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Perspectives on corporate finance and strategy

Value-creating M&A

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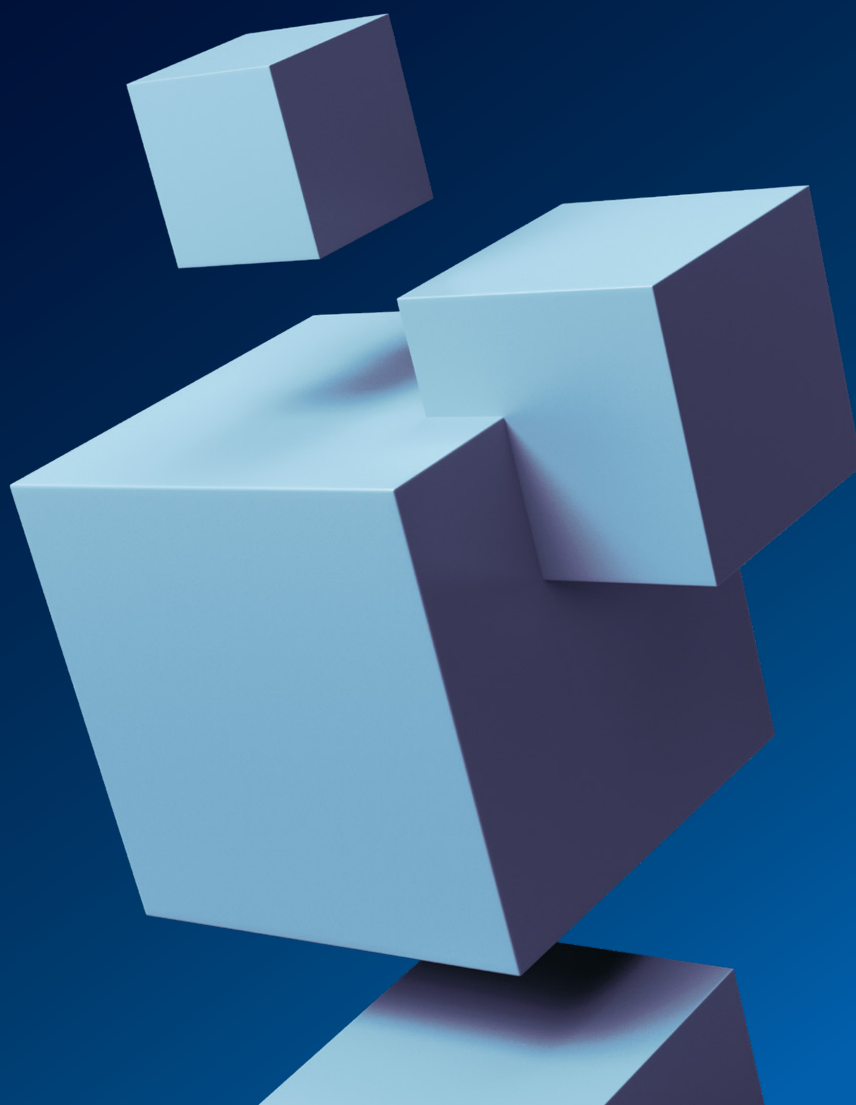

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Editorial Contact:
McKinsey_on_Finance@McKinsey.com

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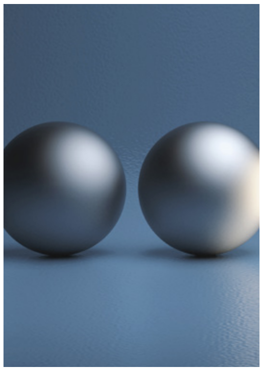

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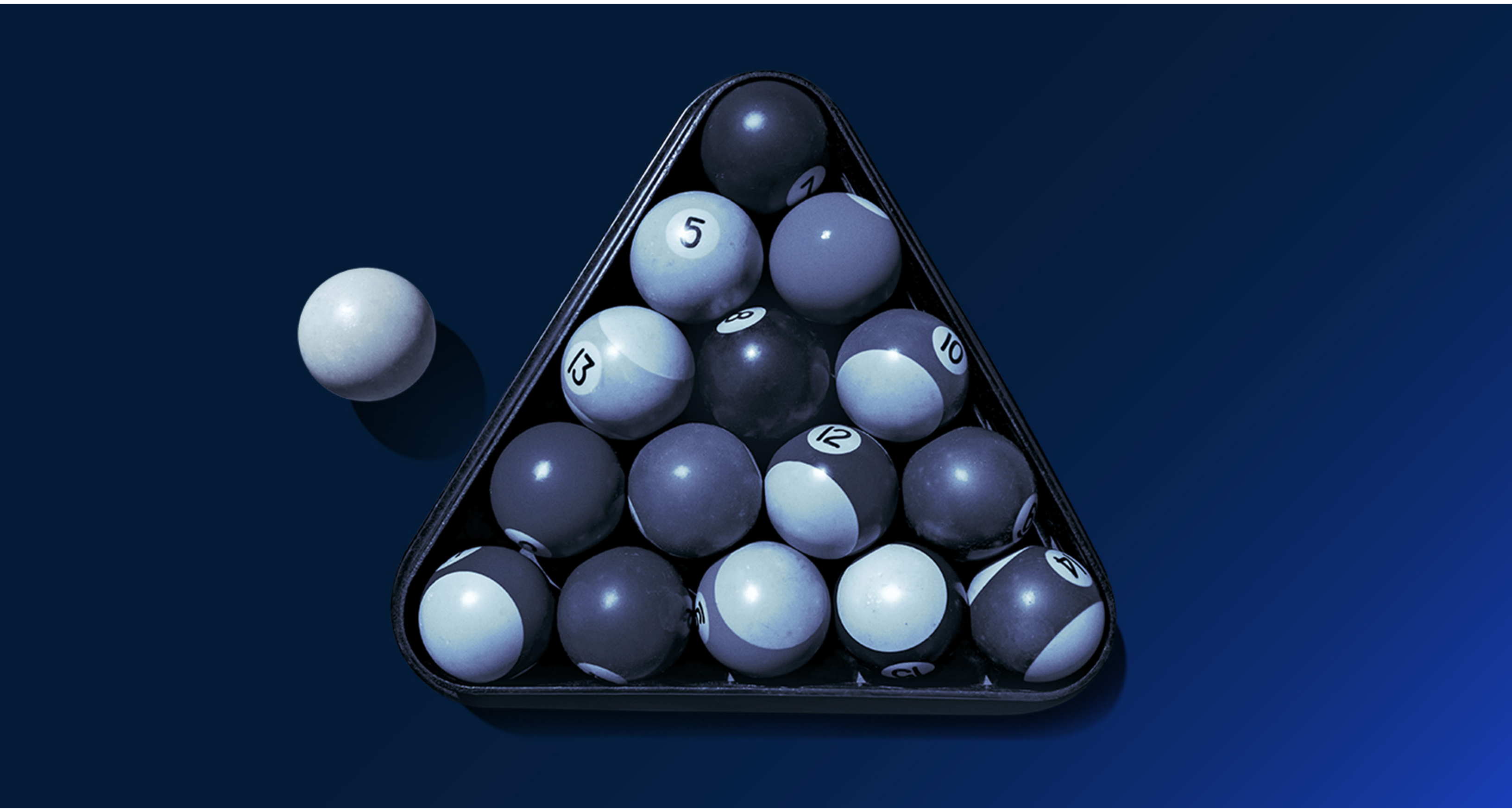
How one approach to M&A is more likely to create value than all others

Two decades of research show that, while large deals still have their place, programmatic M&A strategies continue to create gains in excess total returns to shareholders, at lower levels of risk.

This article is a collaborative effort by Paul Daume, Tobias Lundberg, Patrick McCurdy, Jeff Rudnicki, and Liz Wol, representing views from McKinsey's Strategy & Corporate Finance Practice.



M&A is having a moment—again. The US Federal Trade Commission (FTC) has had to adjust its premerger review process to manage the tidal wave of filings coming its way.[1] And according to some sources, deal value rose more than 300 percent in the first half of 2021 compared with the first half of 2020, and "was virtually equivalent to the total value recorded in all of 2020."[2]

Activity is surging as companies use M&A to manage the still-unpredictable economic effects of the COVID-19 pandemic and find their strategic footing. They are pursuing deals to streamline their assets, establish or extend their digital capabilities, acquire top talent, and otherwise strengthen their competitive positions. None of this is news to those companies that have adopted a through-cycle mindset to M&A; alliances, partnerships, and other transactions have been top of mind for them all along.

What might interest *all* executives, however, is a reminder of what really works when it comes to deal making. Our empirical research, which analyzes more than 20 years of data, confirms, once again, that programmatic M&A is the strategy that is most likely to create the most value for companies. That is, carefully choreographing a series of deals around a specific business case or M&A theme—rather than relying on episodic "big bang" transactions—is far more likely than other approaches to lead to stronger performance and less risk.[3]

Indeed, our most recent survey data, which we'll explore in this article, reveal other facts about the impact of programmatic M&A across sectors, during downturns, and in the context of large deals. (Hint: large deals are not always value-destroying, especially when complemented by some form of programmatic M&A.) We'll examine which M&A strategies create the most value, why programmatic still reigns over other approaches to M&A, and how programmatic acquirers do what they do.

Proof of efficacy aside, it's critical for executives to remember that programmatic M&A is not purely a volume play; it's a strategy for systematically building new businesses, services, and capabilities. The companies that use a programmatic approach create deal flows linked to their conviction in their corporate strategy, understanding of their competitive advantage, and confidence in their capacity to execute. They manage their growth strategies proactively. And their approach to M&A does not change, regardless of the success or failure of any single deal.

Which M&A strategies create the most value?

McKinsey's Global 2,000 research had previously demonstrated that companies that use a programmatic approach to M&A—versus organic, selective, or big-deal approaches—generally outperform their peers.[4] These companies are able to build lasting, distinctive capabilities in M&A precisely because they do deals frequently and systematically.

Fast-forward to 2021, and the results of our ongoing M&A research are even more compelling. Data from the most recent decade reconfirm that companies that regularly and systematically pursue moderate-size M&A opportunities deliver better

[1] *Competition Matters*, "Adjusting merger review to deal with the surge in merger filings," blog entry by Holly Vedova, August 3, 2021.
[2] Michael Deyong and John Reiss, *New heights: US M&A H1 2021*, White & Case, August 2021.
[3] Organic M&A entails making less than or equal to one deal every three years, where the cumulative value of deals is less than 2 percent of the acquirer's market capitalization. Selective M&A entails making less than or equal to two deals a year, where the cumulative value of deals is greater than 2 percent of the acquirer's market capitalization (and not organic). Programmatic M&A entails making more than two small or midsize deals a year, where the total market capitalization acquired is meaningful (median of 19 percent). Large-deal M&A entails making more than or equal to one deal a year, where the target market capitalization is more than 30 percent of the acquirer's market capitalization.
[4] In our ongoing Global 2,000 Survey, we track the largest 2,000 global companies (by market capitalization), measure the amount of excess total shareholder returns (TSR) they created compared with industry peers, and examine the type of acquisition strategy they deployed. The data confirm that programmatic acquirers continue to perform better than industry peers across sectors; the more deals a company did, the higher the probability that it would earn excess returns. Programmatic M&A entails pursuing a minimum of two small or midsize deals a year, with meaningful market capitalization acquired (20 percent to 30 percent).

shareholder returns than companies that do not. For instance, programmatic acquirers, on average, delivered about 2 percent more in excess total shareholder returns (TSR) annually as compared with their peers. By contrast, none of the other approaches to M&A (organic, selective, big deal) created any excess TSR, on average, for the cohort of companies.

But the following five new pieces of information emerged for the first time.

Finding 1: Organic-growth strategies are now—on average—the worst performing of all M&A approaches

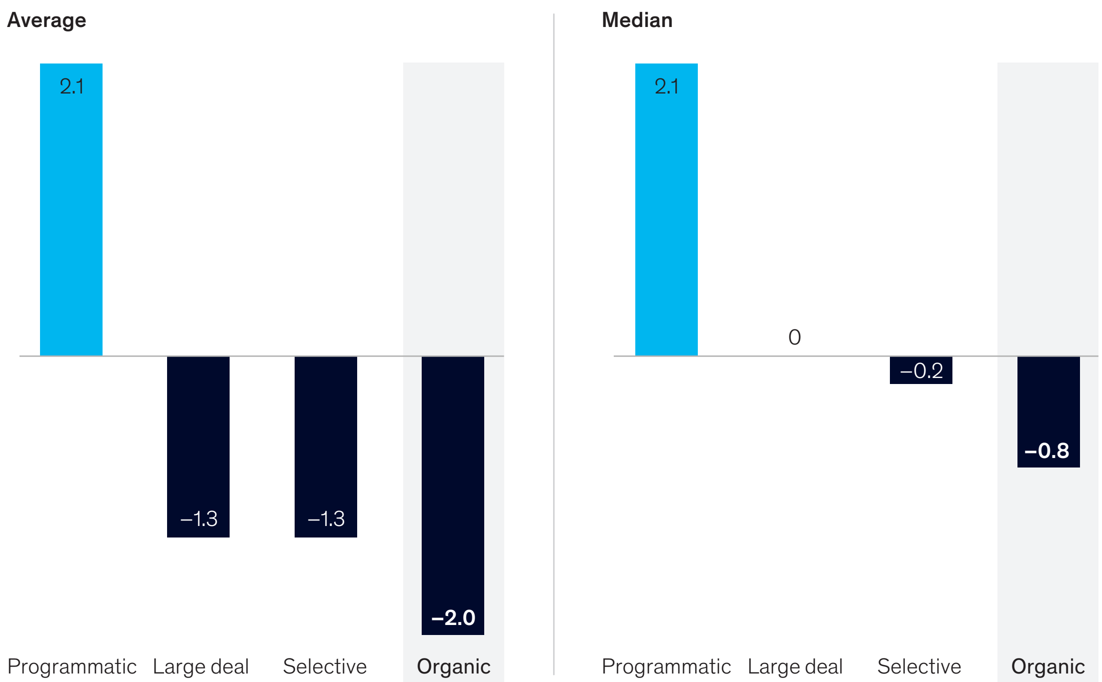
In the past, our data have shown the limitations of both selective-acquisition and organic-growth[5] (or not pursuing M&A) strategies; both had, on average, created notable losses in excess TSR relative to the other two approaches (programmatic and large-deal programs). However, our most recent numbers show that, of the four types of programs studied, organic-growth strategies are now the worst performing and the riskiest, while the large-deal approach to M&A essentially amounts to a coin flip (Exhibit 1).

According to our analysis, programmatic M&A remains the least risky approach with the smallest deviation in performance and the largest share of companies that generate positive excess TSR (65 percent). In other words, two out of the three companies that practice programmatic M&A outperformed against their peers.

Exhibit 1

The organic approach to M&A is more risky than other approaches.

Global 2,000[1] excess total shareholder returns by program type, Jan 2010–Dec 2019, %



[1]Companies that were among the top 2,000 companies by market cap (>$2 billion) on Dec 31, 2009, and were still trading as of Dec 31, 2019. Excludes companies headquartered in Africa and Latin America.
Source: Deal Patterns 2019; S&P Capital IQ; Corporate Performance Analytics by McKinsey

[5] Organic growth refers to the growth a company achieves by expanding its own capacity, using internal resources.

Finding 2: The programmatic approach succeeds across nearly all sectors of the economy
Our close look at how global companies in various sectors performed (again, keying in on excess TSR created) shows that a programmatic approach wins the day—particularly in advanced industries and the energy and materials sectors (Exhibit 2).

Finding 3: The large-deal approach to M&A does not necessarily destroy value
For companies using a large-deal approach to M&A—that is, pursuing deals in which the target company's market cap is greater than or equal to 30 percent of the acquirer's market cap—our research confirms that such pursuits are, as mentioned earlier, the equivalent of a coin toss. But companies can increase the odds of success with this approach by complementing it with a programmatic strategy. The data show that companies that pursued large deals early during the 2010s, but augmented this approach with programmatic M&A, generated 1 percent more annually in TSR (on average) than their peers did. They in fact won the coin toss (Exhibit 3).

Take one medical-device company, for example: between 2000 and 2009, it completed around one deal a year, and its excess TSR over the period was –1.5 percent. Between 2010 and 2019, the company went through a leadership change and adopted more of a programmatic model. It was then completing about six deals per year, including some larger targets (up to 10 percent of the company's own market capitalization). Most of the deals were focused on expanding the medical-device-company's geographic footprint. In part because of its new approach to M&A, the company's excess TSR over the decade averaged 2.7 percent per year above that of its peers.

Exhibit 2

Programmatic M&A leads to higher performance across most sectors.

Global 2,000[1] median excess total shareholder returns by M&A type, Jan 2010–Dec 2019, %

Outperformance, percentage points

–2.4 –2.0 –0.1 0 0.1 2.0 5.9

	Programmatic	Selective	Large deal	Organic
Advanced industries	5.9	–0.5	–0.4	–0.8
Transport, logistics, and infrastructure	2.0	0.0	–1.9	0.0
Consumer packaged goods and retail	1.1	–0.7	–0.7	0.3
Financial services	1.2	0.0	0.6	–0.1
Energy and materials	2.2	0.3	–0.1	–1.7
Pharmaceutical and medical products	1.2	–0.3	–0.6	0.9
Healthcare systems and services	1.0	–1.8[2]	–1.3	–1.8[2]
Technology, media, and telecommunications	1.3	–2.2	1.7	–2.4

[1]Companies that were among the top 2,000 companies by market cap (>$2 billion) on Dec 31, 2009, and were still trading as of Dec 31, 2019. Excludes companies headquartered in Africa and Latin America.
[2]Small sample size (n = 5).
Source: Deal Patterns 2019; S&P Capital IQ; Corporate Performance Analytics by McKinsey

Finding 4: The programmatic approach can withstand periods of high economic volatility
Even during the COVID-19 pandemic, programmatic acquirers' performance far outpaced that of their peers using other approaches to M&A, which is consistent with patterns we have seen in prior downturns. What's more, the numbers show a widening performance gap between programmatic acquirers and companies using other approaches to M&A (Exhibit 4).

Finding 5: Changing course remains difficult
Despite all the evidence in favor of a programmatic approach, more than 50 percent of companies in our research base have kept the same M&A strategy over the past 20 years (Exhibit 5).

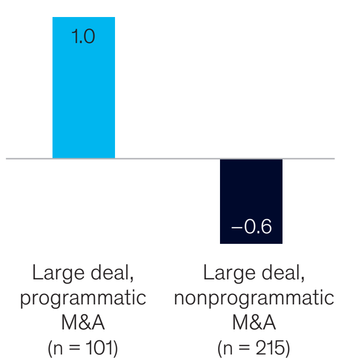
Why? Change is hard, and the programmatic model may not be the right fit for every company: some businesses may have to contend with organizational limitations or industry-specific obstacles. Nevertheless, it can be instructive for companies with any type of M&A program to take lessons from those that are changing course.

Consider a large brewing company: it increased its average annual deal count from about 1.5 (2000–09) to about three (2010–19) deals per year, and, perhaps more important, the size of the deals increased. In the first period, the deals targeted less than 2 percent of the brewing company's own market cap. In the second period, the deals targeted more than 5 percent of the company's market cap,

Exhibit 3

Companies using a large-deal approach to M&A can improve their performance by also engaging in programmatic M&A.

Global 2,000[1] median excess total shareholder returns by program type, Jan 2010–Dec 2019, %

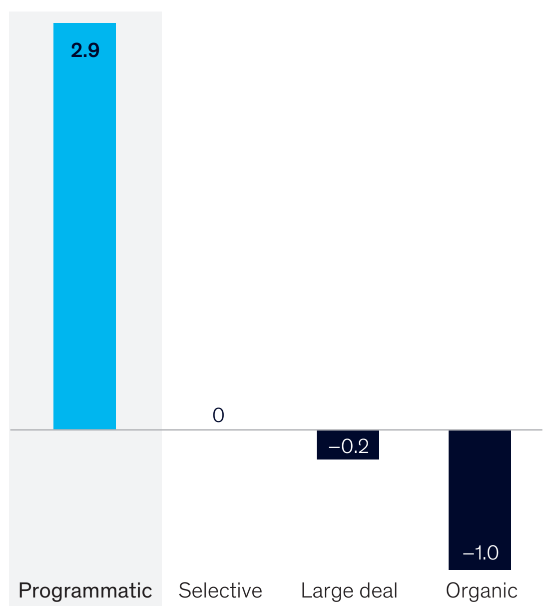


[1]Companies that were among the top 2,000 companies by market cap (>$2 billion) on Dec 31, 2009, and were still trading as of Dec 31, 2019. Excludes companies headquartered in Africa and Latin America.
Source: Deal Patterns 2019; S&P Capital IQ; Corporate Performance Analytics by McKinsey

Exhibit 4

Programmatic M&A outperformed other M&A strategies during the COVID-19 pandemic.

Median excess total shareholder returns,[1] Jan 2019–Dec 2020, %



[1]Companies that were among the top 2,000 companies by market cap (>$2 billion) on Dec 31, 2009, and were still trading as of Dec 31, 2019. Excludes companies headquartered in Africa and Latin America.
Source: Deal Patterns 2019; S&P Capital IQ; Corporate Performance Analytics by McKinsey

Exhibit 5

Most companies stick with the same M&A strategy.

Global 2,000[1] companies

Starting program As of Jan 2008–Dec 2017	**What happened to the cohort in the Jan 2010–Dec 2019 period,** % (Kept starting M&A program / Changed to other M&A program) Programmatic	Selective	Large deal	Organic	Dropped out of Global 2,000
Programmatic	**57**	16	11	2	13
Selective	9	**54**	9	14	14
Large deal	9	19	**50**	7	17
Organic	1	29	3	**51**	16

Note: Figures may not sum to 100%, because of rounding.
[1]Companies that were among the top 2,000 companies by market cap (>$2 billion) on Dec 31, 2009, and were still trading as of Dec 31, 2019. Excludes companies headquartered in Africa and Latin America.
Source: Deal Patterns 2019; S&P Capital IQ; Corporate Performance Analytics by McKinsey

with some acquisitions targeting 15 percent above its market cap. In part because of this change in approach, the brewing company's annual excess TSR grew from –6 percent in 2000–09 to +2 percent in 2010–19.

What do programmatic acquirers do differently?

M&A is not "an event," and it is not something that "happens" to a company. It is a capability that is essential for creating outsize value, and like any capability, it requires sufficient attention and resources to grow. Our decades of research on companies' M&A approaches and underlying capabilities point to three critical focus areas for success—what we've dubbed the three Cs of M&A: competitive advantage, conviction, and capacity. The programmatic acquirers in our research base are particularly adept in each of these areas.

Competitive advantage

Our most recent data show that programmatic acquirers are more likely than their peers to understand how economic shocks, such as the COVID-19 pandemic, affect their competitive advantage and how to modify their corporate and M&A strategies and initiatives accordingly. Programmatic acquirers are also more likely than their peers to develop a robust M&A blueprint that explicitly defines how M&A will contribute to corporate strategy and guide proactive deal sourcing.

For instance, our 2021 survey revealed that programmatic acquirers are:

— 1.5 times more likely than peers to strongly agree that they have a clear understanding of their source of competitive advantage

— 1.4 times more likely than peers to strongly agree that they are aligned on the industry and market trends they want to pursue

— 1.4 times more likely than peers to strongly agree that they understand which assets they need to acquire to meet the company's M&A aspirations

These companies have a trusted process for generating multiple financial and operational scenarios and leaning into them as they unfold, adjusting their strategies (including their M&A strategies) as they go. Previous McKinsey research points to the large

TSR gains resilient companies achieved as a result of careful actions taken before, during, and after the 2008 credit crisis.[6] With a focus on competitive advantage during the latest economic shock, it is likely that programmatic acquirers have similarly positioned themselves ahead of their competition for several years.

Conviction

Programmatic acquirers continually assess and update their central M&A themes, so they can build conviction for targeted deals and act quickly when opportunities emerge. All too often, companies dedicate less time and attention to assessing an M&A opportunity than they would an internal deployment of capital—which is ironic, given how much larger M&A investments can be compared with most internal investments. Our research shows that programmatic acquirers are about 1.2 times more likely than their peers to build comprehensive business cases around potential M&A targets. By doing so, they can persuade senior managers and board directors to buy into the deal relatively quickly; they can also create a strong M&A narrative that can be shared with prospective targets, investors, the market, and others.

Our research also shows that programmatic acquirers are 1.4 times more likely than their peers to proactively reach out to prospective targets, and about 20 percent more likely than their peers to reallocate capital in line with corporate strategy. Notably, only 13 percent of programmatic acquirers paused their M&A activity in 2020 amid the COVID-19 pandemic, compared with 31 percent of nonprogrammatic acquirers.

Capacity

A company's ability to execute on its strategy often comes down to whether it has enough financial, talent, and organizational capacity. Programmatic acquirers tend to have a strong sense of that capacity given their well-developed M&A operating model. Because they don't have to reinvent the wheel for every due-diligence process or integration plan, for instance, they can execute more transactions while creating more value from each.

According to our 2021 survey, programmatic acquirers are:

— 1.9 times more likely than peers to strongly agree that they have the right capabilities (tools and talent) to execute their M&A strategy

M&A is not 'an event' or something that 'happens' to a company. It is a capability for creating outsize value, one that requires attention and resources to grow.

[6] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 21, 2019.

— 1.4 times more likely than peers to strongly agree that they have clearly defined processes for all dimensions of a due-diligence process (financial, legal/risk, operations, culture, and talent)

— 1.6 times more likely than peers to strongly agree that they have a clear process for designing a new, integrated organizational structure

These and other data confirm that a programmatic approach to M&A and a focus on the three Cs can lead to outperformance. But the proof is not just in the numbers; it's in the stories of businesses that have differentiated themselves through their ability to source the deals that align most with their overall corporate strategy—and to act quickly because of the knowledge, infrastructures, and capabilities they have built up around M&A.

The lessons come from, for instance, the luxury-goods company that has been able to generate outsize returns over the past ten years—and has continued do so, even during the COVID-19 pandemic. Between 2010 and 2020, the company completed nearly 50 deals and achieved excess TSR of 15.2 percent. Most of the targeted deals have been small (less than 5 percent of the company's market cap) although several have been larger (nearly 30 percent of its market cap). Through these acquisitions, the company has been able to build out product segments and expand its geographical reach. Given the high volume of deals the company has pursued, M&A has become a full-fledged capability—along the lines of R&D or marketing.

The case for a programmatic approach to M&A has long been established. But newer findings about its compatibility with the large-deal approach to M&A; its effectiveness in multiple sectors of the economy, notably during times of high volatility; and how it fares against organic-growth strategies reflect the staying power of this deal-making strategy—and the opportunities for the companies that are paying attention. Those that have tested and evolved their M&A strategies toward a programmatic approach will likely have the edge moving forward.

Paul Daume (Paul_Daume@McKinsey.com) is a partner in McKinsey's Cologne office; **Tobias Lundberg** (Tobias_Lundberg@McKinsey.com) is a partner in the Stockholm office; **Patrick McCurdy** (Patrick_McCurdy@McKinsey.com) is a partner in the Boston office, where **Jeff Rudnicki** (Jeff_Rudnicki@McKinsey.com) is also a partner; and **Liz Wol** (Liz_Wol@McKinsey.com) is a partner in the New York office.

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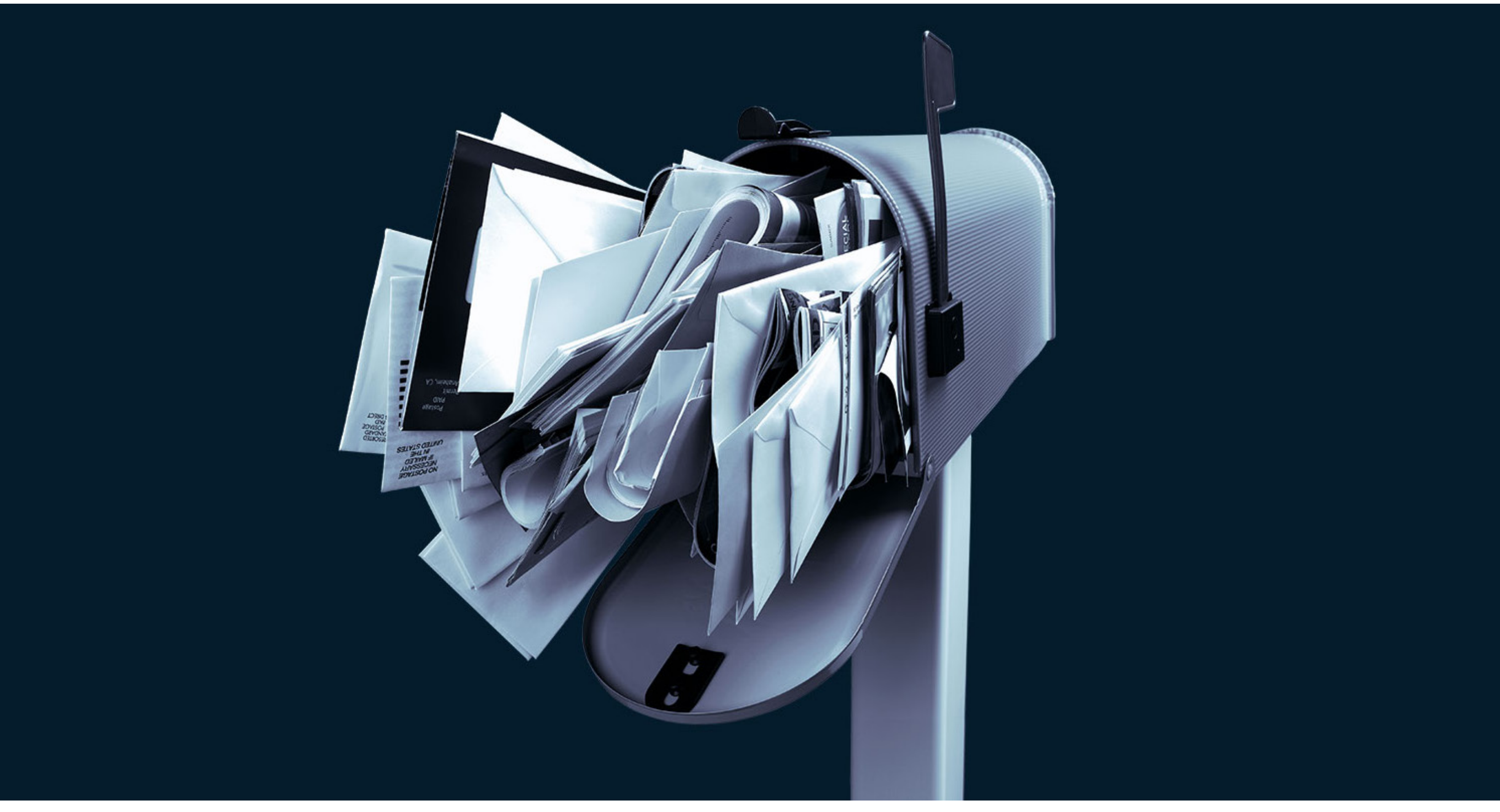
When bigger isn’t always better

The recent spate of spin-off announcements reveals the limits of diversification as well as some of the potential value-creating benefits of separations.

by Jamie Koenig, Tim Koller, and Anthony Luu



Breakups aren't just fodder for celebrity-gossip websites. Separations are back in the business pages, as large conglomerates in healthcare, consumer electronics, logistics, and other sectors announce their intentions to spin off business units or explore avenues for doing so.[1]

Despite all the new ink being spilled on this trend, in many ways it's just another chapter in the long-running story about diversification strategies: a company matures, prompting executives to look outside the core business for ways to grow. (A logistics company acquires a software company. A pharmaceutical company enters the consumer-health market.) As revenues increase, so do costs and complexity. Some operational and other synergies may materialize—but eventually executives and boards realize how difficult it is to add value to businesses that have little or no direct connection to the company's core business.[2]

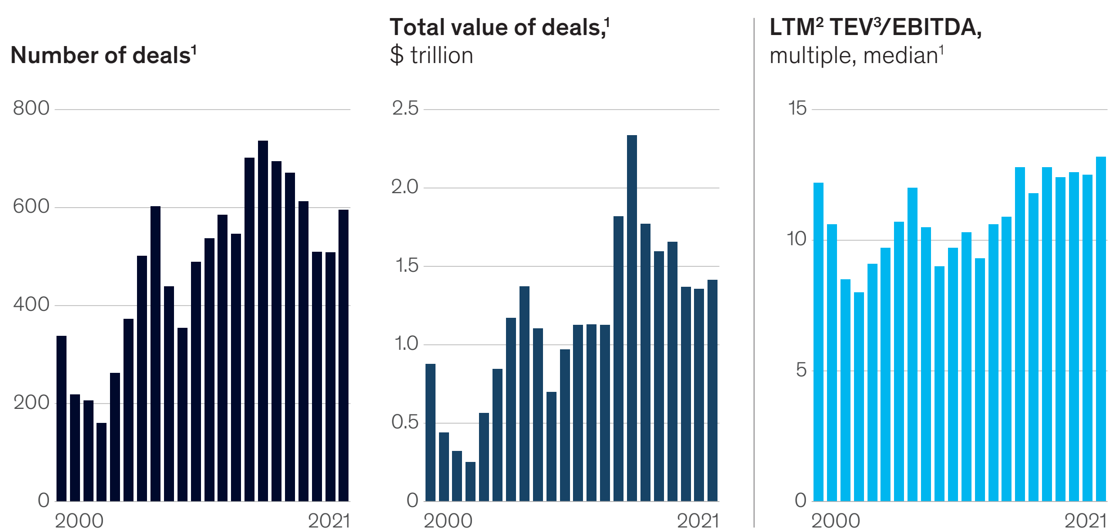
The realization may come when a business unit's performance is lagging behind that of its peers with no clear path to catch up. Or a review of the company's portfolio may reveal that some business units' cost structures are not comparable with peers. Or executives may recognize that the company lacks sufficient management capabilities to grow all the businesses in its portfolio.

When these signals appear, companies acknowledge that they are no longer the best owner of an asset, and spin-offs ensue—especially in an environment like the one we're experiencing now, when business models are being tested by a crisis and new strategies are needed, market valuations are high, and financial engineers are hard at work (exhibit).

There are fundamental reasons why we're seeing more large companies pursuing spin-offs—specifically, because such deals can help to improve

Exhibit

Divestitures are exceeding prepandemic levels while benefiting from historically high valuations.



Note: 2021 data as of end of Q3.
[1]Global corporate divestitures with deal value >$500 million. [2]Last twelve months. [3]Total enterprise value.
Source: S&P Capital IQ

[1] Kevin Dowd, "Death to conglomerates: GE, J&J and Toshiba all reveal plans to break themselves up," *Forbes*, November 14, 2021.
[2] Joseph Cyriac, Tim Koller, and Jannick Thomsen, "Testing the limits of diversification" McKinsey, February 1, 2012.

the operating model, management focus and strategy, and capital management for both the parent company and the divested business unit.

Operating model

A group structure often imposes operating requirements on all the business units in a company's portfolio. A pharmaceutical and medical-device conglomerate, for instance, may require all business units to use a centralized compliance and regulatory process or common inventory-management and sales-reporting systems. But different drug and device divisions have different needs, so the teams managing these common compliance, procurement, and sales functions would likely struggle to cater to each unit's unique circumstances and priorities. Indeed, when companies' portfolios mix high-margin, high-growth businesses with lower-margin, mature businesses, there can be a clear operating-model mismatch.[3]

A breakup would allow for a more tailored operating model. Consider the case of a global consumer company that owned both a high-margin branded business along with a lower-margin, nonbranded-commodity business: there were clear synergies in distribution and supply-chain processes. But razor-thin margins in the highly competitive consumer-packaged-goods industry meant that the nonbranded-commodity business required a much leaner cost structure and a more focused operating model than the consumer company had. By selling off the nonbranded-commodity business to a better owner, the global consumer company was able to streamline its operating model and pursue growth in its branded business.

Management focus and strategy

Experience shows that senior leaders in conglomerates tend to overinvest attention and organizational resources in high-growth parts of their business and underinvest in lower-growth or more mature parts of the organization.[4] The opposite can happen, too. Senior leaders may be overly focused on the success or failure of the biggest business unit and less so on overall growth. The result is often uneven development of businesses within the portfolio. Mature organizations fall further and further behind peers and struggle to find the resources to maintain or recapture their leadership positions, even when they represent most of the company's total revenues. Even if management is appropriately tending to all parts of the business, analysts and investors with limited time to evaluate companies may struggle to understand what's driving growth in disparate parts of a diversified business.

At one technology services provider that also owned and developed its own software, senior management struggled with resource-allocation decisions and at times missed out on some of the biggest trends in the industry—particularly in moving the provider's software to a cloud infrastructure. It was only after divesting its services business that the company was able to position itself as a player in the market for software as a service.

Capital management

A group structure can also make it more difficult for executives to determine how to balance investments in high-risk, high-reward opportunities (or, as they are known in most companies, "the most exciting initiatives") versus low-risk, low-reward ones. Moreover, some executives are reluctant to raise capital for discrete business units—in the case of an acquisition, for instance— when they feel like their share price doesn't fairly reflect the full value of the organization.

Divesting noncore business units can help address these concerns.[5] For instance, if a technology company spins out a legacy infrastructure business unit as a pure-play stand-alone company, it may be easier for the infrastructure business to raise capital

[3] Tim Koller, Dan Lovallo, and Zane Williams, "Should assessing financial similarity be part of your corporate portfolio strategy?" McKinsey, November 6, 2017.
[4] Iskandar Aminov, Aaron De Smet, and Dan Lovallo, "Bias busters: Resisting the allure of 'glamour' projects," McKinsey, February 6, 2019.
[5] Obi Ezekoye and Anthony Luu, "Divesting with agility," McKinsey, November 11, 2020.

for an acquisition and pursue market consolidation—without having to compete for funding with all the other businesses within the technology company.

Executives frequently comment that a “sum of all parts” valuation, versus applying peer multiples to each business in a portfolio, doesn’t fairly reflect the full value of their business. That is because individual business units tend to perform less well than pure-play companies. In the case of the technology company, then, the separation of the legacy infrastructure business would eliminate this noise and, theoretically, would ensure that each business within the technology company’s portfolio is valued at a fair multiple.

In perfectly rational capital markets, the value from a spin-off would come primarily from the operating-model efficiencies it enables and the management attention that it frees up. Capital markets aren’t completely rational, though, and as we noted, many businesses struggle with allocation decisions. Additionally, there is at least a perceived multiples discount on companies with diverse business lines, perhaps because investors would prefer to make their own diversification decisions rather than rely on management. As a result, companies pursuing spin-offs often include all three sources of value creation when announcing their plans.

It’s true that some technology companies are, so far, still following a bigger-is-better approach. But for most others, the days of the diversified conglomerate are receding.

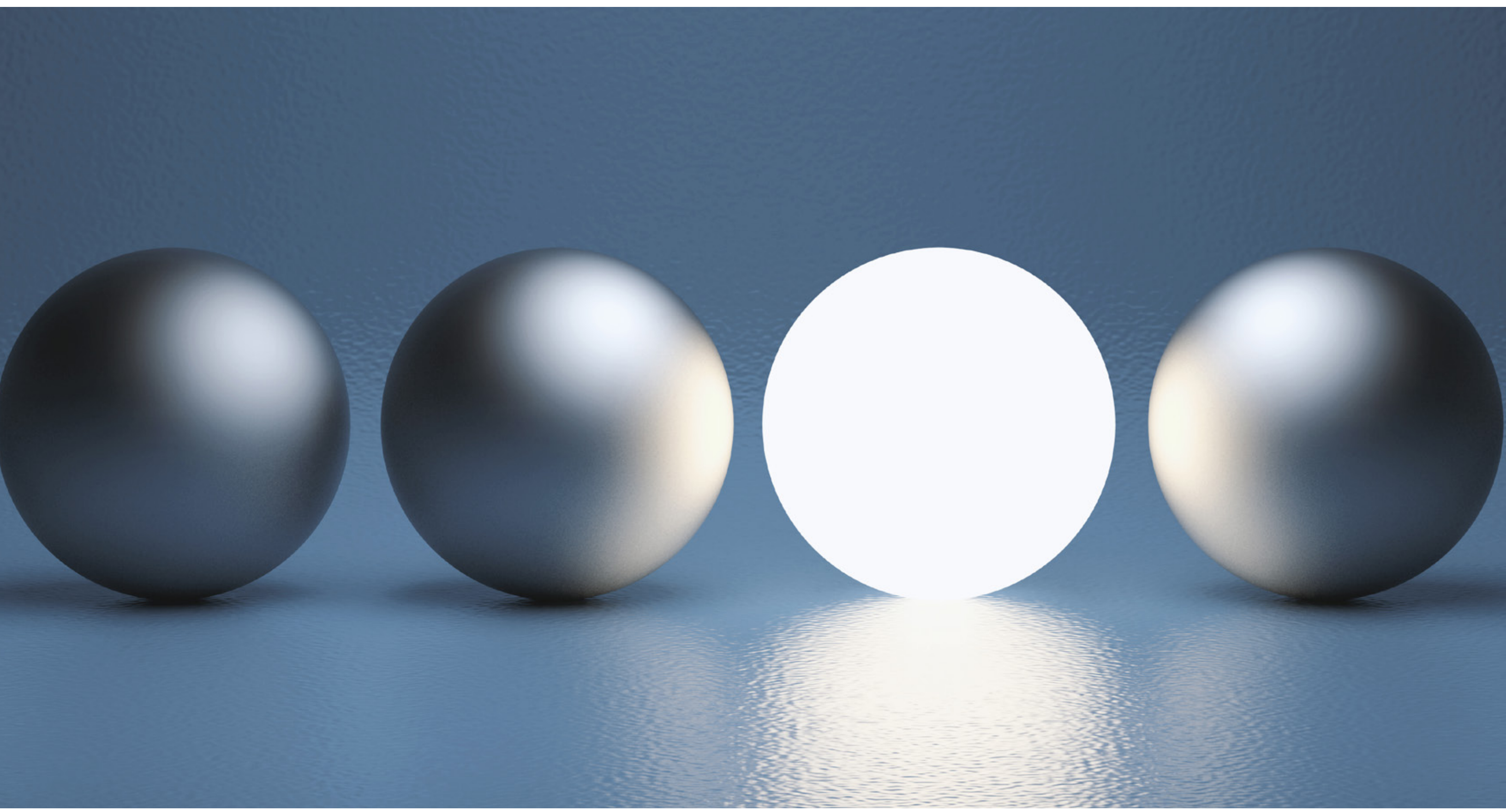
Our own research and experience suggest two things: first, the best-performing conglomerates do well not because they are diversified but because they are truly the best owners of the businesses within their portfolio. And second, for conglomerates that acknowledge their flaws and that are seeking improvements in the three areas cited earlier (operations, management focus, and capital), breaking up doesn’t need to be so hard to do—as long as executives systematically consider the growth strategies, operations, talent, and cultural changes the parent company and divested business unit will require for a win–win scenario.[6]

Jamie Koenig (Jamie_Koenig@McKinsey.com) is a partner in McKinsey’s New York office. **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Denver office. **Anthony Luu** (Anthony_Luu@McKinsey.com) is an associate partner in the Austin office.

[6] Jan Krause, Anthony Luu, Robert Uhlaner, and Andy West, “Achieving win–win spin-offs,” McKinsey, October 11, 2021.

Much anew about ‘nudging’

Almost 15 years after introducing a critical choice-making framework, behavioral economists Cass Sunstein and Richard Thaler reflect on its continuing impact on business and society.



Since Harvard professor Cass Sunstein and University of Chicago professor Richard Thaler introduced the concept of nudging to the world, in 2008, about 400 "nudge units"—or behavioral-insights teams—have been established in public- and private-sector organizations around the world. Nudges are interventions, big and small, aimed at getting people to act in their own best interest. Health organizations, for example, have used nudges to educate citizens about COVID-19 testing and vaccination. Consumer-goods companies have used them to steer customers toward climate-friendly products and services. Indeed, nudging has become so widespread that Sunstein and Thaler decided to update their thinking and to capture it in the newly released *Nudge: The Final Edition* (Penguin Books, August 2021). In a recent conversation with McKinsey's Julia Sperling-Magro and Roberta Fusaro, the authors reminded us what nudge and choice architecture are. They also considered how technology and other changes in business and society have altered the practice of nudging and the amount of "sludge" in decision making. An edited version of the conversation appears here.

McKinsey: For the uninitiated, what is nudging?

Cass Sunstein: A nudge is an intervention that maintains freedom of choice but steers people in a particular direction. A tax isn't a nudge. A subsidy isn't a nudge. A mandate isn't a nudge. And a ban isn't a nudge. A warning is a nudge: "If you swim at this beach, the current is high, and it might be dangerous." You're being nudged not to swim, but you can. When you're given information about the number of fat calories in a cheeseburger, that is a nudge. If a utility company sends something two days before a bill is due, saying that "You should pay now, or you are going to incur a late fee," that is a nudge. You can say no, but it's probably not in your best interest to do so. Nudges help people deal with a fact about the human brain—which is that we have limited attention. The number of things that we can devote attention to in a day or an hour or a year is lower than the number of things we should devote attention to. A nudge can get us to pay attention.

McKinsey: How is nudging different now than it was, say, 13 years ago, when your book was originally published? What makes for a good nudge in 2021?

Cass Sunstein: The basic theory is similar, though I think we understand it better now than we did then—and I think we'll understand it better in ten years than we do now. We know that good nudges still make the chooser's life better, and bad nudges don't. What we're seeing more of now, however, is nudging to protect third parties. You might have a climate-change nudge where the basic goal isn't to protect the chooser; it's to reduce greenhouse-gas emissions. In Switzerland, for instance, people have been nudged to automatically enroll in clean-energy programs. If they don't want to, they can opt out, although the "dirtier" program may be more expensive. That nudge is designed to protect people from climate change generally, not necessarily to protect individual choice makers.

McKinsey: Nudging is tied very closely to the concept of "choice architecture." What is that? Can you remind us?

Cass Sunstein: Really, any situation where you're making a choice has an architecture to it. The owner of a website may put certain things in a very large font—the things that the private or public institution really wants you to attend to and maybe choose—and keep certain things hidden in small print at the bottom. And it turns out that small differences in this kind of architecture can lead to large differences in social outcomes. If you have a choice architecture where people must opt in, for instance, the participation rate is a lot lower than if the architecture prompts them to opt out.

One example of that is a US program that is designed to help children get access to school meals. The kids are legally entitled to these meals if they're poor. But a lot of their parents don't sign them up, probably because it's scary to figure out how or it's confusing or it's just a matter of time commitment, and the parents don't have a lot of time. The government switched from an opt-in design to an opt-out design—if the school or the locality knows that you're poor and you're a child, you automatically get the meal. The idea was that this would not involve a big advertising campaign. It would be very simple. And at last count, 15 million children in the US are enjoying nutritious and tasty meals in school.

McKinsey: For all the good that nudges can do, there are also ethical concerns. How can you be sure people are using nudges in the right way?

Richard Thaler: I get this question all the time. Do we worry about how people are thinking about this

Cass Sunstein

Education

Holds a JD from Harvard Law School and a bachelor's degree from Harvard College

Career highlights

Harvard University
2013–present
Robert Walmsley University Professor

World Health Organization
2020–21
Chair of the Technical Advisory Group for Behavioural Insights and Sciences for Health

Harvard Law School
2012–13
Felix Frankfurter Professor of Law

US Government
2016–17
Defense Innovation Board

2013
The President's Review Group on Intelligence and Communications Technologies

2009–12
Administrator of the Office of Information and Regulatory Affairs

University of Chicago
1993–2008
Karl N. Llewellyn Distinguished Service Professor of Jurisprudence, Law School and Department of Political Science

Fast facts

Is the founder and director of the Program on Behavioral Economics and Public Policy at Harvard Law School

Has testified before numerous congressional committees and participated in constitution-making and law-reform activities in many nations

Has written numerous articles and books, including *Noise: A Flaw in Human Judgment* (Little, Brown Spark, 2021), with Daniel Kahneman and Olivier Sibony

Is the recipient of the 2018 Holberg Prize, awarded to a scholar who has made outstanding contributions to research in the arts and humanities, the social sciences, law, or theology

Is a member of the American Academy of Arts and Sciences, the American Law Institute, and the American Philosophical Society concept? It's been a concern, sure. For the past 13 years, I've been signing copies of the book with the note, "Nudge for good," which was meant as a plea. But I don't think bad people need our book to do bad things.

Cass Sunstein: In the book, we refer to a bill of rights for nudging. Nudges should satisfy certain constraints—that is, they should be transparent, not covert or hidden. They should be in the interests of the people who are being nudged and consistent with their values. They should be subject to political safeguards, in the sense that if the people don't like them, they should be able to say, "We don't want that one." And they should be consistent with constitutional understandings in the relevant nation. We're very focused on ensuring that nudges are compatible with human dignity. If you're nudged and you think, "That was awful. Why did that happen? I'm sadder and poorer," that's an unethical nudge.

McKinsey: How have advances in technology changed the practice of nudging?

Cass Sunstein: Technology enables something we call smart disclosure. If you have a cell phone—most people do—or a credit card—most people do—you get information somewhere, somehow, about your usage. Under the rules of smart disclosure, there would be simple, easily accessible, machine-readable information about your own data. You could compare your current cell-phone usage with the usage in a previous period and, possibly, with other people's usage, so long as everyone's privacy is respected. With more information about your credit-card usage, you could see that something important is getting underfunded relative to other things and make better choices.

Richard Thaler: Or suppose your kid is allergic to peanuts. You'd like to buy things that don't have peanuts. You could start picking up every package and scanning all the ingredients—hopefully, you have good eyesight or glasses. That's a nuisance. But if you're a member of a shoppers' club or a supermarket, they know everything you've bought, right? If they could make the technology work right, you could go to the store's website and download, with one click, a file that lists everything you've bought in the past six months. With one more click, you could send that file to another website, NoPeanuts.com, and they could filter it: "Don't buy those 20 things; here are some suggested substitutes." That's smart disclosure. We should be able to do this for everything, for all our own data.

Also, there are connectivity devices, like fitness bands and smart watches, that allow people to nudge more efficiently and effectively. I was on a video call with a few academics and a company that is trying to help people deal with diabetes. We were discussing the use of glucose monitors that would be somewhere on your body, and maybe your phone starts beeping after the first bite of that ice-cream sundae. There are lots of ways an inobtrusive thing on your wrist can help you make better choices—even if it's not always perfect.

McKinsey: The increased use of technology and smart disclosures seem important for reducing sludge in decision making. That's one of the new concepts you introduce in this edition of the book. What is sludge?

Cass Sunstein: Think of it as frictions or burdens or barriers that make it hard for you to get where you want to go. It's the company that keeps you waiting on the phone for hours to resolve an issue with a product. Or if you're trying to get a permit to build something or to do some kind of job that you're qualified for, you may have to fill out a 40-page form, go in for an interview, deal with six people who are hard to get ahold of—that's sludge. By the latest counts, the US government imposes 11 billion annual hours of paperwork on people. Some of it is justified; you can have cases where people are rightly asked to prove something, and that takes some administrative burdens to navigate. But often, the level of sludge that people are asked to endure is much too high. It's like a wall between people and something that can make their lives much better.

Richard Thaler: Think about the COVID-19 vaccination process. Every state set up its own rules, and most had mostly sensible priorities: "Let's vaccinate older people and healthcare workers first,

Richard Thaler

Education
Holds a PhD and a master's degree in economics from the University of Rochester and a bachelor's degree in economics from Case Western Reserve University

Career highlights
University of Chicago Booth School of Business (1995–present)
Charles R. Walgreen Distinguished Service Professor of Behavioral Science and Economics, as well as director of the Center for Decision Research

Fast facts
Was awarded the 2017 Nobel Prize in Economic Sciences

Is the author of *Misbehaving: The Making of Behavioral Economics* (W. W. Norton & Company, 2015)

Is a member of the National Academy of Sciences and the American Academy of Arts and Sciences, and is a former president of the American Economic Association

since they are among the most vulnerable, then educators," and so forth. All those rules are well meaning, but they still added sludge to the process. Officials had to determine—in the category of educator, for instance—"do we include classroom teachers who were working remotely and the superintendent of the school district, who doesn't interact with children directly?" Or think about the logistics of how vaccines were administered. One COVID-19 vaccine came in six-dose vials. If you gave one shot and stopped there, the other five would be wasted. But when some sites opened up the vaccination opportunity more widely, so they wouldn't have to throw vials out, they got into trouble. That's another example of sludge.

McKinsey: If I'm an executive, how should I think about reducing sludge and designing and deploying nudges in my organization?

Cass Sunstein: Dick and I have both learned that the best way for organizations to reduce sludge and develop a capability in nudging is to bring in people who have some training in this area. It may be that they studied behavioral economics at university, or they have experience in the field with nudging.

It's no secret that social media companies have behavioral expertise which, in some cases, they're using for good. Some companies that sell food and drink are thinking hard about how to use nudges to increase profits and, simultaneously, do better by their customers.

The second-best thing, however, which can help a lot, is to train people in-house on the basics of behavioral science or behavioral economics. It's not that technically complicated. And if you have people who are willing, who have fun with it, and who are eager—maybe they are doing this as half of their job—they can make a massive difference within a company.

McKinsey: You mentioned the word "fun"—and it is the theme of an entire chapter in the new book. How is nudging fun? Or how can it be fun?

Cass Sunstein: There's increasing research showing that if people find it fun to do something, then they're going to do it, even if it's a departure from what they're used to. There are plenty of examples from the private sector—Amazon, for instance, sells products that involve very little packaging, or "frustration free" packaging. It's fun. The product arrives; you open it up; there it is. The underlying nudge is actually about sustainability and the environment—no plastics, no wires, less solid waste to dispose of. It's an environmental plus, but it's billed as fun. And it genuinely is fun. In dealing with COVID-19, some countries had slogans or themes focused on the fun things you could do during the lockdown; these campaigns showed real wit and humor but also reflected a very good behavior-change strategy. We are very much focused, in this book, on fun as a strategy for behavior change.

McKinsey: Is there any personal behavior you've nudged yourself out of?

Richard Thaler: No, I'm basically perfect, you know [laughs]. We all know our weaknesses, I think. When I was a young professor, I would often do things like promise to present a paper at some conference nine months on, just to make sure that there would be a paper to present. When we agreed to this interview, I told whoever was involved, "Make sure to send me a calendar invite." We professors aren't called absent minded for no reason. I make lists. If I get sent to the supermarket, my rule is if there are more than two things, I need a list.

Cass Sunstein: I have an intense aversion to cruelty or bullying. Even after the first edition of *Nudge* and before the second, I would be stern and reactive to someone who was cruel. But if you tell a bully they're a bully, they'll argue, "No, I was right" or "I didn't mean anything by it." Now, I have this phrase going through my head a lot: each of us, in some sense, is the hero of our own life. We all have a narrative that puts us in a better light than others might see us in. So I try to remember this when I see others act in ways that I wish they hadn't. I'm sure I wouldn't have had as much clarity on this dynamic without my work on the book.

McKinsey: Is this *really* the final edition?

Cass Sunstein: Well, there is a little bit of a dispute between the authors about this. I'd like to think that "the final edition" has a tiny question mark in parentheses next to it. But the fact that we approached this as the final edition gave us the sense that this was a real chance to try to do it right. Our hope is that if you're in business, medicine, law, academia, or elsewhere, the book will have something for you. It covers the deep issues that all of us, at least sometimes, think about—freedom and what it means, choice and how wonderful it often, but not always, is, and well-being and what that is and how to achieve it.

Richard Thaler: In the book we talk about commitment strategies. If you want to quit smoking, you don't keep any cigarettes at home. If you want to save for retirement, you make sure to take money out of your paycheck before you can spend it. If you think completely rewriting an already successful book is crazy, and you want to make sure you never do it again, you call it "the final edition" [laughs]. So if Cass wants to write another edition, it will have to be bylined "Cass Sunstein and former colleague Richard Thaler."

Cass Sunstein is the Robert Walmsley University Professor at Harvard Law School. **Richard Thaler** is the Charles R. Walgreen Distinguished Service Professor of Behavioral Science and Economics at the University of Chicago Booth School of Business. This interview was conducted by **Roberta Fusaro** (Roberta_Fusaro@McKinsey.com), an executive editor of McKinsey Global Publishing, based in McKinsey's Waltham, Massachusetts, office, and by **Julia Sperling-Magro** (Julia_Sperling-Magro@McKinsey.com), a partner in the Frankfurt office.

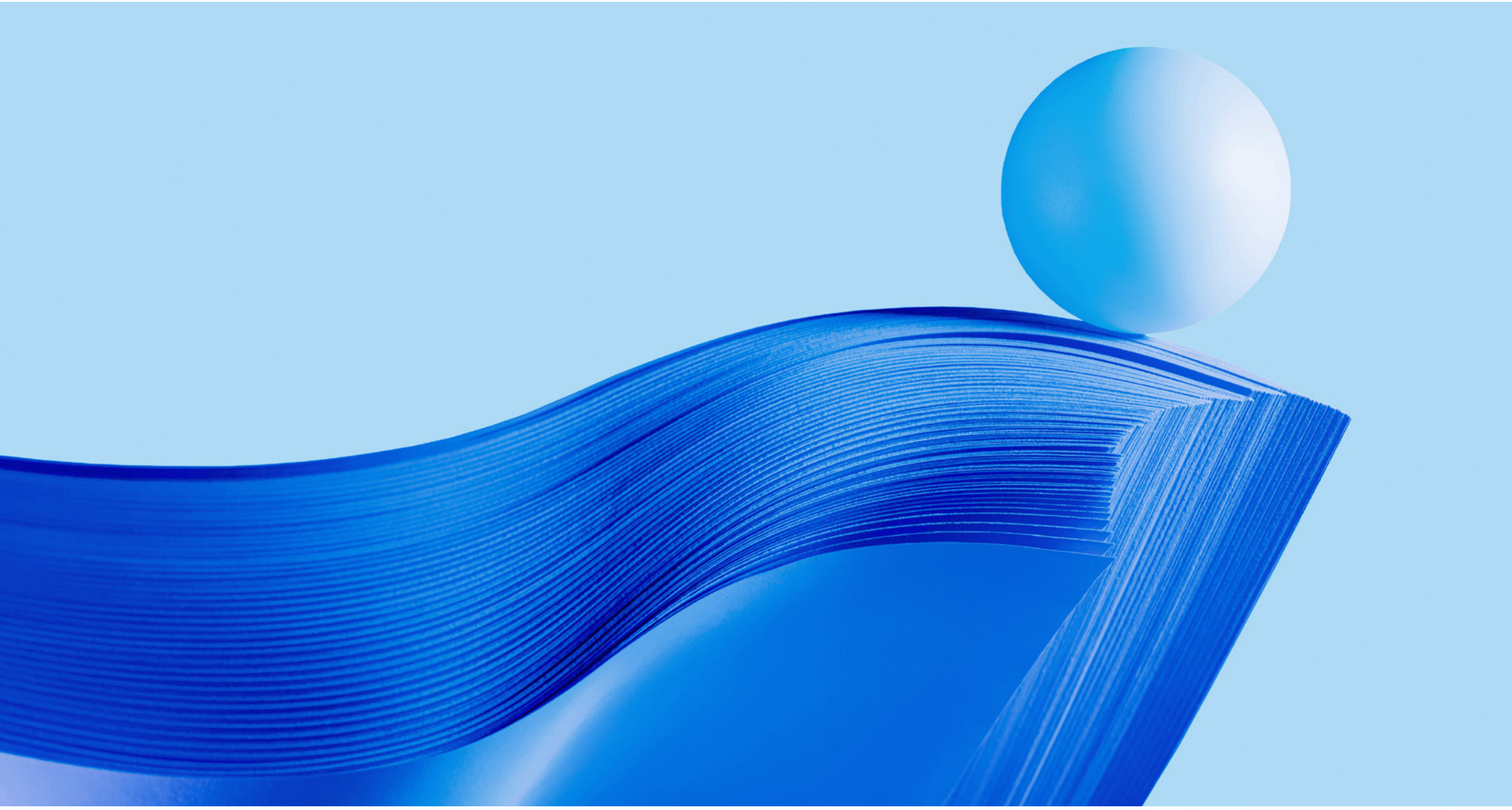
Despite their best intentions, executives fall prey to cognitive and organizational biases that get in the way of good decision making. In this series, we highlight some of them and offer a few effective ways to address them.

Our topic this time?

Bias Busters

A better way to brainstorm

by Eileen Kelly Rinaudo, Tim Koller, and Derek Schatz



The dilemma

The regional CEO of a large US cosmetics company has invited all the business unit leaders to brainstorm about M&A priorities and potential opportunities in the new year. Everyone knows that digital acquisitions have been a pet project for the senior-leadership team. But some business unit heads believe the company should look at other targets as well—expanding overseas, for instance, where the cosmetics market is booming, or investing in organic beauty products or a men's grooming line. Ahead of the call, some of the business unit heads even prepare pages to support these ideas, citing links to current businesses, trend analyses, and so on. On the call itself, however, the regional CEO steers most of the conversation to digital-growth opportunities—again. Frustrated, some business unit leaders stay silent, and the brainstorming proceeds in a pro forma way, with little debate, as the group circles back to the same priorities and growth opportunities everyone has heard many times before.

How can the regional CEO convene a more productive brainstorming session?

The research

When it comes to group interactions in the workplace, individuals are particularly vulnerable to *motivations to conform*.[1] The reasons we conform are varied, but according to a five-part model developed by professors Paul Nail, Geoff MacDonald, and David Levy, they can include the need to avoid rejection and conflict, accomplish group goals, or establish one's identity.[2] After all, why undercut a superior's views or challenge an opinionated CEO if it means somehow diminishing one's own power, influence, or authority? This risk aversion is a big factor in the success or failure of brainstorming sessions. Consider the situation at the cosmetics company. The leadership team's desire to explore digital targets was well known in the company, and once that idea was propagated by the regional CEO, some business unit heads were deflated: to speak out against it could be viewed as a repudiation of existing priorities. Individuals' motivations to conform created an environment in which mediocre ideas were allowed to flourish and true change was less likely to happen.

Anonymous brainstorming, along with silent voting, can serve as a counterweight to individuals' motivations to conform and help contributors feel like their expertise and ideas are being fairly considered.

[1] "Conformity," *Psychology Today*, January 8, 2022.
[2] David A. Levy, Geoff MacDonald, and Paul R. Nail, "Proposal of a four-dimensional model of social response," *Psychological Bulletin*, June 2000, Volume 126, Number 3, pp. 454–70.

The remedy

Anonymous brainstorming, along with silent voting, can serve as a counterweight to individuals' motivations to conform and help contributors feel like their expertise and ideas are being fairly considered. To understand how this works, let's reconsider the brainstorming session at the cosmetics company. To ensure that all ideas are truly weighted equally, the regional CEO could appoint a facilitator to collect ideas written on pieces of paper, for instance, or submitted through a central software application. (This step would be managed ahead of the brainstorming session.) During brainstorming, ideas would not be presented in a specific order or tied to specific sources, which would free up business unit heads and other company leaders to offer proposals that may run counter to the senior-leadership team's well-known digital stance. The facilitator could then read aloud the list of submissions, and the business unit heads could vote on them independently (and anonymously) to reveal the degree of alignment behind each idea. Once the submissions have been vetted and reprioritized, the group could repeat the silent-voting process until a clear choice can be made.

No question, this type of structured facilitation will take more time and effort than a traditional brainstorming session—but it has the potential to reveal truly original business initiatives that may not have come to light had participants' reputations been on the line. Using a structured approach to brainstorming removes some of the risks that can thwart honest discussion.

Eileen Kelly Rinaudo (Eileen_Kelly_Rinaudo@McKinsey.com) is director of Advancing Women in Energy in McKinsey's New York office, **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Denver office, and **Derek Schatz** (Derek_Schatz@McKinsey.com) is a consultant in the Chicago office.

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