance-sheet structures may affect borrowing costs.

Company and industry circumstances, which change over time, uniquely drive each element in the financial-resource management pentagon. Therefore, incremental adaptations and improvements are likely to be insufficient. A holistic approach, on the other hand, can create a multiplier effect that feeds directly to value creation. Very much as seen in investment, in which diversification is a standard theoretical paradigm, optimizing across multiple elements can allow companies to lift returns without increasing risk exposures. This means being able, and willing, to make changes across funding, risk management, and capital allocation. More granular analyses of capital allocation, for example, can precipitate balance-sheet restructuring that frees up strategic liquidity for investment.

Still, one size does not always fit all, and companies can also make significant gains by focusing on specific areas of activity. One top-tier automaker unlocked annual savings of $15 million by reducing balance-sheet hedging by 50 percent (without a shift in risk appetite) and converting part of its FX forward-based hedging program to out-of-the-money options.

A leading infrastructure company, meanwhile, deployed a holistic approach to address a surfeit of cash on its balance sheet and significant exposure

Sophisticated multifactor modeling, applied holistically, can unlock insights that embrace all of a company's financial positions.

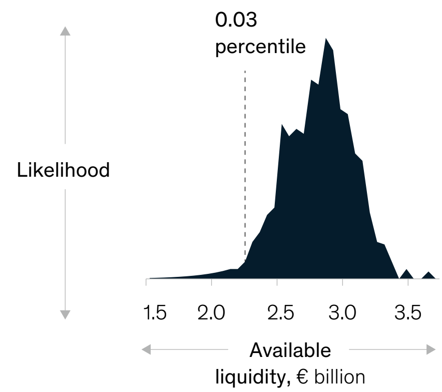
[5] Abhishek Anand, Cindy Levy, Ernestos Panayiotou, and Aleksander Petrov, "Navigating stormy waters: A stress-testing framework for non-financial corporates," McKinsey, November 2016.

Exhibit 2

A leading infrastructure company deployed a holistic approach to create probability models for a range of factors, taking into account uncertainties.

Uncertainty regarding future sources of liquidity,
sources of cash (stressed/simulated)

Committed bank facilities + liquid short-term investments + free cash flow stressed by
- Lower demand
- Supply-chain disruptions
- Geopolitical issues
- Adverse markets
- Reputational-risk events
- Higher taxes
- Special charges

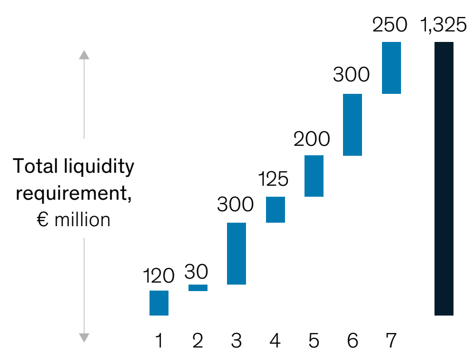


Uses of liquidity,[1]
uses of cash (stressed)

Resilience
1. Fixed costs
2. Critical capital expenditures
3. Debt repayments
4. Dividends
5. Disaster liabilities

Strategic opportunities

6. Price of potential targets
7. Safety cushion



Advanced modeling techniques
- Create joint uncertainty distributions for macro factors (eg, GDP, government-debt levels, inflation) consistent with commodity prices, foreign exchange, and interest rates
- Incorporate potential impact of geopolitical crises, economic shocks, and new economic paradigms (eg, persistently negative interest rates)
- Introduce impact of cyber-related risks (eg, cloud outage, contagion malware, large data exfiltration)

[1] Stressed by foreign exchange, interest rate, commodities, and inflation.

to foreign exchange markets (Exhibit 2). This involved using advanced techniques to create probability models for a range of factors and taking into account uncertainties, such as cyberrisks and data risks. The company's analysis showed that its liquidity buffer of $2.2 billion was excessive and that, in fact, it required just $1.3 billion of liquidity to maintain resilience and strategic flexibility. It used the outstanding $900 million to repay a maturing bond, reduce hedging costs, and boost its dividend. It generated additional savings by swapping $500 million of fixed-rate debt to a floating rate. The combination of these actions contributed to a 15 percent increase in the company's valuation over a year.

The arguments for holistic financial-resource management are compelling. However, there are also sound performance metrics behind the theory. Companies that reallocate resources (including financial resources) most aggressively (41.0 to

100.0 percent) achieve 10.2 percent growth in total returns to shareholders, compared with 7.8 percent for companies that reallocate 20.0 percent or less.[6] Over 15 years, this implies a 40 percent relative valuation uplift.

Holistic transformation, assisted by advanced analytics and modeling, can be a game changer in corporate financial-resource management. Effectively implemented, it can generate a seamless view of a company's key future financial position. Rarely will all five elements identified in this article be equally relevant; leaders must pick and choose (perhaps two or three), according to their own strategic agenda. In most cases, a holistic approach will require trade-offs between the various risks and commitments in focus. However, successful transformations are likely to boost financial transparency, support a nimble approach to management, and create a significant boost to the bottom line.

Michael Birshan (Michael_Birshan@McKinsey.com) is a senior partner in McKinsey's London office, where **Aleksander Petrov** (Aleksander_Petrov@McKinsey.com) is a partner and **Yuri Polyakov** (Yuri_Polyakov@McKinsey.com) is a senior adviser; **Arno Gerken** (Arno_Gerken@McKinsey.com) is a senior partner in the Frankfurt office; and **Stefan Kemmer** (Stefan_Kemmer@McKinsey.com) is a partner in the Munich office.

[6] Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds*, first edition, Hoboken, NJ: John Wiley & Sons, 2018.

BIAS BUSTERS

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

Our topic this time?

Seeing strategy alternatives in the momentum case

by Tim Koller, Dan Lovallo, and Werner Rehm

The dilemma

Complacency can wreak all kinds of havoc on companies' strategies. A maker of printing products learned this the hard way. Competitors from Asia and Germany announced that they would be releasing new printing devices and accessories within the next three years. Many of those new products would be redundant with the manufacturer's own. Still, the company's strategy team believed it was best to stay the course. Name recognition for the brand was still strong among US customers (the manufacturer's largest market), and the company had invested a lot on R&D in the preceding several years; it believed it had the horses to keep up in any innovation race. Meanwhile, the company could cut operating costs to make up for any decrease in pricing. Margins would stabilize eventually. Everything would be fine, right? Wrong. Over time, the company began missing growth targets, and its share price dropped sharply.

The research

There's no shortage of management literature and research showing the degree to which executives at all levels hold overly optimistic views about projects and performance, and seek to maintain the status quo. For reasons of comfort and sometimes even self-preservation, they focus on their own perceptions of the market rather than external points of view, and they use mostly internal data to build forecasts and set strategy—something researchers call the "inside view."[1] No one asks hard questions: Exactly *why* do we

[1] Daniel Kahneman and Dan Lovallo, "Delusions of success: How optimism undermines executives' decisions," *Harvard Business Review*, July 2003, hbr.org.

believe the company can grow faster than the market in two years? Exactly *which* investments are supporting this optimistic outlook, and are they accurately reflected in the operating plan for the next 12 months? And what about the pricing pressures and new competitors that will surely emerge? Absent an "outside view," strategy teams fall back on hockey-stick plans that don't reflect market realities. Underinvestment and underperformance are common outcomes.[2]

The remedy

One way to infuse the outside view into strategy discussions is to build a momentum case for consideration alongside base-case and other forecasting scenarios.[3] A momentum case is an objective assessment of industry growth and competitive dynamics. It's built using external variables, such as market share, competitors' reactions, pricing or margin drops, and changes in cost structure. Companies can use it to set more realistic performance targets, point out gaps in their product portfolios, and reveal the investments necessary just to keep the current business going.

Unlike a base case, a momentum case can also reveal potential negative consequences if the company takes only limited or no strategic action. It would have been a useful tool for those banks in the early 2000s, for instance, that were deciding whether to embrace digital along with the rest of the industry: building or buying new mobile-banking applications likely would have required high investment for only limited returns in the short term, but doing nothing would have resulted in lower market share and revenues over time.

It often doesn't take much time to develop at least an initial momentum case. Companies can work with the data they have and refine those data as they go. In the case of the maker of printing products, a relatively simple "best guess" forecast on how pricing would change as new entrants emerged would have revealed challenges to the company's top and bottom lines. As the strategy team incorporated more external data and reference cases, it might have discovered how companies in similar situations reacted to similar competitor threats—and it might have noted the 20 to 40 percent drop in prices that materialized in those scenarios. These data, though imperfect, would have anchored the momentum case in some facts, making it harder for the strategy team to cling to its optimistic view—and harder for senior management to overlook a declining forecast.

Tim Koller (Tim_Koller@McKinsey.com) is a partner in McKinsey's Stamford office; **Dan Lovallo** is a professor of business strategy at the University of Sydney and a senior adviser to McKinsey; and **Werner Rehm** (Werner_Rehm@McKinsey.com) is a partner in the New Jersey office.

[2] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[3] Werner Rehm and Anurag Srivastava, "Are your strategy discussions stuck in an echo chamber?," April 2018, McKinsey.com.

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