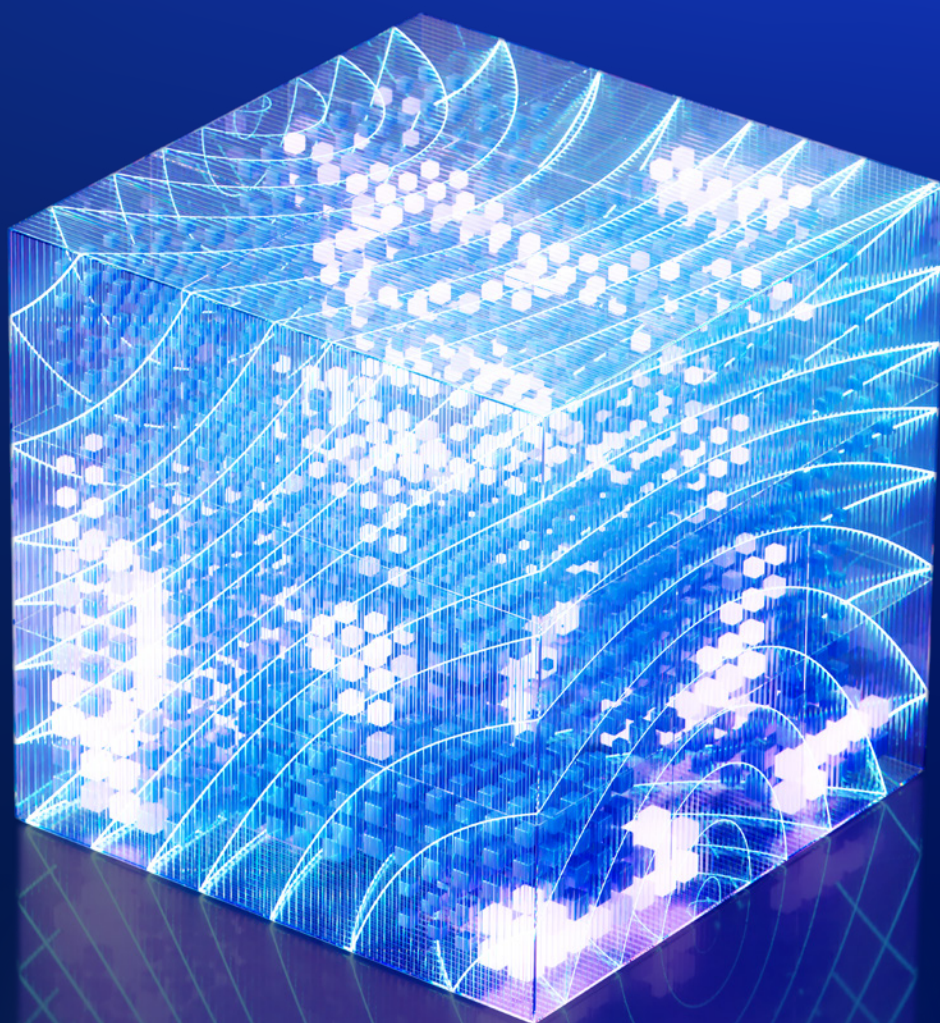


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McKinsey on Finance

Perspectives for CFOs and other finance leaders



Forward, faster

Inside: Gen AI reality,
VC clarity, TSR winners,
M&A leaders, and
advantages of long-term
value creation

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McKinsey on Finance is a quarterly publication offering perspectives drawn from across—and beyond—McKinsey for CFOs, those who aspire to be CFOs, and other finance professionals.

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Editorial Contact:

McKinsey_on_Finance@McKinsey.com

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Circulation: Alexandra Campos

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McKinsey Global Publications

Publisher: Raju Narisetti

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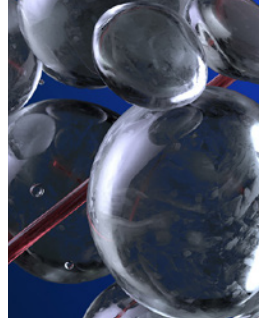
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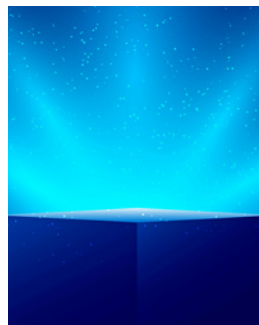


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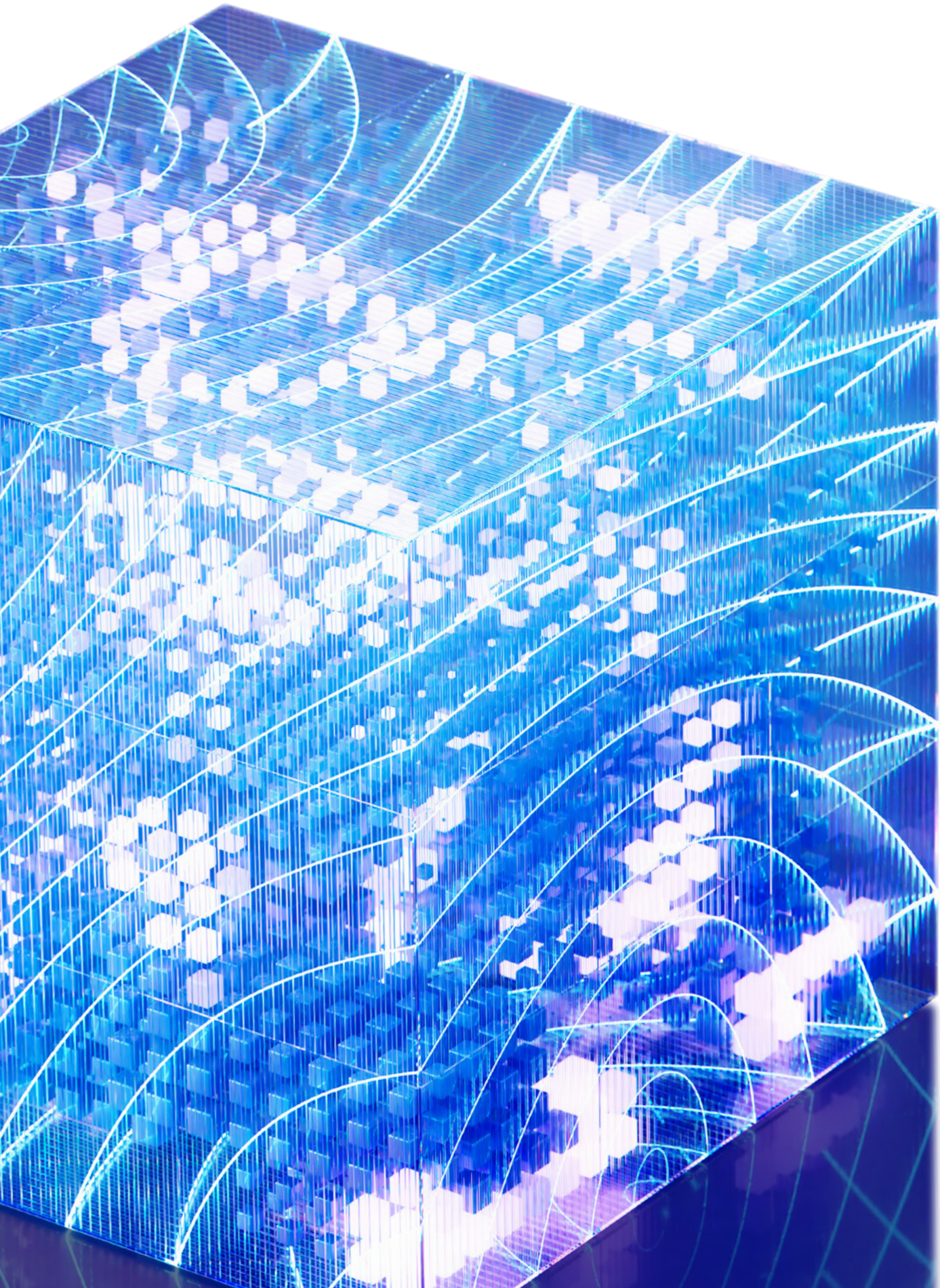
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Item 1: This edition

It's unclear who said it first, but by 1899 the phrase was widely published: "Everything that can be invented has been invented." Airplanes, antibiotics, digital computers, and the internet might like a word. Much fun had been poked at the observation even before it was displayed on overhead projectors—and then after software made that equipment obsolete.

For more than 12 decades (and counting), the best CFOs have helped to ensure that innovation continues to charge ahead. They're leaders, doers, and champions of change; people who act in well-considered, bold ways, moving capital where it will have the greatest effect while being ever mindful of guardrails, risks, and broader, social implications.

Today, these characteristics are particularly essential. Technology is moving faster, particularly at the dawn of generative AI (gen AI). In "Gen AI: A guide for CFOs," Ankur Agrawal, Ben Elleneweig, Rohit Sood, and Michele Tam discuss the principles, approaches, and actions that finance leaders can apply in allocating capital to the most value-creating gen AI opportunities for their corporation, while at the same time implementing the most effective gen AI initiatives within the finance function.

Janet Bannister—the well-known high-tech pioneer, venture capitalist, and gen AI proponent—enforces that message in this edition's interview: "How CFOs can adopt a VC mindset: Staircase Ventures' Janet Bannister." She sat down with McKinsey's John Kelleher and Tim Koller to exhort CFOs to be change agents and focus relentlessly on long-term results.

Understandably, CFOs still need to mind resilience. Our recent global CFO survey, "CFOs' balancing act: Juggling priorities to build resilience," explores how today's finance leaders manage growth-oriented and defensive considerations, and the

major changes these leaders expect in the months ahead. But are they being bold enough? While these are remarkably challenging times, we crunched the numbers in "Do big companies cut dividends to grow?" and found that even when economic conditions are favorable, large companies almost never cut dividends to fund growth.

Yet the long term has a way of catching up with everyone. In "Five paths to TSR outperformance," our colleagues show how extraordinarily difficult—particularly for large companies—it is to beat ten-year market TSR decisively by even a few percentage points. Strategy can't be shortsighted, and M&A can't be decoupled from strategy. The most effective dealmakers follow a clear set of practices, as shown in "The seven habits of programmatic acquirers." Intrinsic investors, for their part, home in on the long-term value-drivers of environmental, social, and governance initiatives, as we discovered in "Investors want to hear from companies about the value of sustainability." In fact, an overwhelming majority of these investors would be willing to pay a sustainability premium. As we see in this edition's "Looking back" chart and discussion, companies that generate more value for shareholders also create more jobs in the economy.

Now, as gen AI accelerates a new wave of disruption, the most effective CFOs are at the ready—and recognize that profound changes are still to come.

Michael Birshan

Senior partner
London

Celia Huber

Senior partner
Bay Area

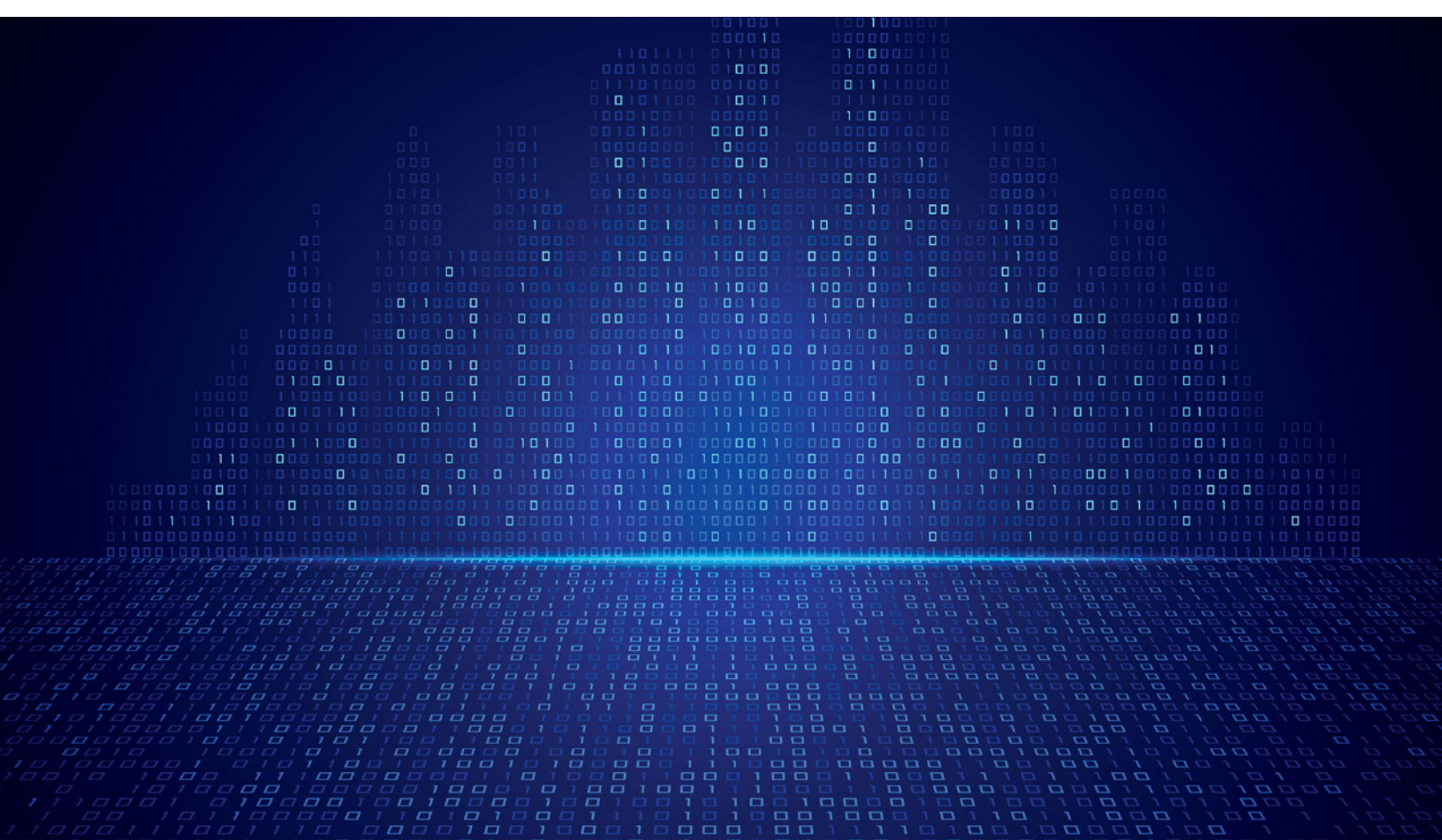
Andy West

Senior partner
Boston

Gen AI: A guide for CFOs

How should CFOs approach generative AI—enterprise-wide and in the finance function—and what can they do right now to rapidly climb the learning curve?

by Ankur Agrawal, Ben Ellenweig, Rohit Sood, and Michele Tam



Technology changes every business, often radically, and the pace of change is getting faster. Now, generative AI (gen AI) is beginning to show its disruptive potential (see sidebar “Gen AI: A primer”). The technology won’t affect all businesses equally, and certainly not at the same time. Yet across industries and geographies, gen AI could present substantial opportunities for significant value creation.

But value doesn’t create itself. Instead, it’s the CFO’s role to allocate resources at the enterprise level—rapidly, boldly, and disproportionately—to the projects that create the most value, regardless of whether they are driven by gen AI. Similarly, in leading the finance function, the CFO can’t implement gen AI for everyone, everywhere, all at once. CFOs should select a very small number of use cases that could have the most meaningful impact for the function. In this article, we’ll discuss how CFOs can most effectively approach gen AI company-wide, prioritize specific use cases within the finance function, and rapidly climb the gen AI learning curve.

Gen AI and enterprise-level value creation

The most important action that CFOs should take is to identify the largest opportunities for value creation—and then make sure that they receive the money and other resources that they need. Gen AI holds the potential to be a revolutionary technology, but it doesn’t change foundational principles of finance and economics: a company must generate a return above its cost of capital.

Moreover, company capital (or access to more capital) is finite, and projects compete with one another. For CFOs to maximize value creation, they must rank the company’s 20 to 30 most value-accretive projects *regardless of whether they are AI-related*. The Pareto principle always applies; usually a very small number of opportunities will deliver most of the company’s cash flows over the next decade. The CFO cannot let the highest-value initiatives wither on the vine merely because a competing project has “gen AI” attached to it. Sooner or later, shareholders have to pay for everything, and none of them should be on the hook for a gen AI premium.

Gen AI: A primer

Generative AI (gen AI) is a predictive language model that produces new *unstructured* content such as text, images, and audio. Traditional, or analytical, AI, by contrast, is used to solve analytical tasks such as classifying, predicting, clustering, analyzing, and presenting structured data.

Gen AI technology is powered by artificial intelligence models called foundation models, which are trained on a broad set of data, including the outputs from

analytical AI. It can be adapted to generate (hence the name) content that seems human, such as written documents, audio conversations, software programming, charts, and visual images. But it doesn’t create the way a human does: it predicts what a human would enjoy or find useful. And unlike traditional, analytical AI, gen AI doesn’t calculate or do math. The technology, therefore, won’t displace traditional AI. Instead, the ideal is that each will complement and enable the other,

with new innovations in robotics and automation, to make human lives better, more creative, and more self-fulfilling.

For more about gen AI, see “The state of AI in 2023: Generative AI’s breakout year,” “The economic potential of generative AI: The next productivity frontier,” “The organization of the future: Enabled by gen AI, driven by people,” and visit our featured insights page “Insights on Artificial Intelligence,” all on McKinsey.com.

The best CFOs are at the vanguard of innovation, constantly learning more about new technologies and ensuring that businesses are prepared as applications rapidly evolve.

But to that same point of maximizing shareholder value, a CFO must recognize existential threats to a company's businesses and be clear about the most important levers for generating and sustaining higher cash flows. When an opportunity squarely addresses or significantly relies on gen AI, CFOs should not shunt it aside because they don't understand the technology or lack imagination to recognize the value it could create.

Often, a choice about capital allocation won't be either/or: an important business or value lever can have an even greater impact by incorporating gen AI. That applies whether the most important drivers are revenue generators (such as creating an interface that will attract more customers or encourage more cross-selling), margin expanders (for example, reducing manufacturing, procurement, or distribution costs), or a factor that spans revenues and costs (such as helping to attract, retain, and motivate employees by freeing them for more creative work).

Microsoft, for example, has been far ahead of the curve in investing in gen AI to build competitive advantage in key core businesses, such as by creating the Microsoft 365 tool Copilot, which provides real-time suggestions to improve documents, presentations, and spreadsheets. While demonstrated commercial success has largely come from digital natives, some traditional, nontechnology companies are moving aggressively

as well. Morgan Stanley's Wealth Management division, for one, has shown remarkable progress in developing an internal-facing service that uses OpenAI technology and Morgan Stanley's proprietary data to provide its financial advisers with relevant content and insights in seconds.

A world-class CFO ensures that these and other gen AI initiatives aren't starved of capital. Indeed, one of the biggest misconceptions we find is the belief that it's the job of the CFO to wait and see—or, worse, be the organization's naysayer. Capital shouldn't sit; it should be aggressively moved to fund profitable growth. The best CFOs are at the vanguard of innovation, constantly learning more about new technologies and ensuring that businesses are prepared as applications rapidly evolve. Of course, that doesn't mean CFOs should throw caution to the wind. Instead, they should relentlessly seek information about opportunities *and* threats, and as they allocate resources, they should continually work with senior colleagues to clarify the risk appetite across the organization and establish clear risk guardrails for using gen AI well ahead of the test-and-learn stage of a project (see sidebar "New technology, new risks").

For some CFOs, it may feel orthogonal as a "numbers person" to champion visionary innovation. But they've got to do it: market-beating growth won't come from incremental change. Behind the scenes, CFOs can take advantage of their

New technology, new risks

The CFO is often a company's de facto chief risk officer, and even when a company already has a separate risk team (as is the case, for example, with financial institutions), CFOs remain a key partner in helping to identify and mitigate risks.

Generative AI (gen AI) brings a slew of them. In fact, the old phrase that “to err is human; to really foul things up requires a computer” applies now more than ever. To start with, even the most cutting-edge gen AI tools can make egregious mistakes. Since gen AI can't do math and can't “create” out of thin air—instead, it's constantly solving for a what a human would want—it can “hallucinate,” presenting what seems to be a convincing output but what is actually a nonsense result. Such was the case, for example, when one leading gen AI platform wrote

what appeared to be a convincing legal brief—except that its citations were fantasy, including court cases and quotations supposedly made by judges but in fact conjured by the model.¹ Gen AI models can also produce wildly incorrect financial reports; the product appears flawless, but the line items don't apply to the company and the math looks like it should sum but doesn't. What *seems* like a real 10-K form on the first flip through may be wholly untethered from reality.

Beyond hallucinations, other important concerns include legal issues stemming from the intellectual property used as the source of gen AI models, not just in terms of the rights to present the information but also to process the information to teach the solution as it learns. (This is a major reason why gen AI can be

particularly applicable for the finance function for internal use cases—company data is often proprietary.) Other risks include privacy breaches, such as exposing confidential or even market-moving information to third-party models, model bias, and tail event errors that could result from an absence of having a human being stress test what the solution creates.² An overreliance on gen AI and lack of understanding underlying analyses or data can also reduce the preparedness of finance teams to gut check “reasonableness” of outputs. It's critical to bear in mind that gen AI is designed to *enhance* the productivity of people, not to *replace* them. While it can boost efficiency tremendously, real people must always be involved.

¹ Dan Mangan, “Judge sanctions lawyers for brief written by AI with fake citations,” CNBC, June 22, 2023.

² See Roger Burkhardt, Nicolas Hohn, and Chris Wigley, “Leading your organization to responsible AI,” McKinsey, May 2, 2019; and Benjamin Cheatham, Kia Javanmardian, and Hamid Samandari, “Confronting the risks of artificial intelligence,” *McKinsey Quarterly*, April 26, 2019.

relationships with functional and business unit leaders to prod them about exploring gen AI opportunities, and repeatedly follow up in subsequent interactions. They should upskill and empower their own team members to build important relationships across the organization and better understand the assumptions underpinning innovation projects. And they should be “always on” when it comes to innovation—not just in periodic reviews or when closer scrutiny is needed for struggling projects.

Gen AI and the finance function

For many finance functions, gen AI will be table stakes—one among several of the essential tools that every effective, forward-looking finance function will use. The technology has the potential to save meaningful amounts of time and resources. That in itself is a reason to move forward—and why most, if not all, finance functions in large enterprises will likely be using gen AI in significant ways within the next three to five years. In fact, one way to conceptualize gen AI is to consider it as

digital's "third wave" (Exhibit 1). The first wave is to establish a digital foundation; in our biennial survey of global CFOs completed in late 2023, about two-thirds of respondents reported that their functions were digitally connected and using data for the basics such as visualization in dashboards.¹

The second wave, clearly under way, is analytics empowerment; about half of the CFOs reported that their functions were already using advanced analytics for discrete use cases such as cost analysis, budgeting, and predictive modeling. The third wave will make extensive use of robotics and AI. Very few companies are at the third wave yet. But

bold CFOs put their finance team in the best position to learn to work with these tools as the technology gains momentum.

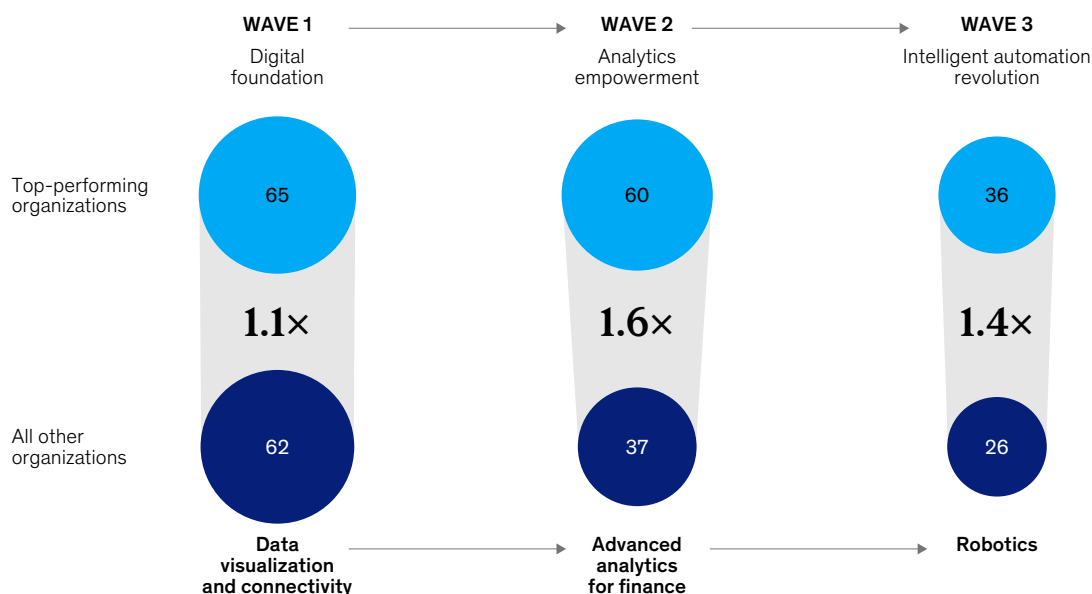
Getting started in the finance function

CFOs typically aren't software engineers, let alone practiced experts in predictive language models. But they don't have to be. Their first step should be to try out the technology to get a feel for what it can do—and where its limits are at the moment. Solutions such as OpenAI's ChatGPT are available online, and other applications (including McKinsey's Lilli) are already in use.

Exhibit 1

Generative AI is part of the 'third wave' of digitization—and leading finance functions are already using it.

Financial performance, by wave level, 2023,¹ % (illustrative)



¹Self-assessed financial performance vs competition. Source: McKinsey biennial global survey of CFOs

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¹ See "CFOs' balancing act: Juggling priorities to build resilience," McKinsey, August 31, 2023.

Try experimenting by uploading publicly available earnings calls transcripts from your competitors and asking the AI tool to produce the five most-asked questions—and to suggest answers. Or upload your company's and its competitors' financials, and ask the gen AI solution to take the perspective of an activist investor: What elements of your company's performance would an activist home in on? Depending upon the sophistication of the gen AI solution, CFOs can also upload invoice and payments data and ask it to create charts that visualize the information—including a request for the one, most important chart. We find that when CFOs experience the technology firsthand, they not only better understand what gen AI is but also more rapidly grasp near- and immediate-term opportunities.

We advise CFOs to budget a nominal amount at the learning stage, *not* for purposes of deploying AI at scale but rather to improve the learning experience for themselves and their team members. Again, though, the goal is not to let a thousand flowers bloom. Instead, CFOs should select a handful of use cases—ideally two to three—that could have the greatest impact on their function, focus more on effectiveness than efficiency alone, and get going.

One point that quickly becomes apparent when moving forward is that gen AI is not plug and play; companies can't simply set the models on existing sources of information and let them have at it.

Gen AI doesn't create like a human does or have a eureka moment. It doesn't even do math (that's the remit of traditional, or analytical, AI). Gen AI is a predictive language model—a translator that sits above existing unstructured data and seeks to generate content that a human would find pleasing. The data sets themselves first need to be rigorously processed and curated, just as data scientists prepare data lakes for advanced analytics and analytical AI.

Identifying use cases

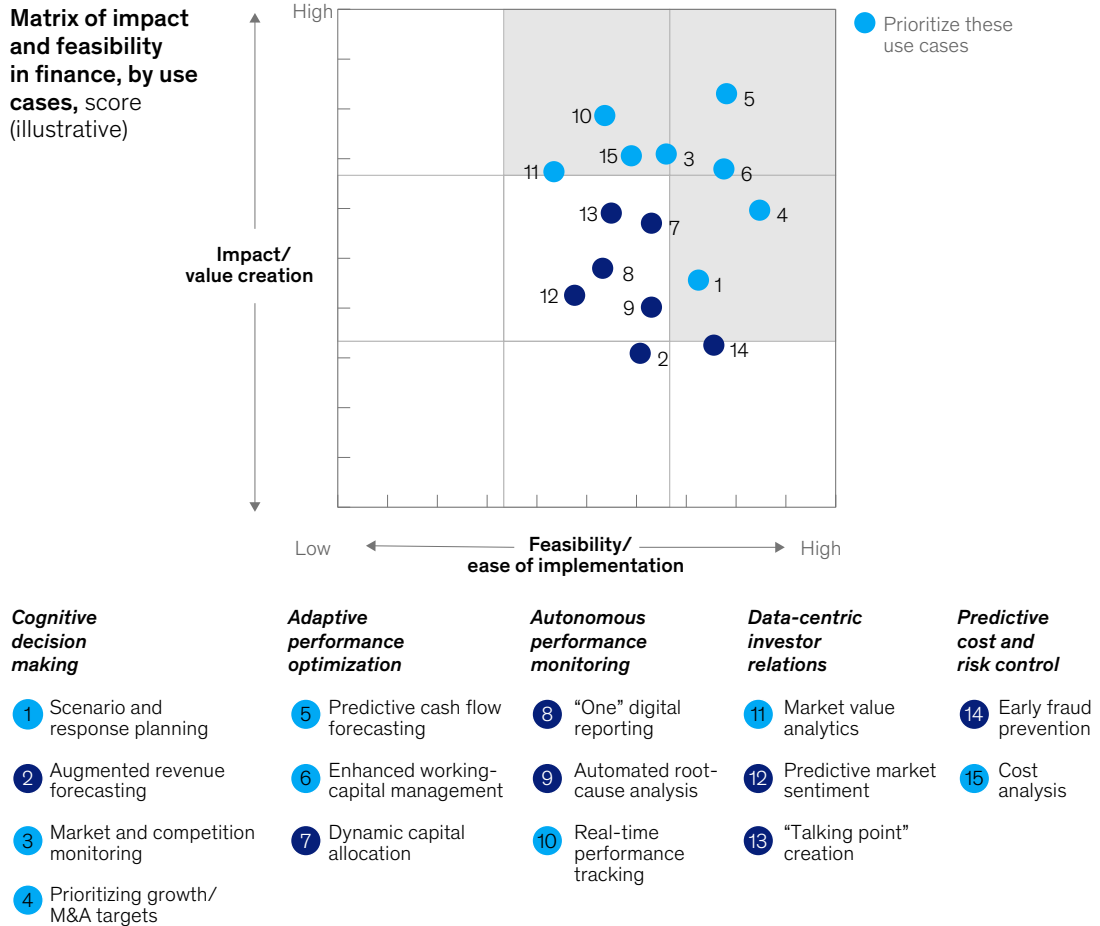
We believe that gen AI can have an impact on finance functions in three major ways. First, through *automation*—performing tedious tasks (such as creating first drafts of presentations). Second, by *augmentation*—enhancing human productivity to do work more efficiently (such as by gathering and synthesizing multiple pieces of information into a coherent narrative). Third, through *acceleration*—extracting and indexing knowledge to shorten financial reporting cycles, and speeding up innovation. Gen AI can greatly enhance CFOs' ability to manage performance proactively and support business decisions. A high-performing finance function understands the use cases that could most significantly and feasibly improve their function (Exhibit 2).

For example—and by no means as an exhaustive list—a few multinational enterprises have already begun to implement the following:

CFOs' first step should be to try out the technology to get a feel for what it can do—and where its limits are at the moment.

Exhibit 2

A high-performing finance function understands the use cases that could most significantly and feasibly improve it.



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— *Synthesis of information*, which can create customizable interactive charts through natural-language queries. For example, solutions exist that provide a general Q&A chatbot, a chart creation tool that generates charts seconds after receiving a prompt or description of code, and a visualization tool that customizes charts by using existing code and validating the accuracy of the code.

— *Digital performance management*, which answers performance-related questions, synthesizes status and scenarios, identifies drivers and root causes of budget variances, and suggests resolutions. This solution is typically self-serve, business user-friendly (as opposed to finance user-friendly), and can lead to more effective performance management dialogues.

— *First drafts of external reporting*, which not only can save weeks of team time in preparing advanced first drafts of securities filings and stakeholder reports (such as sustainability reports) but also runs queries on the current regulations and standards to help ensure that the reports meet current standards.

— *Working capital management* with features such as an always-on support bot to help facilitate collections and payments, and an always-updated customer payment history risk assessment, including the capability to limit customer credit based on real-time information about customer-specific activity and market events.

The array of gen AI use cases is wide, varied—and no longer merely theoretical. And while it's still early days, the rate of adoption is speeding up. Those realities make it even more important for CFOs to get started in a considered and proactive way.

Gen AI can be an important tool for value creation. CFOs should strive to be gen AI enablers, not gatekeepers, and make sure that strategically critical initiatives rapidly and continually receive necessary resources. They should also ensure that they and their own function quickly climb the gen AI learning curve. The future is already starting.

Ankur Agrawal (Ankur_Agrawal@McKinsey.com) is a partner in McKinsey's New York office; **Ben Ellenweig** (Ben_Ellenweig@McKinsey.com) is a senior partner in the Stamford, Connecticut office; **Rohit Sood** (Rohit_Sood@McKinsey.com) is a senior partner in the Toronto office; and **Michele Tam** (Michele_Tam@McKinsey.com) is an expert associate partner in the Chicago office.

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How CFOs can adopt a VC mindset: Staircase Ventures' Janet Bannister

A high-tech pioneer describes how technology has continually disrupted business, why generative AI is accelerating today's disruption, and what leaders can do to stay ahead.



It's probably no coincidence that Janet Bannister was a competitive long-distance runner and a Canadian National Triathlon champion: she's focused on winning over the long term. Decades ago, Bannister spent four years at eBay, where she helped transform the company from a collectibles site to a mainstream marketplace. In 2004, she launched the online classifieds business Kijiji and expanded it to become one of Canada's most visited websites. Her firsthand experience in the disruptive power of new technologies has been critical to her success in venture capital (VC)¹—she's the founder and managing partner of Staircase Ventures—and she's bullish about generative AI (gen AI). In a series of conversations with McKinsey's John Kelleher and Tim Koller, excerpted here, Bannister discusses how executives can adopt a VC mindset, the threats and opportunities of gen AI and technology more generally, and the human and organizational challenges of focusing on the long term.

McKinsey: What does it mean to have a “VC mindset”?

Janet Bannister: My portfolio companies and I spend our working hours figuring out how we can disrupt the incumbents, take away their most valuable customers, and nullify their competitive advantage. When you have a VC mindset, you're focused on the long term, you're willing to take bets, and you are relentless about winning. When I meet with legacy companies, often the absence of a growth focus is striking. They are more focused on maintaining what they have than on growing. At a young technology company, you expect year-over-year growth of 100 percent *at a minimum*. I remember working at eBay in its early days, and one of my direct reports stood up and made a presentation to Meg Whitman [former president and CEO of eBay] about how great a particular opportunity was and how the business unit's revenue was going to grow three times every year over the next few years. Meg's comment was, “You've just spent the first half hour convincing me

how great this opportunity is. Why is it only growing three times year over year?” Granted, it is easier to have that level of growth when you are starting from a small base, but that aggressiveness, that mindset of constantly seeking new ways to grow, and to grow as quickly as possible, is critical.

In venture capital, it's the long-term results that count. My approach when working with my portfolio companies reflects this focus. If a company misses a quarter's revenue, that in and of itself is typically not a problem. What I care about is *why* they missed their number. Is this an indication of a larger problem, or is it because they are setting themselves up for long-term success? Provided the company is building a long-term, high-growth, profitable, and sustainable business, they are on the right track. Obviously, this approach is much more difficult when leading a public company that is judged on a quarterly basis, but the mindset of focusing on the long term is critical.

This long-term focus is particularly important now as technology disruption is accelerating. The average life span of a company listed on the S&P 500 was 61 years in 1958. Today, it is less than 18 years. Technology is the driver of this change. In 1980, technology stocks accounted for 6 percent of the S&P 500; today it is close to 30 percent. Technology is disrupting every industry, and companies need to disrupt or be disrupted. Yet, as the pace of innovation is accelerating, most large companies' ability to innovate is stagnating.

McKinsey: In your experience, what stops incumbents from disrupting themselves? Is it that they don't see the disruption coming, or that they are incapable of making the right strategic choices, hiring the right people, and executing well?

Janet Bannister: It varies. One way to think about it is on a *skill* versus *will* matrix. In some cases, the incumbents lack the will because they do not believe that a major tech disruption will impact

¹ In addition to serving as co-chair of C100 and on the boards of Communitech in Waterloo, Vector Institute in Toronto, and the Ivey Business School, Bannister has won numerous awards and recognition, including *Venture Capital Journal's* 2021 Women of Influence in Private Markets, PitchBook's 2021 Female Founders and Investors to Know, and American Banker's 2019 Most Influential Women in Payments.

‘If a company misses a quarter’s revenue, that . . . is typically not a problem. I care about why they missed their number. Is this an indication of a larger problem, or is it because they are setting themselves up for long-term success?’

their industry. Over the last 25 years, I have watched industry after industry say, “We’re different; technology is not going to dramatically change our industry.” People who have worked in an industry with little change for 30 or more years often cannot conceive of the idea that their industry’s dynamics could be radically and rapidly reshaped.

The other aspect—the skill dimension—is the ability to disrupt oneself. Even if a company wants to change, it may not have the capabilities to rethink and remake its core business. Often the biggest challenge is attracting the right types of people who will drive innovation, and then ensuring that the rest of the organization enables—rather than inhibits—their progress.

McKinsey: And one of the things about venture capital is that you’re always looking down the road when you make an investment. You’re taking a risk, and you accept that the companies you invest in are going to have volatile P&Ls [profit and loss statements] in the beginning. It’s an approach that many big companies don’t seem to be very comfortable with.

Janet Bannister: Right. But there are a couple of changes that enterprises can consider to be more comfortable with investing in disruptive business ideas. The first is to change leadership compensation. Often, except for the most senior executives, compensation is primarily based on short-term results. In venture capital, all upside compensation is based on long-term results.

Venture capital companies can take a relatively high level of risk with each investment because they have a portfolio of investments. Similarly, companies can make a portfolio of “bets” into disruptive business ideas, each with a series of “investment gates,” whereby each initiative gets more funding if it is on track to reach its long-term goals.

Companies should also think through the build, buy, or partner options when adopting innovative technology. If a company is going to acquire another business in order to innovate or disrupt itself, it may not want to buy at the earliest stage; it may want to wait until it can be sure that the fit is right and that the acquired company will be one of the

winners in the space. If a company is not going to build in-house, partnering is often a good place to start. But, ultimately, the right strategy for any specific company is dependent upon their situation; what works in one context may be wrong in another.

McKinsey: Definitely, too many companies seek a “silver bullet.” Large companies in particular can get so big and complex that they can’t see the nuances. I’m always surprised, for example, when a company says: “Every department needs to cut expenses by 10 percent.”

Janet Bannister: That kind of “peanut butter approach”—equal cuts across the board—is taking the easy road, and it’s a common problem. To draw a parallel, most venture capital firms have money for initial investments and money reserved for follow-on investments in their existing portfolio. How do they decide how much money each of the portfolio companies should get in follow-on investment? Some firms have simple rules such as: “At the company’s next funding round, we invest \$1 for every initial \$1 we put into the company.” Sure, it makes life easy; you don’t have to do deep analytical work nor have hard discussions with your founders. But doing the in-depth company analysis, making difficult decisions, and having tough conversations is what you’re paid to do in VC and in large enter-

prises. CEOs or CFOs who take the approach of “We’re reducing every department by the same percentage” don’t have to have uncomfortable discussions with executives whose departments are being disproportionately negatively affected. Often, though, the right call is to cut one department more than another. Developing well-informed conclusions and having hard conversations is a key part of any executive’s job.

McKinsey: Speaking of well-informed conclusions, what effect do you think generative AI—and AI in general—will have on business?

Janet Bannister: AI, particularly generative AI, is transformational. It is critical that all business leaders, in every industry, understand the threats and the opportunities posed by AI. It will change virtually every aspect of every business over the next several years. If an executive has not spent time playing with it, using it, and thinking about how it could help or hinder their business, they have work to do. For those reading this who have not yet tested the capabilities of generative AI, don’t go to bed tonight until you do.

I believe that generative AI will usher in the next wave of rapidly growing tech disruptors. As a parallel, the rise of cloud computing enabled the

‘For those reading this who have not yet tested the capabilities of generative AI, don’t go to bed tonight until you do.’

growth of thousands of tech companies; suddenly, entrepreneurs could relatively easily and cheaply launch and scale a software business, as they could access computing power at a low cost and sell software online with a SaaS [software-as-a-service] business model. I think we're going to see a similar dynamic with generative AI. We are already seeing some tech start-ups scaling more quickly and with fewer people, and therefore at a lower cost, by leveraging generative AI to write software, conduct analysis, and optimize their operations.

McKinsey: The world has seen plenty of disruptions over the years. Is AI really any different, compared to what has gone on for a long time, perhaps even as far back as Schumpeter's theory of creative destruction?

Janet Bannister: AI is an accelerant; disruption from technology invariably comes, and now it's coming faster. I have long been fascinated by how different industries have responded to the disruptive power of technology. When I moved to Silicon Valley in early 2000 and joined eBay, it was primarily a collectibles trading site. My mission was to expand it to be a broader marketplace, including clothing, home items, jewelry, and sporting goods. This was in the early days of e-commerce. For perspective, at that time, Amazon was solely a bookseller. Retailers spoke of how consumers would never shop extensively online, as consumers wanted to flip through books before purchasing them, try on clothes in a store, and touch and hold items before making a buying decision. "Online shopping only works for a very small subset of the population and for very few items; it will never get above 1 percent or 2 percent of all consumer commerce," they said. In 2004, I launched Kijiji, an online classifieds site that went on to virtually eliminate the classifieds section of newspapers, which had accounted for up to 25 percent of their profits. When I launched Kijiji, I tried to partner with newspapers to reach consumers, but most would not even take my call, as they were convinced that online classifieds would never achieve wide-scale adoption. Later

in my career, I consulted for a broadcast television company and explained to them that their viewership was vulnerable to Netflix, YouTube, and other innovative platforms. "No one will ever stop watching television," the industry insiders said. "It is engrained in the American way of life." I have seen this scenario play out over and over: people say that *their* industry is different, and then time proves that it's not. If you look at the most valuable companies in the world, they are now almost all technology companies. Go back 15 or 20 years and that was not the case.

McKinsey: But can AI and technology in general really change all industries? Take a mining company, for example. Someone's got to dig the ore out of the ground. That won't be a technology company, right?

Janet Bannister: I think about technology in terms of challengers and enablers. Challengers are companies that directly compete with the incumbents; enablers sell technology to incumbents to enable them to win versus other incumbents. Will mining companies disappear? Probably not. But if you're in the mining industry, you need to be thinking about how technology can enable you to win versus your competitors. If you don't use it, one of your competitors is going to adopt the technology and establish an edge over you.

Consider the construction and agriculture industries. I don't think you'll see technology companies buying dump trucks, cranes, or farms. But today's large companies that adopt technology faster and better will separate themselves from the competition. In construction, technology has enabled companies to dramatically increase their efficiency, reduce errors, communicate across the value chain more quickly and transparently, and complete projects more quickly. I see the same potential in agricultural businesses.

In other industries though, technology companies are more than enablers; they are challengers, seeking to win at the expense of the legacy compa-

nies. The financial-services industry is an example where we see a lot of challenger companies, from payments, including Square, Stripe, and Venmo, to bank accounts—for example, Revolut and Chime—to wealth management, such as Betterment and Wealthfront. Financial services is particularly attractive to challenger companies because incumbents find it difficult to innovate, and the reward for successful challengers is great. Specifically, large legacy players spend, by some estimates, 70 percent of their technology budget to keep their current systems running. In addition, many lack a culture of innovation, and they are working in a cumbersome regulatory environment. Add to that the massive size and profitability of financial-services markets, and it is a very attractive market for challengers.

McKinsey: On a granular level, how do VC funds decide which specific early-stage companies to invest in, especially when an early-stage business has minimal revenue and market traction?

Janet Bannister: Venture investors seek at least a ten times return on each investment. So VC investors approach an opportunity with the question, “If I invest today at, say, a \$20 million valuation, do I believe that this company is

going to be worth more than \$200 million in the foreseeable future?” To answer that, venture investors will dig into questions including: What is the size of the market? How is the market evolving? Who are the competitors, and how will they respond? How will this company win long term? How strong is the team? What gross and net profit margins can we expect from this company? And of course, investors would also look at the company’s cash projections, determine if and when the company will need to raise more money, and understand where that next round of financing could come from, among other things.

All upside compensation for venture investors is based on the long-term outcome, which may be eight to ten years after we make an initial investment. Therefore, VC investors spend a lot of time thinking about where technology is going, how industries and market dynamics will evolve, and how existing players will react. Technology will dramatically impact every industry, transform the competitive dynamics, create new winners, and lead to the deterioration of many incumbents. If executives are not thinking seriously about technology, particularly now at the dawn of generative AI, they may be just rearranging deck chairs on the *Titanic*.

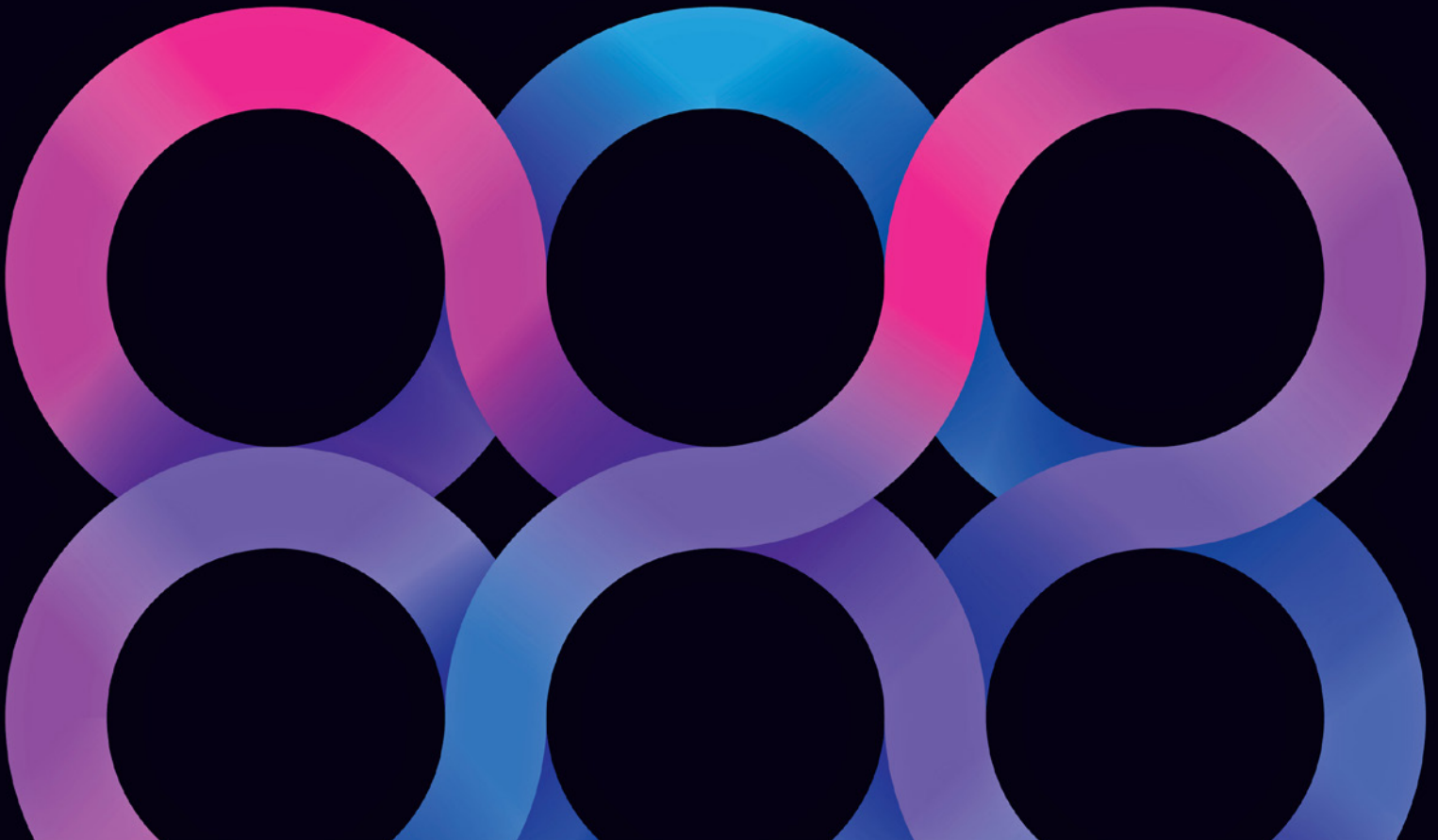
Janet Bannister is the founder and managing partner of Staircase Ventures. **John Kelleher** (John_Kelleher@McKinsey.com) is a senior partner in McKinsey’s Toronto office, and **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Denver office.

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The seven habits of programmatic acquirers

Our latest research shows that programmatic acquirers continue to create value from this approach to M&A and identifies the capabilities and practices these companies use to deliver their M&A strategies.



There are no ‘sure things’ in any M&A transaction—but there are clear conclusions that one can draw from thousands of deals over the past decades. Among the most prominent is the power of programmatic M&A, which is when companies pursue multiple small or medium-size acquisitions per year as part of their growth strategy. Taking a programmatic approach to dealmaking gives companies the greatest likelihood of generating excess TSR with comparatively low levels of risk. Our latest findings—drawn from both our annual, in-depth analysis of the world’s largest global public companies (what we call the “Global 2,000”) and our most recent McKinsey Global Survey on M&A capabilities¹—reinforce and advance more than two decades of research.

Strikingly, we found that programmatic dealmakers with the most deals earned the highest returns:

70 percent outperformed programmatic peers that made fewer deals. Moreover, the gap between programmatic acquirers and companies that take an organic approach widened through the turbulent COVID-19 years (programmatic acquirers created 3.9 percent of excess TSR in the past decade, compared with 2.9 percent in the 2010s). Indeed, even with some of the lowest M&A volumes in recent years,² the latest research shows that the case for programmatic M&A is stronger than ever.

Our latest research also takes a closer look at companies that operate in high-growth sectors to test whether the case for programmatic M&A remains as compelling: it does. Programmatic acquirers in high-growth sectors outperform their high-growth peers that did not pursue M&A as part of their strategy (that is, an organic approach to M&A).

Taking a programmatic approach to dealmaking gives companies the greatest likelihood of generating excess TSR with comparatively low levels of risk.

¹ The online survey was in the field from January 17 to January 31, 2023, and garnered responses from 1,092 participants representing the full range of regions, industries, company sizes, functional specialties, and tenures. To adjust for differences in response rates, the data are weighted by the contribution of each respondent’s nation to global GDP.

² Andres Gonzalez and Anirban Sen, “Global dealmaking sinks to lowest level in over a decade,” Reuters, March 31, 2023.

The case for programmatic M&A

Companies can take one of four approaches to M&A: programmatic, selective, large deal, and organic. A programmatic approach treats deal-making as a capability and not an event. The continuous process of acquiring and integrating new businesses and divesting nonstrategic ones can improve an organization's odds of outperforming companies that only do one-off

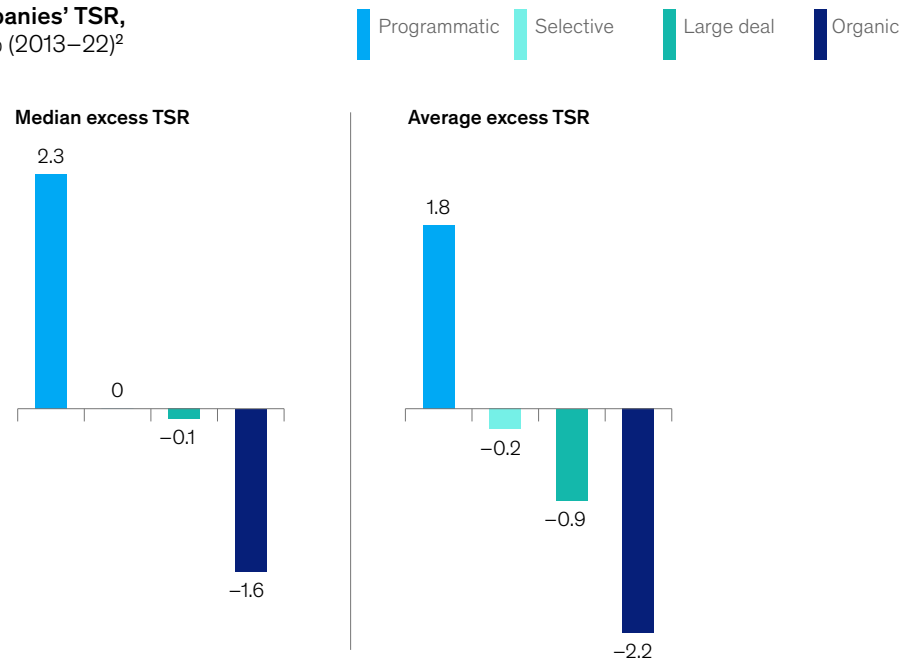
and very large deals, occasionally pursue M&A, and are often reactive in their dealmaking—or largely forgo M&A and choose to grow purely organically (Exhibit 1).

Our latest Global 2,000 research shows the degree to which programmatic acquirers are outperforming other companies.

Exhibit 1

Programmatic M&A strategies tend to achieve higher returns than others.

Global 2,000¹ companies' TSR, by M&A strategy, % (2013–22)²



¹Companies that were among the top 2,000 companies by market cap at Dec 31, 2012 (>\$2.5 billion), and were still trading as of Dec 31, 2022; excludes companies headquartered in Latin America and Africa. Programmatic companies are those with more than 2 small/midsize deals per year, with meaningful total market cap acquired. Selective companies are those with 2 or fewer deals per year, where the cumulative value of deals is more than 1.4% of acquirer market cap. Large-deal companies are those with at least 1 deal where target market cap was at least 30% of acquirer market cap. Organic companies are those with 1 deal or fewer every 3 years, where the cumulative value of deals is less than 2% of acquirer market cap.

²Jan 2013–Dec 2022.

Source: Global 2,000 (2022); S&P Global; Corporate Performance Analytics by McKinsey

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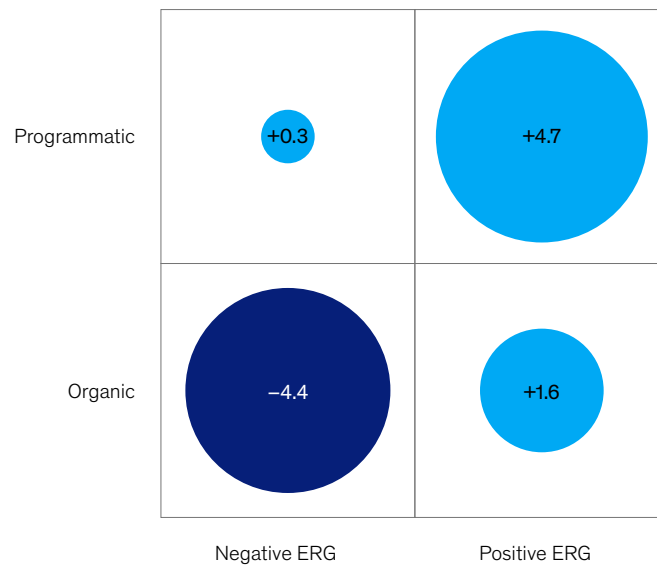
The results are particularly intriguing when compared with the performance of companies that took an organic approach: it might seem counterintuitive for a company in a high-growth business to allocate meaningful resources to deals when it likely has an abundance of internal investment opportunities.

As we dug into the details, we found that these programmatic acquirers markedly outperformed organic peers that didn't enjoy growth tailwinds (Exhibit 2). But even high-growth organic companies did not, in the aggregate, outperform companies across sectors that took a programmatic approach.

Exhibit 2

High-growth programmatic acquirers outperform high-growth companies that take an organic approach.

Global 2,000¹ organic and programmatic acquirers' median excess TSR, by excess revenue growth (ERG),² % (2013–22)³



¹Companies that were among the top 2,000 companies by market cap at Dec 31, 2012 (>\$2.5 billion), and were still trading as of Dec 3, 2022; excludes companies headquartered in Latin America and Africa.

²Delta between company 10-year revenue CAGR and median revenue CAGR of artificial index composed of the same Global 2,000 companies by sector.

³Jan 2013–Dec 2022.

Source: Global 2,000 (2022); S&P Global; Corporate Performance Analytics by McKinsey

Lessons from programmatic acquirers

The accumulated research suggests important lessons for companies that are engaged in or actively considering M&A. What capabilities and actions set successful dealmakers apart?

- 1. Double down on successful strategy:**
Programmatic acquirers create a well-defined M&A blueprint that outlines why and where the company needs M&A to deliver on specific themes in its strategy. But this is just the first step. Programmatic acquirers also actively manage their portfolios and regularly reallocate capital to the acquisitions that align with their enterprise strategy (Exhibit 3). Our research finds

that programmatic acquirers have become even more likely than others to take these steps since our 2021 survey, suggesting that they do so even amid times of uncertainty. In our experience, the most effective acquirers understand how economic cycles will affect their M&A plans, proactively explore different scenarios, and develop plans to continue investing even during downturns. Indeed, we found that survey respondents from programmatic acquirers were more likely to say that their companies' level of M&A activity remained the same or increased in 2022, a year fraught with economic challenges.

Exhibit 3

Programmatic acquirers confidently allocate capital to M&A opportunities that support their corporate strategy.

Those who strongly agree that their organizations regularly reallocate capital to potential M&A opportunities that align most closely with their overall strategy,¹ % of respondents

■ Respondents from programmatic acquirers ■ All other respondents



Those whose companies' level of M&A activity remained the same or increased in 2022 in light of the economic climate,¹ % of respondents



¹For respondents from programmatic acquirers, n = 166. For all other respondents, n = 564. Source: McKinsey Global Survey on M&A, 1,092 participants, Jan 17–31, 2023

2. *Do not window shop.* Once an M&A plan is in place, experience shows that successful execution requires unwavering focus—from the initial stages of creating comprehensive views of the market to developing an outreach strategy

for the top-priority targets. Our research indicates that programmatic acquirers are more likely than others to run an effective target-prioritization process and to have key stakeholders well coordinated when working on a deal (Exhibit 4).

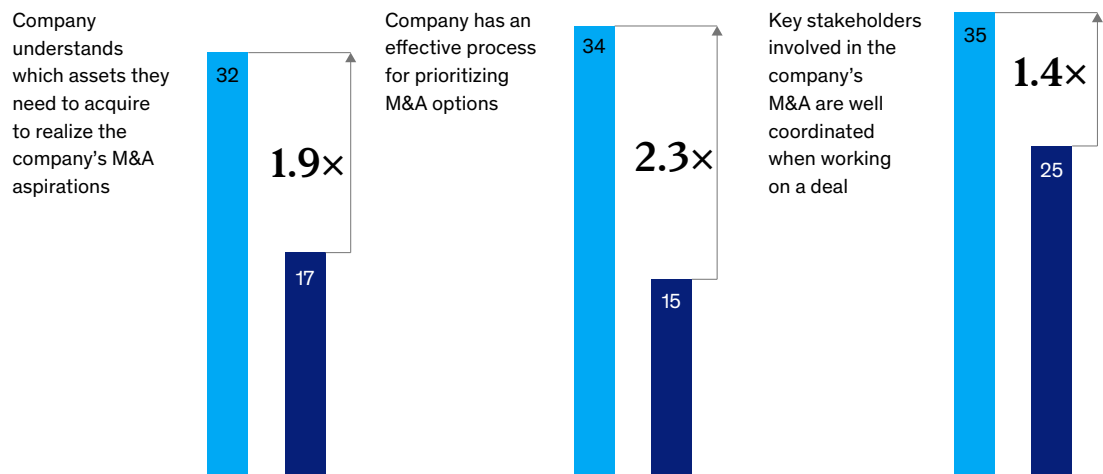
The most effective acquirers understand how economic cycles will affect their M&A plans, proactively explore different scenarios, and develop plans to continue investing during downturns.

Exhibit 4

Programmatic acquirers zero in on the assets they need to meet their strategic aspirations and keep stakeholders aligned.

Those who strongly agree with the given statement,¹ % of respondents

■ Respondents from programmatic acquirers ■ All other respondents



¹For respondents from programmatic acquirers, n = 166. For all other respondents, n = 564. Source: McKinsey Global Survey on M&A, 1,092 participants, Jan 17–31, 2023

3. **Develop strong internal conviction.** In our experience, the conviction to go after the necessary M&A targets becomes even more crucial—and even more difficult to maintain—in challenging economic times. Responses to our survey suggest that programmatic acquirers are more likely than others to take a proactive approach to sourcing deals, regardless of prevailing economic conditions; they provide a steady stream of options to the top team and

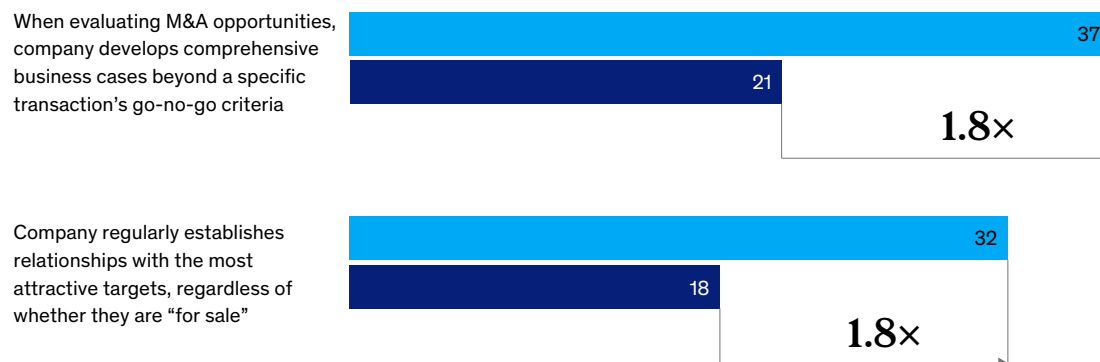
the board that will allow them to execute their M&A strategy effectively. Additionally, respondents from programmatic acquirers are more likely to develop comprehensive business cases, well beyond a specific transaction’s go-no-go criteria (Exhibit 5). A business case can be a valuable tool for gaining agreement among executives and the board about a proposed transaction—and for enabling swift decision making.

Exhibit 5

Programmatic acquirers use comprehensive business cases to build internal conviction.

Those who strongly agree with the given statement,¹ % of respondents

■ Respondents from programmatic acquirers ■ All other respondents



¹For respondents from programmatic acquirers, n = 166. For all other respondents, n = 564. Source: McKinsey Global Survey on M&A, 1,092 participants, Jan 17–31, 2023

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4. *Deliver the full potential of the deal.* The findings suggest that programmatic acquirers manage potential disruptions to their core business, and the targets, while also aggressively pursuing the full value potential of a deal. Programmatic acquirers are much more likely than other companies to set internal synergy targets (revenue, cost, and capital) equal to or above the due diligence estimates (Exhibit 6). They also carefully budget and track the costs—often one-time in nature—required to deliver

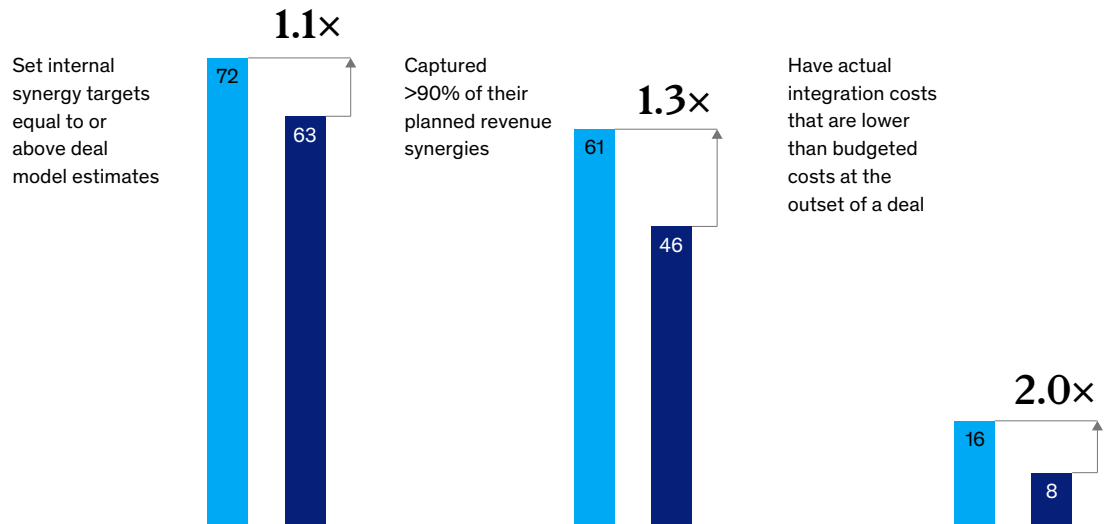
deal synergies. In fact, survey respondents from programmatic acquirers are twice as likely as their peers to report actual integration costs that were at least 20 percent below what was budgeted at the outset of a deal. In our experience, having a clear and accountable owner is essential for seizing a deal’s full potential. That accountability, paired with financial discipline, should be present at all stages of M&A, from ideation to execution.

Exhibit 6

Programmatic acquirers are better than other acquirers at setting and capturing synergies.

Companies’ synergy-target practices and results,¹ % of respondents

■ Respondents from programmatic acquirers ■ All other respondents



¹For respondents from programmatic acquirers, n = 166. For all other respondents, n = 564. Source: McKinsey Global Survey on M&A, 1,092 participants, Jan 17–31, 2023

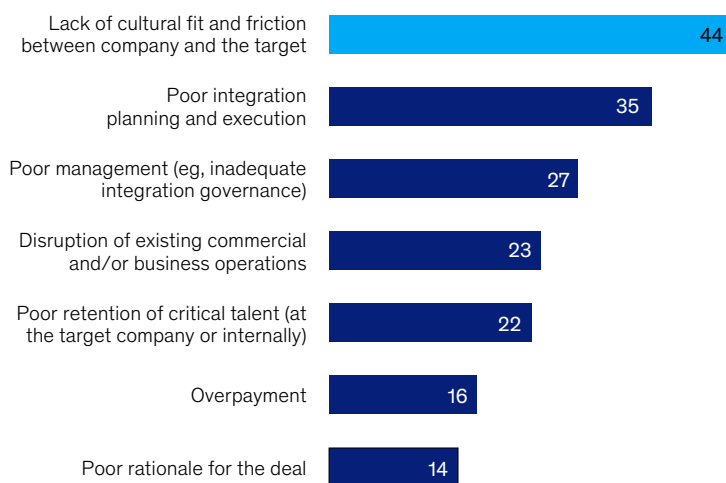
5. **Start with a healthy culture.** Culture is often the forgotten factor in a deal's success. Lack of cultural fit and friction between the acquiring company and the target is the most common reason that survey respondents say an integration has not met expectations. In our experience, culture is often an important driver of financial performance. Also, related research has determined that large acquisitions by healthy companies tend to perform better than do

those by less healthy ones.³ Specifically, companies with healthy cultures (that is, companies in the top two quartiles of organizational health) see an improvement of 5 percent excess TSR, while those companies with unhealthy cultures (that is, companies in the bottom two quartiles of organization health) realized a 17 percent decrease in excess TSR (measured in median excess TSR, two years post deal closing) (Exhibit 7).

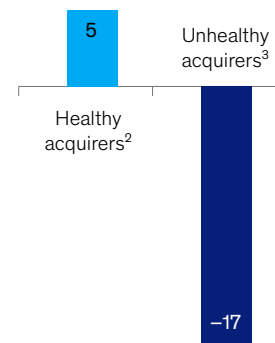
Exhibit 7

Deprioritizing culture and organizational health can put deal success at risk.

Most common reasons that integrations fell short of leadership's expectations, past 5 years, % of respondents



Median change in excess TSR 2 years post deal closing,¹ %



¹Measured using excess total shareholder returns compared with their industry peers, to isolate the effects measured from broader industry trends.

²Those companies with Organizational Health Index scores in the top 2 quartiles of the data set.

³Those companies with Organizational Health Index scores in the bottom 2 quartiles of the data set.

Source: McKinsey Global Survey on M&A, 1,092 participants, Jan 17–31, 2023; Organizational Health Index by McKinsey

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³ Becky Kaetzler, Kameron Kordestani, and Andy MacLean, "The secret ingredient of successful big deals: Organizational health," *McKinsey Quarterly*, July 9, 2019.

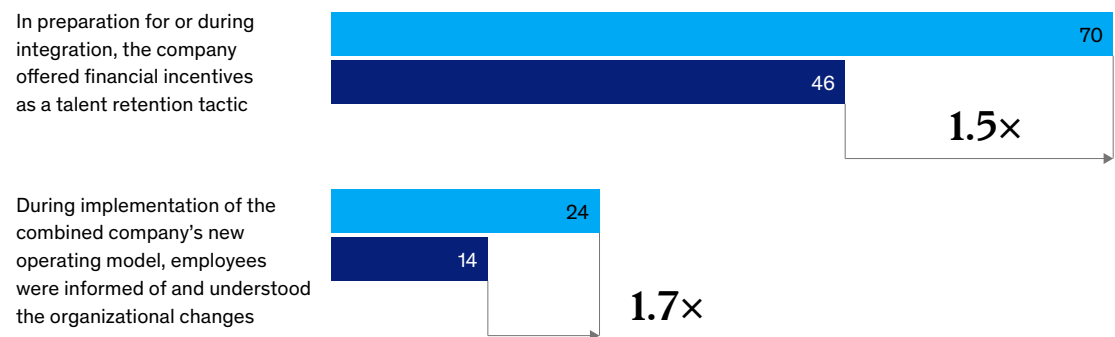
6. **Recognize the value of people and plan for the worst.** The talent of an M&A target is often the key to its success. Leaders should approach integrations with the expectation that talented employees, from both the target and their own organizations, are at a high risk of leaving. Rapidly identifying critical roles and individuals as early as possible (often during due diligence) is a critical risk mitigation step not to be overlooked. Our research shows that programmatic acquirers are much more likely to offer financial incentives to encourage employees to stay, but that is just one piece of the puzzle. Nonfinancial recognition and cultural factors, such as personal communications from senior leaders and tailored career development plans outlining advancement potential, are often as or more effective for retention (Exhibit 8).
7. **Take a best-owner mindset.** Programmatic acquirers also understand the flip side of a clear acquisition strategy: which assets are nonstrategic and should be divested (Exhibit 9). Survey respondents from programmatic acquirers are more likely than others to say their organizations have conducted divestitures in the past five years, and research on the Global 2,000 companies shows that the companies making the most deals—including divestitures in addition to acquisitions—have higher excess TSR. By divesting, they can help management focus on the strategically “core” businesses they already own and those that they should consider acquiring.

Exhibit 8

Programmatic acquirers recognize the power of people.

Those who strongly agree with the given statement,¹ % of respondents

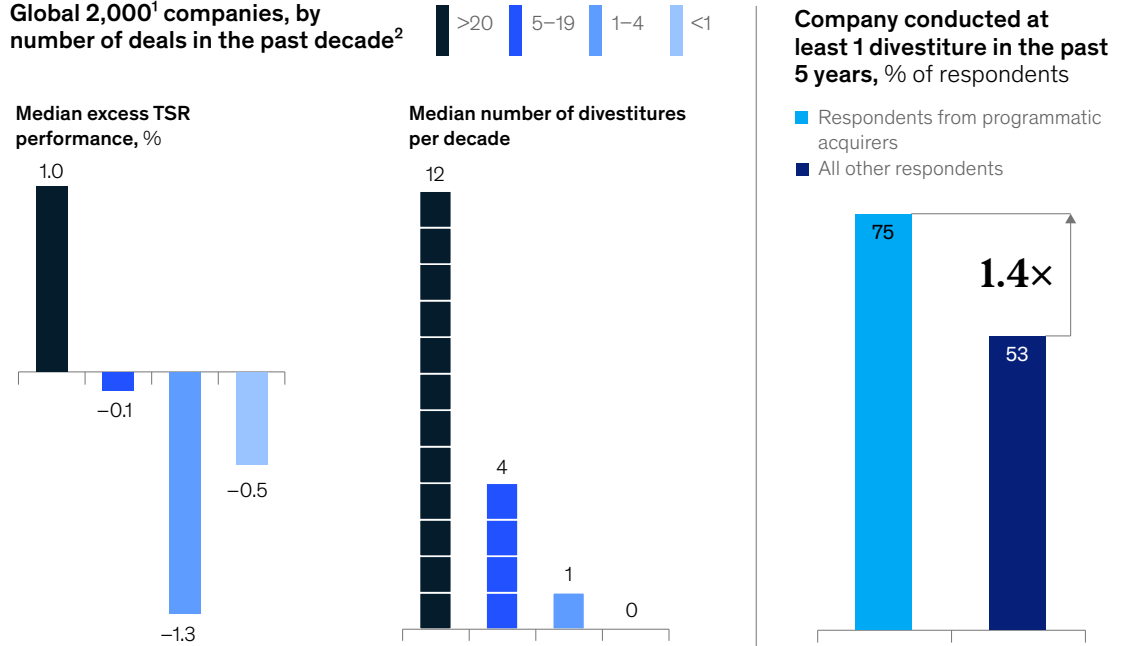
■ Respondents from programmatic acquirers ■ All other respondents



¹For respondents from programmatic acquirers, n = 166. For all other respondents, n = 564. Source: McKinsey Global Survey on M&A, 1,092 participants, Jan 17–31, 2023

Exhibit 9

Programmatic acquirers know when it is time to divest from a business.



¹Companies that were among the top 2,000 companies by market cap at Dec 31, 2012 (>\$2.5 billion), and were still trading as of Dec 31, 2022; excludes companies headquartered in Latin America and Africa.
²The number of deals includes both acquisitions and divestitures.
 Source: Global 2,000 (2022); S&P Global; Corporate Performance Analytics by McKinsey; McKinsey Global Survey on M&A

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Decades of research show the efficacy of programmatic M&A—and our latest findings make it even more clear. Whether external conditions are favorable or challenging, programmatic acquirers

continue to invest in their M&A capabilities and demonstrably outperform companies that take a less strategic approach to M&A.

The survey content and analysis were developed by **Paul Daume** (Paul_Daume@McKinsey.com), a partner in McKinsey's Cologne office; **Cathy Lian** (Cathy_Lian@McKinsey.com), a consultant in the New York office; and **Patrick McCurdy** (Patrick_McCurdy@McKinsey.com), a partner in the Boston office.

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Five paths to TSR outperformance

It's hard for companies to significantly beat long-term market TSR, harder still for the largest corporations, and hardest of all in the face of low growth. But industry endowment needn't be destiny.

by Pedro Catarino, Tim Koller, Rosen Kotsev, and Zane Williams



What does it take for large companies to decisively beat market TSR over a decade? To analyze how top performers achieved their success, we studied the 1,000 largest corporations by market capitalization in the United States. In all, we found that long-term TSR outperformers took one of five distinct paths: (1) being in or moving to high-growth markets (or segments of markets), (2) offering new or enhanced products, (3) refreshing their business portfolio, (4) conducting a successful turnaround, or (5) managing their business better than their peers. Some of these paths were more likely to best market TSR outperformance—and being in or moving to growth provided the widest path of all. But growth wasn't the only way to beat long-term market TSR. Strikingly, the same five paths were apparent over each of the three decade-long periods we analyzed.

Methodology: The importance of realistic expectations

To quantify and more clearly frame long-term TSR outperformance, we conducted two analyses. First, we looked at the 1,000 largest corporations in the United States by market capitalization, examining how many reached the top decile of ten-year TSR performance over any of three different ten-year periods.¹ Doing so meant beating market TSR by about 20 percent. During those periods, only 11, 15, and 18 percent, respectively, of the top-decile TSR performers were “very large” companies—that is, among the 250 largest companies by market capitalization.

Because so few of the largest companies were among the high-TSR performers, we conducted a second analysis, identical to the one for

‘Merely’ beating market-average TSR by more than 5 percent over a decade still puts large corporations on an extraordinary list: only 23, 28, and 37, respectively, of the 250 largest companies were able to do so in the ten-year periods ending 2012, 2017, and 2022.

¹ The ten-year periods that ended as of year-end 2012, 2017, and 2022.

the 1,000 largest companies, that focused just on the 250 largest publicly traded US companies. Knowing that very few could best long-term market TSR by about 20 percent, we gave them a lower bar—to beat ten-year market TSR by 5 percent or more. Very few large companies reached even that mark.

The first lesson, therefore, is one of setting expectations. It's not unusual for senior executives of very large corporations, particularly managers who are new to their roles, to pronounce mandates such as “this company will beat market TSR by 10 percent”—or sometimes by an even greater margin. Realistically, however, that goal is rarely attainable. There's a limit, after all, to how much market size a company can ultimately capture, and smaller companies have a lot more room left to grow. When the market or segment in which a company competes isn't growing, smaller companies have much better odds of long-term TSR outperformance: the smaller a company's initial market share, the greater the likelihood that it can beat and *keep beating* investor expectations.

The five paths to outperformance

“Merely” beating market-average TSR by more than 5 percent over a decade still puts large corporations on an extraordinary list: only 23, 28, and 37, respectively, of the 250 largest companies were able to do so in the ten-year periods ending 2012, 2017, and 2022. As well, over the past decade, about 10 percent of large companies that bested market TSR by 5 percent or more were in cyclical industries such as oil and gas or aerospace and defense; decades of research show that cyclical companies will not reliably beat the broader markets when their industry cycles inevitably turn down.

Still, whether or not one considers cyclicity (we conducted both analyses), the results remained stark: there were five distinct paths to substantially beat market TSR (exhibit).

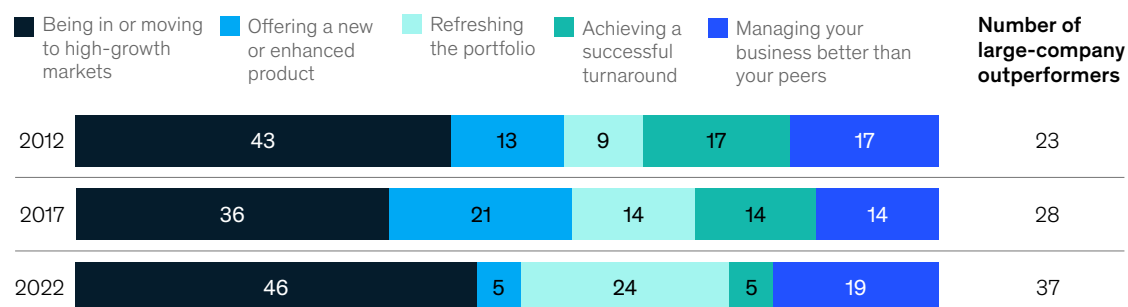
1. Being in or moving to high-growth markets

The widest path to significant TSR outperformance is growth. Many of the companies that took this path started with the good fortune of strong tailwinds,

Exhibit

Few of the 250 largest companies beat ten-year market TSR by 5 percent or more.

Distribution of large companies¹ that outperformed 10-year² S&P TSR by category and time period,³ %



¹250 largest companies by market capitalization, excluding cyclicals.

²Time periods are measured as the 10-year periods that ended as of year-end 2012, 2017, and 2022, respectively. “Outperformance” and “outperformer” for purposes of this analysis are defined as beating, by 5 percent or more, 10-year S&P TSR.

³Figures may not sum to 100%, because of rounding.

Source: S&P Capital IQ; Corporate Performance Analytics by McKinsey

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particularly those whose core businesses were in industries such as high tech or that competed in other sectors in which technology could make an outsize difference (as was the case for payment systems in financial institutions). Yet endowment is not destiny; for example, not every semiconductor company was a TSR outperformer. Across industries, the companies that did outperform by taking advantage of tailwinds both executed well in their core business and continued to invest in innovation and improving their business processes. Most important, they relentlessly sought out a high-growth “niche within the niche.” For example, rather than settling for providing technology support, one services firm took advantage of a surging demand for cybersecurity. Similarly, while the pharmaceutical sector has generated strong returns for decades, pharmaceutical *suppliers* have recently been a growth dynamo within the broader life sciences industry.

2. Offering new or enhanced products

The second-biggest category of large companies that beat market TSR comprised companies that offered new or enhanced products. We distinguish this second category from “being in or moving to high-growth markets” because the major driver or drivers of outperformance were a small number of specific products (sometimes, only one product) rather than an uplift in a specific business as part of industry-wide trends. Here again, companies in the pharmaceutical industry, along with the biotechnology sector, are instructive. Several companies in these industries introduced breakthrough medicines (for example, for autoimmune diseases or diabetes) for which there were large, eager markets; these new products enabled these large corporations to meaningfully beat broader market TSR.

3. Refreshing the portfolio

A third path to TSR outperformance is to refresh the corporation’s portfolio of businesses, tacking toward more value-creating businesses while at the same time not going too far beyond the organization’s core. Companies in this category

proactively seek out faster-growing markets where they can build, or practicably acquire, a competitive advantage. It’s a narrow path; over the last decade-long period we studied, only nine of the 250 largest companies were able to succeed in beating market TSR by 5 percent or more by refreshing their portfolios. Having a proven track record in a core business or businesses was typically a precondition to successfully expanding into new spaces and capturing new pockets of growth. One outperformer, for example, had operated significant publishing and education businesses while also providing financial research. Recognizing emerging trends and businesses for which it was and was not the best owner, the company divested its publishing and education divisions and allocated more resources toward financial research and analytics, which then played an outsize role in value creation. Another prominent example is Microsoft. In 2007, it was the third-largest US company by market capitalization; many of its core products, including Office, Windows, and Xbox, were household names. Yet the company still committed to refreshing its portfolio. In 2008, it began to develop its cloud business; in 2014, new CEO Satya Nadella made clear that the cloud was among the company’s highest priorities; and by 2022, Microsoft’s “Intelligent Cloud” was firmly in the lead as its largest and most profitable division—and still its fastest growing—as the company moved up to become the second-largest US corporation.

4. Achieving a successful turnaround

A small number of large companies—fewer than 20 percent in each ten-year period (and in the last period studied, fewer than 5 percent)—beat market TSR by more than 5 percent by achieving a successful turnaround. These companies came from a diverse range of industries. Several of them generated large improvements in ROIC through efficiency upgrades and economies of scale. Typically, the turnarounds were extremely rigorous, going far beyond the superficial to substantially improve core operations. Best Buy, for example, ended its European operations and Best Buy Mobile stores and focused

‘Managing your business better than your peers’ was the second- or third-largest category of TSR outperformers among each of the ten-year periods. Even so, there were more than twice as many TSR outperformers from a high-growth sector in each period.

on dramatically growing revenue from its US stores and operations, including through initiatives such as the “Geek Squad” for in-home support and repair and by more seamlessly matching its online- and physical-store offerings. Or consider a large manufacturer of technology products. The company dramatically upgraded its manufacturing process, shifting from a labor-intensive model to one that was faster, more automated, and highly digitized; by year-end 2022, it had exceeded ten-year market TSR by more than 6 percent.

5. Managing your business better than your peers

Finally, one additional path presented itself for large corporations: superb execution. As hard as it is for a company in a traditional, steady-state industry to gain market share, continue to outperform peers, and, as a result, beat long-term TSR by 5 percent or more, a handful of large caps did just that. Consider the retailer Costco and the insurer Progressive. Neither could avail itself of an industry growth wave, and neither substantially changed its business portfolio. But they managed their businesses

superbly. Execution brought exceptional strategy and distinctive capabilities to life, as reflected by their long-term TSR performance. During the ten-year period ended December 31, 2022, these companies delivered an excess TSR of about 6 and 11 percent, respectively. Over the last ten years, Costco grew almost four percentage points faster than the median for large-cap retail companies. Progressive, for its part, outgrew the insurance industry median by about 5.5 percentage points, continually investing in advanced institutional capabilities such as analytics, consumer experience, and others. Both companies also expanded internationally and benefited from strong customer retention. Indeed, “managing your business better than your peers” was the second- or third-largest category of TSR outperformers among each of the ten-year periods. Even so, there were more than twice as many TSR outperformers from a high-growth sector in each period.

An examination of three decade-long periods reveals that there are five paths to beating long-term market TSR. Growth is the widest path, though none of the approaches ensure success, and strong strategy and exceptional management are always essential. Indeed, even when everything breaks

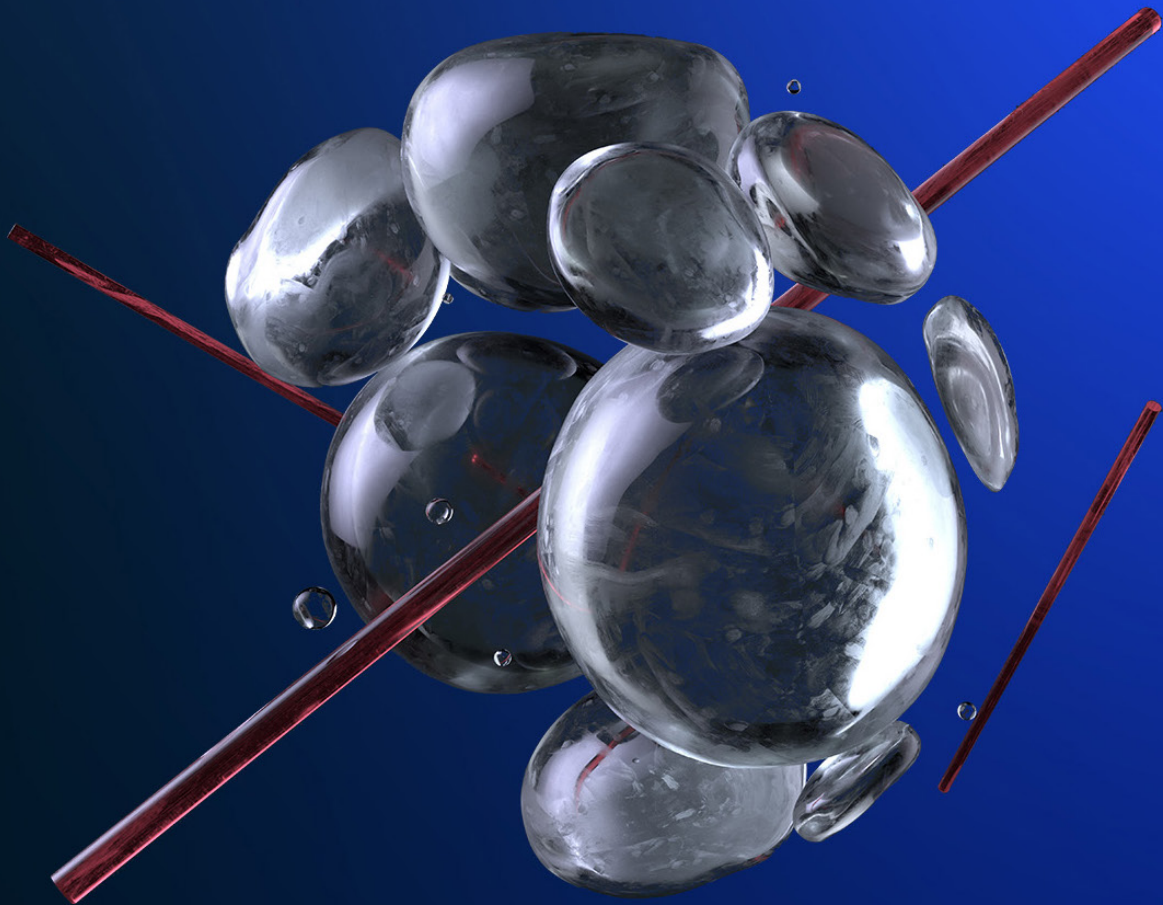
right, companies should be realistic about the level of sustained TSR outperformance that's attainable. For the largest corporations, beating market TSR over a ten-year time frame by more than 5 percent is a significant achievement indeed.

Pedro Catarino (Pedro_Catarino@McKinsey.com) is a capabilities and insights analyst in McKinsey's Lisbon office; **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Denver office; **Rosen Kotsev** (Rosen_Kotsev@McKinsey.com) is a director of client capabilities in the Waltham, Massachusetts, office; and **Zane Williams** (Zane_Williams@McKinsey.com) is a senior knowledge expert in the New York office.

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CFOs' balancing act: Juggling priorities to build resilience

As surveyed CFOs concurrently manage defensive and growth-oriented considerations, they expect major changes in the months ahead and see two pivotal paths for strengthening their organizations.



In the past few years, CFOs have been faced with daunting challenges and tectonic opportunities. Is this the time for offense or defense? The latest biennial McKinsey Global Survey on the role of the CFO reveals that CFOs' priorities are not a matter of either/or.¹ Instead, we find that effective CFOs report that they toggle continually between offensive and defensive considerations, while also addressing other priorities such as capability building. These CFOs have a bifocal view of both short-term and longer-term priorities, which call for different mindsets and approaches. We find that CFOs are balancing different strategies, driven by the need to navigate what they see as the top threats to their companies' growth: increasing industry competition and greater economic volatility. The results show how CFOs are spending their time as they aim to develop their organizations' resilience. They further reveal that CFOs expect profound changes for their organizations in the year ahead. These finance leaders identify capability building

and advanced technologies as the two sources that will best support their organizations for the long term. Indeed, respondents who say they work for organizations that outperform industry peers report being further ahead in both areas.

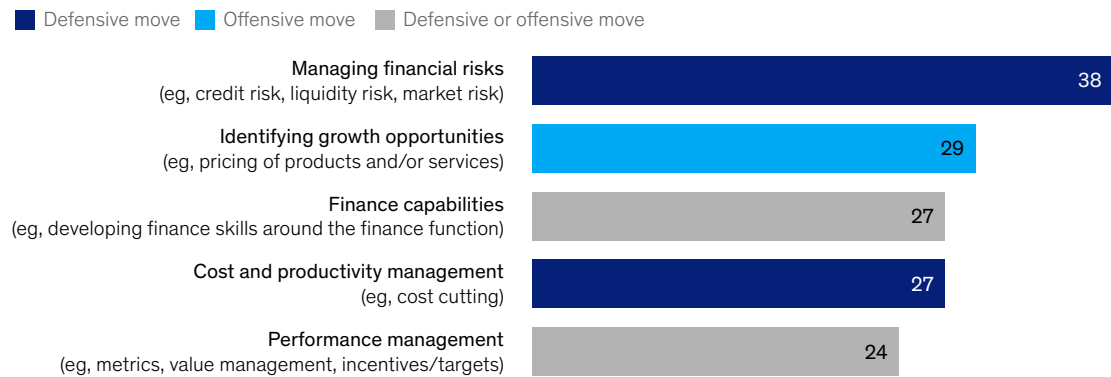
How CFOs are preparing for the future

The survey results show that CFOs perform a strategic balancing act, spending much of their time taking steps to reduce their companies' exposure to financial risks while also seeking growth opportunities. While surveyed CFOs report spending most of their time in the past year managing financial risks, nearly three in ten also prioritized future growth: they report having invested significant time identifying growth opportunities, while also addressing areas, such as capability building, that support both defensive and offensive efforts (Exhibit 1).

Exhibit 1

In the past year, CFOs spent the most time managing financial risks but also looked ahead to offensive strategies.

Areas where CFOs spent the most time, past 12 months,¹ % of CFO respondents (n = 136)



¹Out of 15 areas that were presented as answer choices. Respondents were able to select up to 3 answer choices. Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

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¹ The online survey was in the field from May 9 to May 19, 2023, and garnered responses from 298 participants representing the full range of regions, industries, and company sizes. Of those respondents, 136 said they were the CFOs of their companies; the others were executives in other roles or members or leaders of the finance function. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

We also see a mix of defensive and offensive considerations when CFOs share their expectations for the year ahead, regarding both how they spend their time and which transformative moves they see on the horizon. CFOs expect profound changes in their organizations to bolster resilience and capitalize on market opportunities (Exhibit 2). Fully 55 percent of surveyed CFOs say their organizations will build a new business in the next year to create new revenues. Respondents who say their organizations outperform their competitors expect changes that are long-term strategic moves: they are, like others, most likely to expect new-business building, and they are much more likely than others to report that

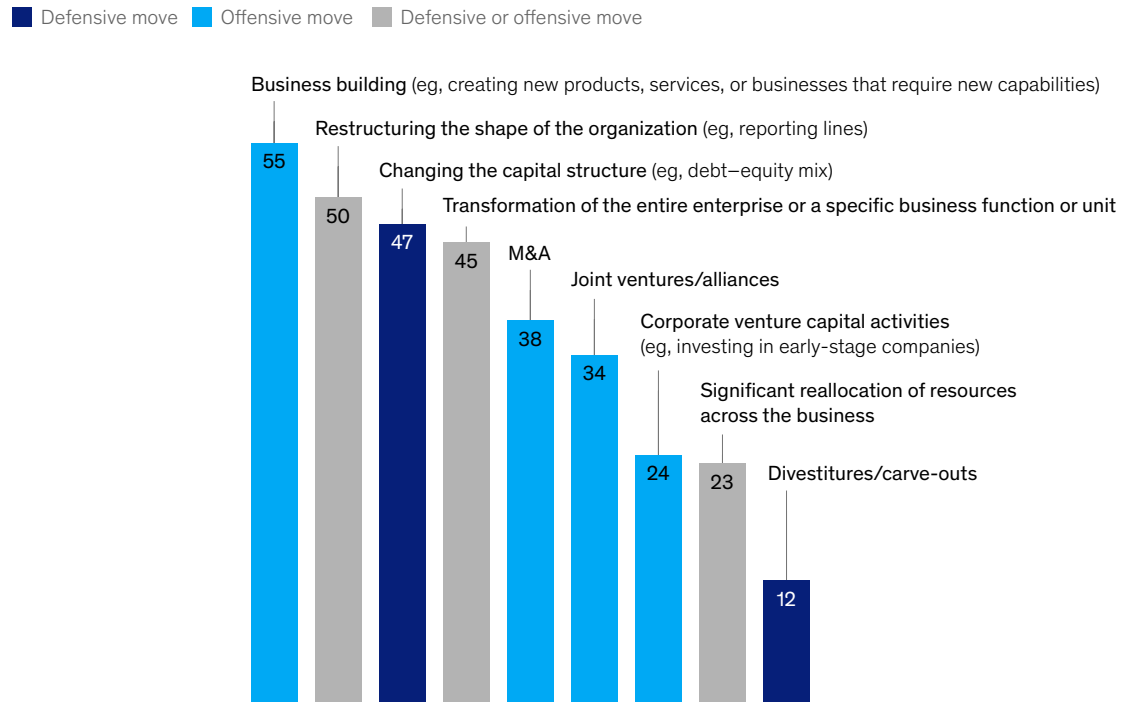
their organizations plan to engage in M&A within the next 12 months.

Amid competing priorities and major initiatives to strengthen their organizations, CFOs point to two key areas that can help their organizations build resilience (Exhibit 3), which we define as overcoming adversity and shocks while adapting and positioning the company to accelerate future growth. They see capability building across the organization and advanced technologies such as automation and real-time reporting as the most valuable areas to address, as opposed to more reactive, short-term measures such as contingency planning.

Exhibit 2

CFOs expect their organizations to make both offensive and defensive moves in the year ahead as part of efforts to build resilience.

Strategic actions that CFOs expect their organization to make within the next 12 months,
% of respondents (n = 136)

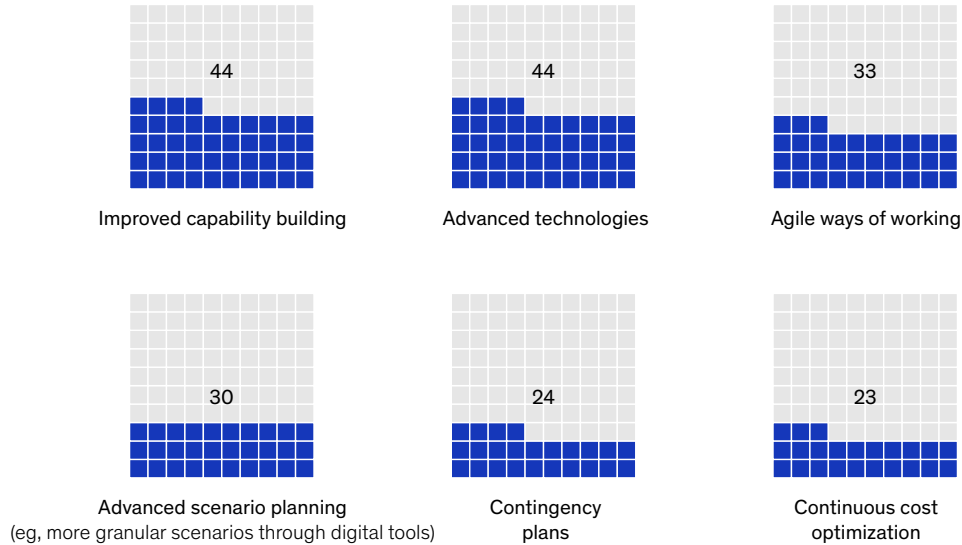


Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

Exhibit 3

CFOs see capability building and advanced technologies as the most effective ways to build their organizations' resilience.

Most valuable step to improve organization's resilience,¹ % of CFO respondents (n = 136)



¹Out of 11 areas that were presented as answer choices. Respondents were able to select up to 3 answer choices. Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

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McKinsey commentary

Christian Grube, Partner

The number and complexity of the challenges that CFOs face have certainly increased over recent years. Pandemic-related risk management rapidly evolved into a cash constrained world where cost of capital is skyrocketing. Yet, we see an increasing risk appetite, with many CFOs actively steering their boards toward bold M&A and business-building endeavors. This through-cycle mentality could unlock outperformance over the next cycle, yet it requires discipline not to overinvest while closely managing the core business's performance.

What's more, CFOs who say their finance function has succeeded at strengthening their organizations' resilience² in the past year are 6.5 times more likely than other CFOs to say they spent most of their time on talent management, and 4.3 times more likely to report spending most of their time supporting digital capabilities and advanced analytics in that time frame.

Retooling the finance function as a strategic priority

Not only do CFO respondents view organization-wide capability building as a top tool for enhancing resilience, but about half say they are involved in capability-building programs, both across the

² That is, the CFOs who describe their finance function's performance in strengthening the organization's resilience over the past 12 months as "good" or "excellent."

organization and within their function. Responses suggest that capability building will be of utmost importance moving forward because finance functions are not equipped with all of the skills that executives believe will be needed. Few survey respondents point to foundational skills, such as understanding financial principles, as those most necessary for the future, suggesting that those skills alone aren't enough. Overall, the skills that respondents—including CFOs and other executives and managers within and outside of the finance function—see as most critical for the future are the skills that they most often say are missing in the function today (Exhibit 4). They most often cite change management skills, such as adaptability and

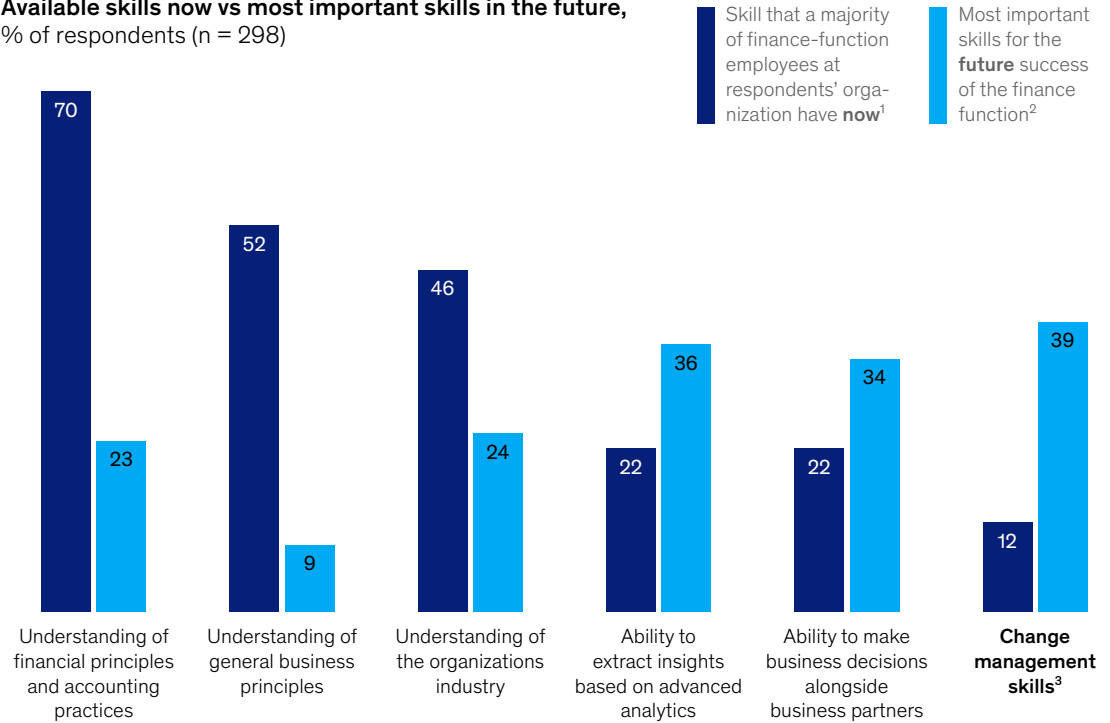
project management, as the ones most critical for the function in the future. Yet, just 12 percent of respondents report that most of their organization's finance employees have that skill set.

However, the survey finds meaningful differences in the skill sets that company CFOs find most important and those prioritized by other executives—that is, the internal customers of the finance function (Exhibit 5). Other executives, for example, are 1.4 times more likely than company CFOs to see change management as critical, suggesting that the importance of finance employees implementing changes during cross-functional projects—as opposed to focusing solely on

Exhibit 4

Change management is the least developed skill in most finance organizations, but respondents say it is a critical addition for the future.

Available skills now vs most important skills in the future, % of respondents (n = 298)



¹Out of 10 areas that were presented as answer choices.

²Out of 10 areas that were presented as answer choices. Respondents were able to select up to 3 answer choices.

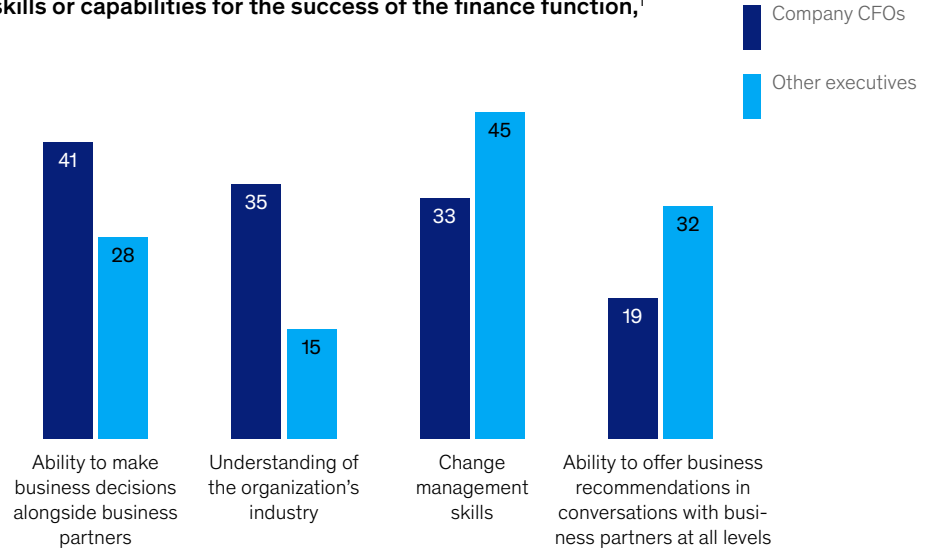
³For example, adaptability, collaboration, project management.

Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

Exhibit 5

Internal customers and CFOs have different expectations regarding the necessary skill sets within the finance function.

Most important skills or capabilities for the success of the finance function,¹
% of respondents



¹Out of 10 areas that were presented as answer choices. Respondents were able to select up to 3 answer choices. For company CFOs, n = 136. For other executives, n = 110.
Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

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analytics—is a high priority for them. Also, CFOs are 1.5 times more likely than other surveyed executives to want finance talent to be able to make decisions alongside business partners, while other executives appear to be satisfied to have finance talent offer financial recommendations to business partners.

Notably, respondents who say they work for organizations that outperform competitors³—who are 1.5 times more likely than others to be satisfied by their organizations' ability to attract, and 1.2 times more likely by their ability to develop, finance talent—think differently about how to develop the capabilities they will need within the finance function. While these respondents from top-performing organizations and respondents from

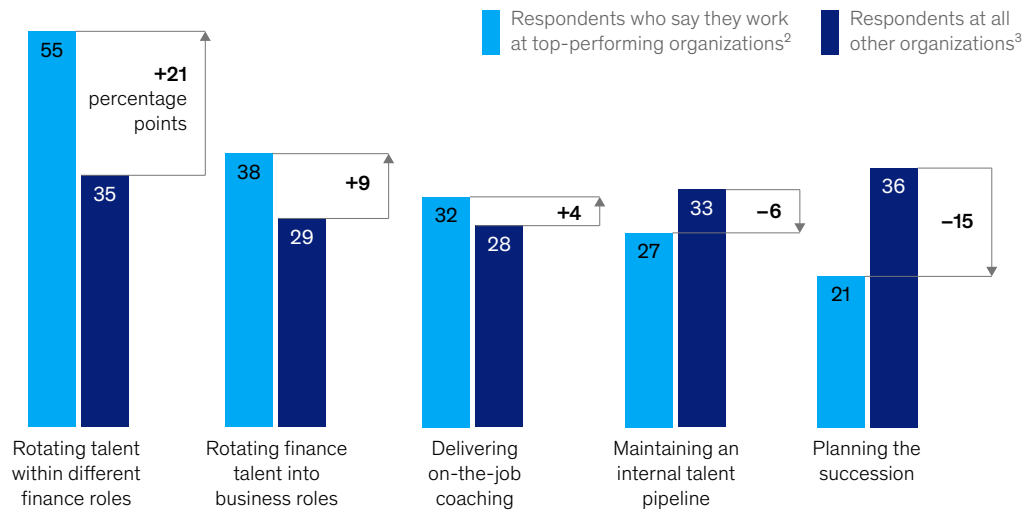
other organizations largely agree on the variety of skills that will be needed, respondents from top-performing companies point to talent development as the best way to strengthen the finance function's capabilities, while others focus on succession planning (Exhibit 6). More specifically, those from top-performing companies see efforts to rotate talent as effective approaches. In our experience, three types of talent rotations are particularly valuable for developing skills within the finance organization: moving finance talent across geographies or divisions; moving employees, such as those working on financial planning and analysis, into specialized roles that focus on areas such as project management or analytics; and allowing finance employees to rotate into business roles and then return to the finance function.

³We define a top-performing organization as one that, according to respondents, has achieved financial performance that is above or far above industry peers' performance over the past 12 months.

Exhibit 6

Executives who say they work for top-performing organizations point to talent rotation as the most effective approach for developing capabilities.

Most effective talent management activities for developing capabilities within the finance function,¹
% of respondents



¹ Respondents' self-assessed financial performance of their organization, compared with industry peers.
² Respondents who say their company's performance over the past 12 months has been above or far above peers'; n = 140.
³ Respondents who say their company's performance over the past 12 months has been far below, below, or about the same as peers'; n = 155.
 Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

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McKinsey commentary

Jonathan Steffensky, Associate partner

Despite ongoing talk about talent shortages, it might surprise some to see that high-performing finance organizations are much less concerned about gaps than others are. Rather than focusing on planning succession for individual roles, they take to heart the old investor's wisdom, "Don't put all of your eggs in one basket," and pursue a portfolio approach to

talent management—and that is paying off, which you can see reflected in survey respondents' satisfaction rates with talent management and training efforts at these organizations. Higher-performing organizations take a long-term view, even promoting rotations outside of their own function in their endeavor to build a pool of highly versatile finance employees

who not only are comfortable with change but can engage others within the organization to participate in those changes. This is high-performing organizations' recipe for talent success: you can't train for every possible scenario, but you can teach employees different problem-solving approaches to use in various situations.

The increasingly tech-enabled finance function

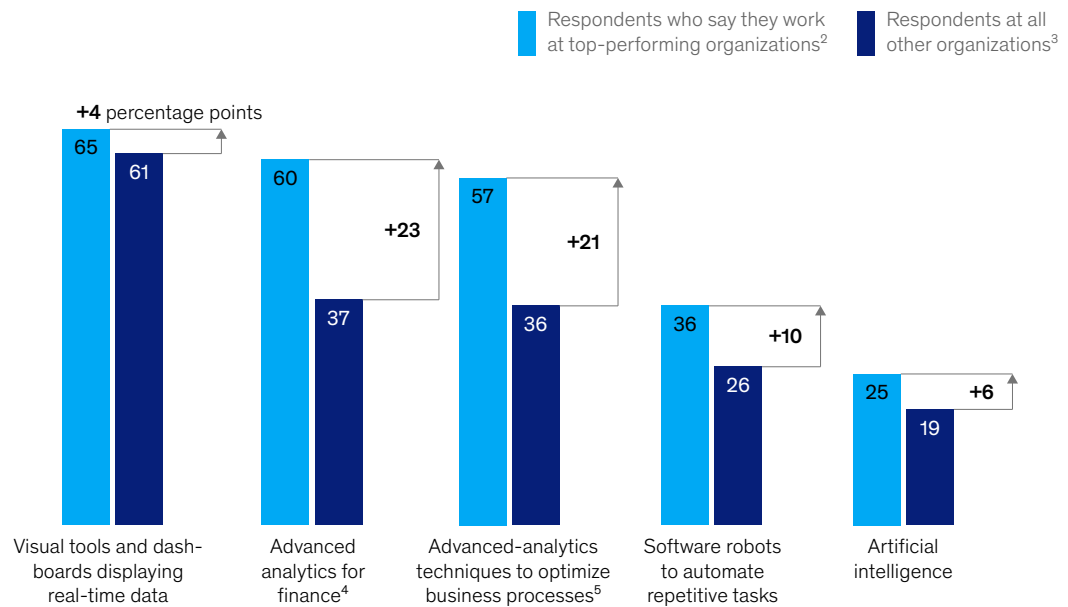
The survey findings suggest that CFOs are increasingly digitizing their finance functions and that top-performing organizations have taken more steps than others to embed technology into their daily finance operations. The share of respondents reporting that more than half of their finance function activities were digitized or automated in the past year doubled since the 2021 survey, which found that increasing technology adoption in finance could

have lasting effects on a company's resilience. This year, two-thirds of respondents say that more than a quarter of finance-related processes have been digitized or automated. Looking at specific technologies, a majority report use of visual tools and dashboards to display real-time data, such as for key measures of business performance, and nearly half report using advanced analytics for finance and business operations, while just 22 percent say their finance functions are using artificial intelligence.⁴

Exhibit 7

The technologies used by finance functions in organizations that respondents say outperform go far beyond visual tools and dashboards.

Share of respondents reporting use of the given technologies within their organizations' finance function,¹ % of respondents



¹ Respondents who said "other," "none of the above," or "don't know" are not shown. ² Respondents who say their company's performance over the past 12 months has been above or far above peers; n = 140. ³ Respondents who say their company's performance over the past 12 months has been far below, below, or about the same as peers; n = 155. ⁴ i.e., use of statistical modeling and data analysis techniques to gain insights and make data-driven decisions in finance processes (eg, cost analysis, budgeting, working capital management, forecasting). ⁵ Eg, predictive modeling, pricing. Source: McKinsey Global Survey on the CFO's role, 298 participants, May 9–19, 2023

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⁴ The survey defined advanced analytics for finance as "the use of statistical modeling and data analysis techniques to gain insights and make data-driven decisions in finance processes (for example, cost analysis, budgeting, working-capital management, forecasting)" and defined advanced analytics for business operations as "the use of advanced analytics techniques to optimize business processes (for example, predictive modeling, pricing)." Artificial intelligence was defined as "the use of computer algorithms to simulate human intelligence and decision-making capabilities (for example, document recognition for expense management)."

Respondents from top-performing organizations report higher levels of digitalization and broader adoption of technologies within their finance functions than other respondents do (Exhibit 7). Thirty-nine percent of respondents at these organizations say that more than 50 percent of processes in their finance function have been digitized or automated, compared with 23 percent of other respondents. Furthermore, these functions are using more data-driven technologies to enable their work. For example, respondents from

top-performing organizations are 1.6 times more likely than others to say their finance functions are using advanced analytics for both finance tasks, like cost analysis and budgeting, and business operations tasks, such as predictive modeling and pricing.

Looking ahead

Amid ongoing economic volatility and, for many industries, strategic challenges with long-term effects such as structurally higher capital costs and geopolitical tensions, it's no wonder that CFOs are spending much of their time managing financial risks. Moving forward, high-performing CFOs are taking a long-term view on their priorities. To best prepare their organizations for the coming years and the next period of volatility, they are focusing on “three Ts.” First, they are taking an active lead in *transforming* their organization's business or operating model, taking steps such as building new businesses and making acquisitions. Second, they are investing in *technology* across the organization, specifically within the finance function, which can help leaders receive the information they need from across the business and improve decision making. Finally, they are prioritizing *talent* development, recognizing that organizations need employees who can help to implement change. Strengthening the finance function's operating model might require significantly rethinking the skills needed within the function and, in particular, adding nontraditional skills that fall at the intersection of finance, technology, and business building.

McKinsey commentary

Ankur Agrawal, Partner

Today, digital technologies are transforming every functional area within an organization: for example, financial and nonfinancial data reporting and visualization capabilities are becoming standard in finance. To differentiate their finance organizations, CFOs should take the next step and embed advanced analytics to make use of their organizations' data—the vast majority of which typically goes unused. The insights generated can be critical in helping to debias leaders' decision making and may unlock new value pools by challenging established beliefs. We expect to see generative AI, in addition to more traditional advanced-analytics and machine learning algorithms, play an important role in getting the most value out of companies' data.

The survey content and analysis were developed by **Ankur Agrawal** (Ankur_Agrawal@McKinsey.com), a partner in McKinsey's New York office; **Christian Grube** (Christian_Grube@McKinsey.com), a partner in the Munich office; and **Jonathan Steffensky** (Jonathan_Steffensky@McKinsey.com), an associate partner in the Frankfurt office.

They wish to thank Eric Matson, Vanessa Palmer, Felix von Oertzen, and Johanna Zittmayr for their contributions to this work.

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Do big companies cut dividends to grow?

Large, stable corporations almost never cut dividends as a strategic choice. Instead, they reduce dividends only when they have low earnings or when challenging economic conditions force their hand.

by Pedro Catarino, Marc Goedhart, Tim Koller, and Rosen Kotsev



CFOs frequently ask whether they should cut dividends to invest in growth. In theory, companies should consider reducing dividends when the funds that would have been used to pay for them are instead invested in initiatives that would generate returns above the company's cost of capital. In practice, however, almost no well-performing corporations—particularly in stable economic conditions—reduce their dividends to fund growth.

What the research shows

Companies usually keep their dividend per share (DPS) levels constant or on an upward trend. Because DPS reductions often come against the backdrop of macroeconomic pressures, disappointing earnings, or even financial distress, they're associated with a decline in stock price. But how often do CFOs announce that they're cutting dividends when all is going well?

Almost never, it turns out. We explored, over the decades-long time span of 1995 to 2021, how frequently large companies publicly listed in the United States announced a significant dividend cut—which we define as a DPS reduction of at

least 10 percent. We also examined how many of these significant dividend cuts were made in response to material underperformance. We excluded companies that don't pay a dividend, have variable dividends (such as real estate investment trusts), or underwent a major restructuring (for example, a spin-off).

That left us with 1,225 companies with a multiyear, stable dividend policy. Among them, 71 percent maintained or increased their DPS level without making a significant dividend cut. The remaining 29 percent that announced a significant dividend cut did so when faced with either an economic crisis or a decline in profit of at least 20 percent—or both. Virtually no company over the multidecade period made a significant dividend cut out of choice rather than need, let alone to fund a bold investment for future growth (Exhibit 1).

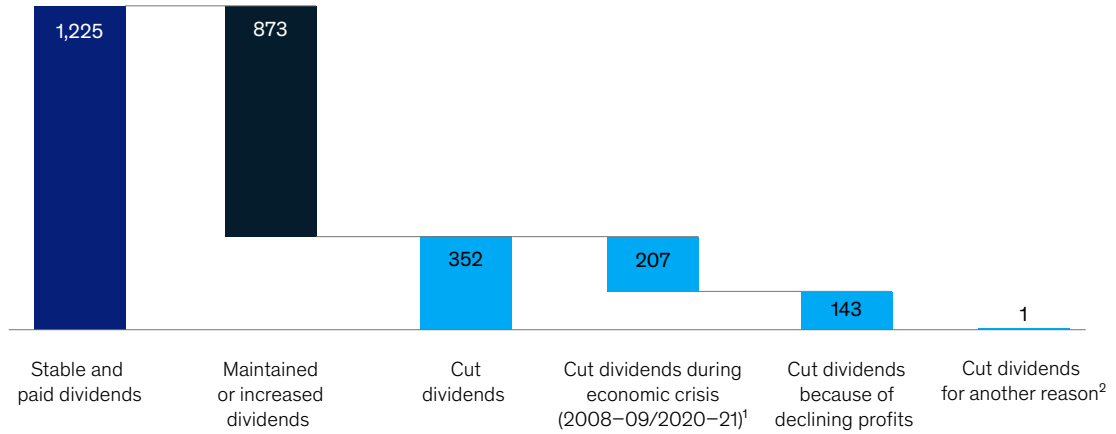
In fact, on an annual basis, *any* dividend cut by large public companies is unusual; in a typical year, fewer than 2 percent of the 1,225 companies that we studied reduced dividends at all. The numbers increased only when there was a major economic crisis: more than 5 percent of companies reduced

Virtually no large, stable company made a significant dividend cut out of choice rather than need, let alone to make a bold investment for a future growth initiative.

Exhibit 1

It's very rare for a large, stable company to announce a dividend cut of 10 percent or more.

Large dividend-paying US public companies, 1994–2021, number



Note: Dividend per share, adjusted for split-offs and spin-offs. Sample excludes public companies that had a significant corporate event (such as being delisted, privatized, acquired, or entered bankruptcy) up to 3 years prior to the dividend cut.
¹Dividend cuts linked to the credit crisis (2008–09) or the COVID-19 pandemic (2020–21).
²Dividend cuts not linked to any profit reduction or economic crisis.
Source: S&P Capital IQ; Corporate Performance Analytics by McKinsey

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dividends during the 2008–09 credit crisis, and more than 15 percent reduced dividends during the COVID-19 pandemic. But in most years between 1995 and 2021, one could count on two hands—and in many years, on a single hand—the number of companies that reduced dividends at all in any given year (Exhibit 2).

It's important to note that the scarcity of historical examples does not prove that cutting DPS will necessarily lower the stock price. But it bolsters what many CFOs have told us: they hesitate to reduce dividends because they're concerned about how "the Street" will react.

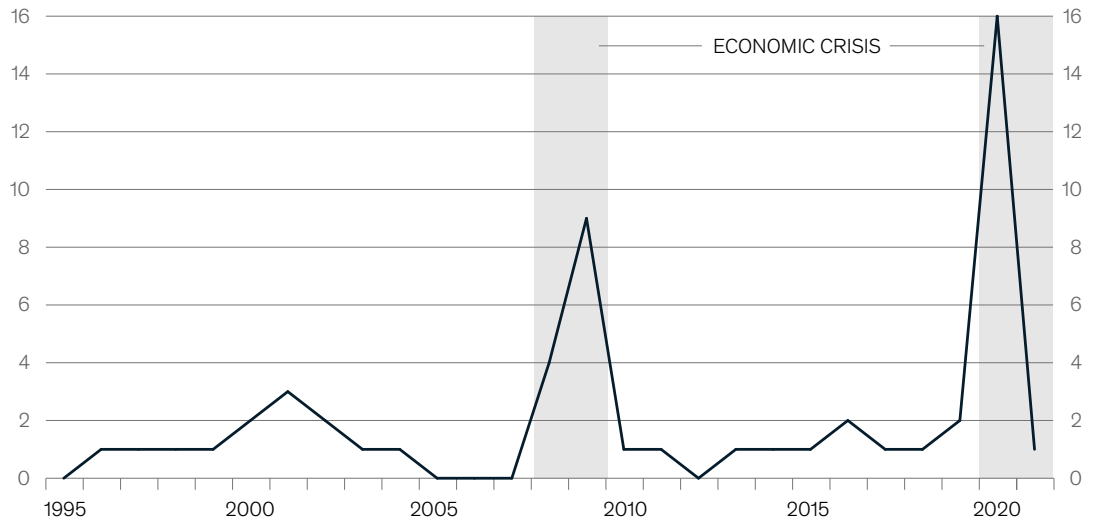
Implications and takeaways

CFOs are right to keep attuned to practical realities, including perceptions by investors that a company that cuts its dividends—for whatever stated reason—may actually be signaling weaker earnings and lower cash flows ahead. Those perceptions could drive down the share price, which can become value destroying in itself. For example, a lower share price can make it harder in the short term to attract and retain talented employees; it can also reduce valuable acquisition currency for M&A, since many deals are paid at least in part in company stock. CFOs should consider whether the company is prepared for potential investor blowback, and how executives could ease investor concerns by clearly

Exhibit 2

The market rarely sees dividend cuts in any single year—except during economic crises.

Stable dividend-paying companies that reduced or eliminated dividend per share, per year, %



Note: Dividend per share, adjusted for split-offs and spin-offs. Sample excludes public companies that had a significant corporate event (such as being delisted, privatized, acquired, or entered bankruptcy) up to 3 years prior to the dividend cut.
Source: S&P Capital IQ; Corporate Performance Analytics by McKinsey

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spelling out the rationale for any dividend cut. They should also run detailed scenarios to determine whether the dividend cut would make a material difference in delivering the expected growth.

Ultimately, changes to a company's dividend policy should always be part of a CFO's tool kit—even if

that means reducing DPS. But CFOs should understand that there isn't much precedent: virtually no stable, large companies choose to cut dividends when earnings and economic conditions are strong.

Pedro Catarino (Pedro_Catarino@McKinsey.com) is a capabilities and insights analyst in McKinsey's Lisbon office, **Marc Goedhart** (Marc_Goedhart@McKinsey.com) is a senior knowledge expert in the Amsterdam office, **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Denver office, and **Rosen Kotsev** (Rosen_Kotsev@McKinsey.com) is a director of client capabilities in the Waltham, Massachusetts, office.

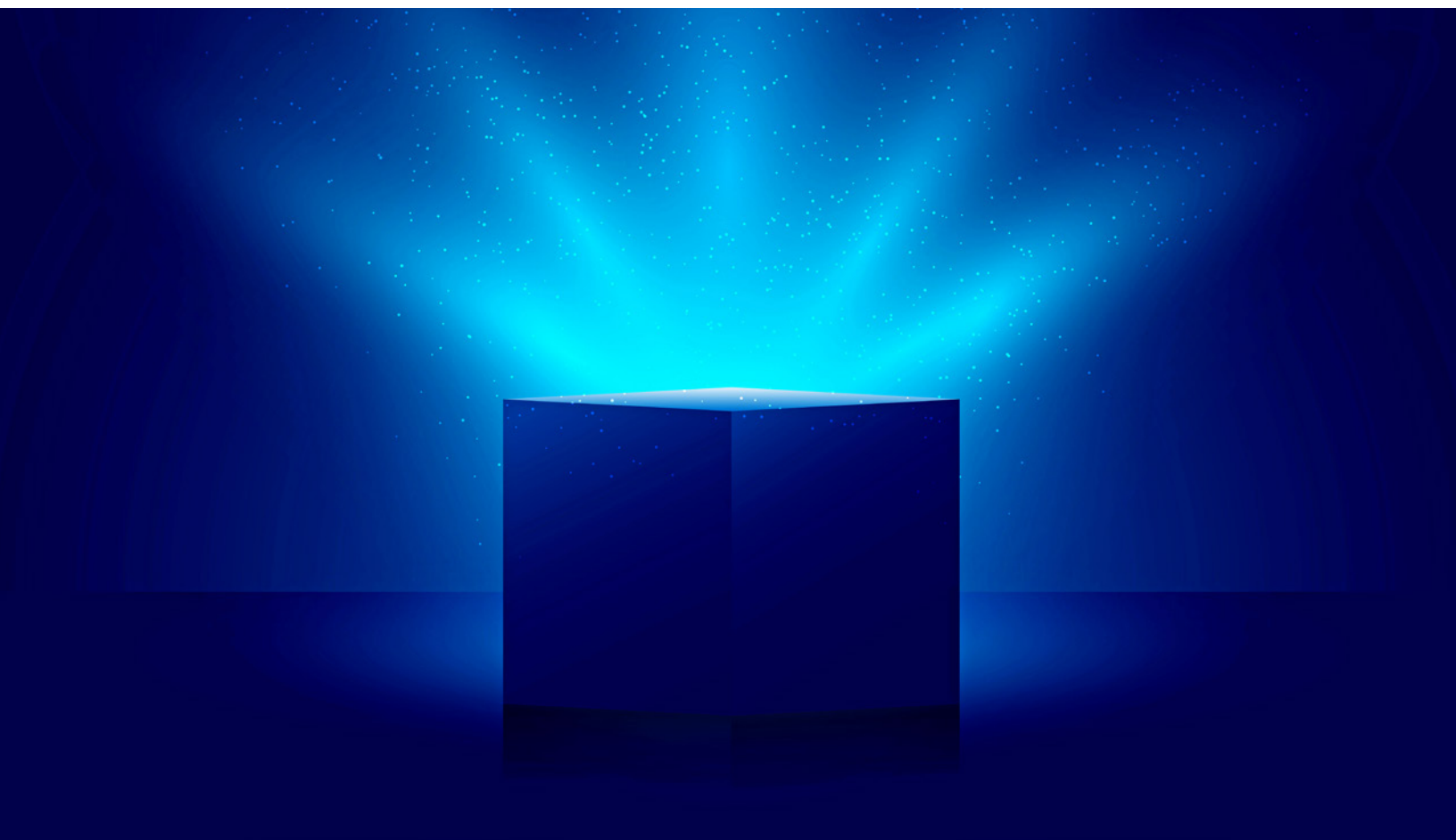
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Investors want to hear from companies about the value of sustainability

Investors want companies to sharpen their equity story and clarify the value of their sustainability initiatives. Here's what company leaders can do.

by Jay Gelb, Rob McCarthy, Werner Rehm, and Andrey Voronin



While more than 95 percent of S&P 500 companies issue a sustainability report,¹ very few fully integrate environmental, social, and governance (ESG) into their equity stories. The lack of a clear link between sustainability and strategy can make it difficult for investors to understand how a company's efforts affect financial performance and, crucially, intrinsic value.

Our recent survey of chief investment officers suggests that while major investors believe that ESG is important, they need greater clarity about the ESG value proposition (see sidebar, "How intrinsic investors look at ESG initiatives"). Sustainability aspirations or metrics on a page, without context, are not sufficient to link initiatives to cash flow. That lack of clarity presents an opportunity for companies to make the ESG-to-value case more clearly.

The investors' view

Long-term-minded investors—whom we call "intrinsic investors"—have an outsize effect on stock performance over time. These investors recognize that ESG will affect value,² but they always want to dig deeper. They seek out granular information about how specific ESG initiatives can be a source of growth and which risks are most material to a specific company and its broader industry—and the extent to which distinct ESG actions can mitigate those risks.

The quest for clarity

About 85 percent of the chief investment officers we surveyed state that ESG is an important factor in their investment decisions. Sixty percent of respondents review their overall portfolio for ESG considerations, and about 80 percent assess individual company positions in the context of how ESG affects forecasted cash flows. Strikingly, a significant majority are prepared to pay a premium for companies that show a clear link between their ESG efforts and financial performance (exhibit).

Surveyed investors are also eager for clearer ESG standards. They understand that ESG scores today, unlike financial ratings, don't correlate fully among ESG score providers. While financial ratings correlate at around 99 percent among providers, ESG ratings can correlate at less than 60 percent because of the different elements and weighting each agency assigns to various ESG metrics.

The importance of sectoral differences

An important part of achieving greater ESG clarity, investors reveal, is understanding industry differences. For example, our survey shows that with respect to ESG in the energy sector, investors prioritize capital productivity and cost optimization. We observed similar trends for the industrials, materials, and consumer sectors. While investors rate the elements of E, S, and G roughly equally in importance when summing across *all* industries, that isn't the case within each individual industry.

A significant majority of chief investment officers are prepared to pay a premium for companies that show a clear link between their ESG efforts and financial performance.

¹ *2022 Sustainability reporting in focus*, G&A Institute, updated February 5, 2023.

² "The triple play: Growth, profit, and sustainability," McKinsey, August 9, 2023.

Exhibit

Most surveyed investors not only consider environmental, social, and governance initiatives to be important—they're also willing to pay a premium.

Share of respondents, %

Importance of ESG¹ initiatives in investment decision making

They matter regardless of their effect on cash flows and risk

53

100

They only matter if they affect cash flows and risk over the short and long term

32

They only matter if they affect cash flows and risk over the long term

11

They do not matter in investment decision making

5

Expected size of ESG premium, cash flows and risk being equal

More than 10%

22

5–10%

33

Less than 5%

28

No premium

17

100

Note: Figures may not sum to 100%, because of rounding.

¹Environmental, social, and governance.

Source: McKinsey Investor survey (Q3 2022); n = 19 (left side), n = 18 (right side)

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Investors find that excellence in different pillars is required based on a company's sector. For companies in the industrials and energy sectors, for example, surveyed investors seek out ESG initiatives in the environmental dimension. For companies in the technology, pharmaceuticals, and travel, logistics, and infrastructure sectors, investors consider social initiatives to be the most important. And for those in the financial and insurance industries, investors rank governance concerns the highest.

Notably, for some industries, the absence of a clearly defined ESG strategy leads surveyed investors to consider decreasing their exposure to or to divest from some industries entirely. That holds particularly true for investments in the energy, materials, and travel, infrastructure, and logistics sectors. But in most cases, ESG is part of a broader set of the detailed investment factors they consider.

The compelling opportunity for a more value-focused ESG story

Investor demand for greater detail and nuance suggests a compelling opportunity for companies to provide a clearer ESG-to-value case. In other words, what is the relevance of ESG for the business? How do ESG initiatives tie to value creation? What are the key levers and value drivers? Consider, for instance, how CEOs and CFOs provide context for quarterly and annual earnings, especially in their accompanying presentations: publicly filed reports are the start, but not the sum, of investor communications. Similarly, managers should not rely on formulaic ESG reporting to provide a comprehensive picture. Just as reports filed under generally accepted accounting principles are not full descriptions of strategy, carbon disclosures and other presentations of ESG metrics do not provide, without more context about the company's unique business model, sufficient descriptions of strategic impact.

How intrinsic investors look at ESG initiatives

If the classic *Monty Python* sketch about wanting to buy an argument were placed in the present day, it might be about the performance of environmental, social, and governance (ESG) funds: Do these funds outperform the market, or don't they? Finance professionals, including academics, sharply disagree.

But what about decisions by traditional, nonpassive equity funds, which don't operate under a specific ESG remit, when it comes to investing in an individual company? How do these sophisticated investors assess the impact that ESG can have on financial performance and company value?

In our survey, most respondents do not rank ESG at the top of their list of factors that drive long-term value creation. ESG is not named as the most important factor, or even the second most important, for

companies in any industry. It ranks as the third-most-important investment consideration in only two industries—energy and materials, which clearly face ever more pressing challenges to manage the net-zero transition. Yet even while the participants typically cite other levers (such as cost optimization and capital productivity) as being significantly more important than ESG in their investment decisions, some investors report that they are considering reducing their exposure to entire sectors because of ESG concerns (Exhibit 1). This is particularly evident in more resource-intensive sectors, such as energy, materials, and logistics.

The group also takes a business-model perspective on the impact of ESG: they assign greater or lesser importance to E, S, or G and elements that fall under each dimension depending upon a company's specific sector (Exhibit 2). The chief

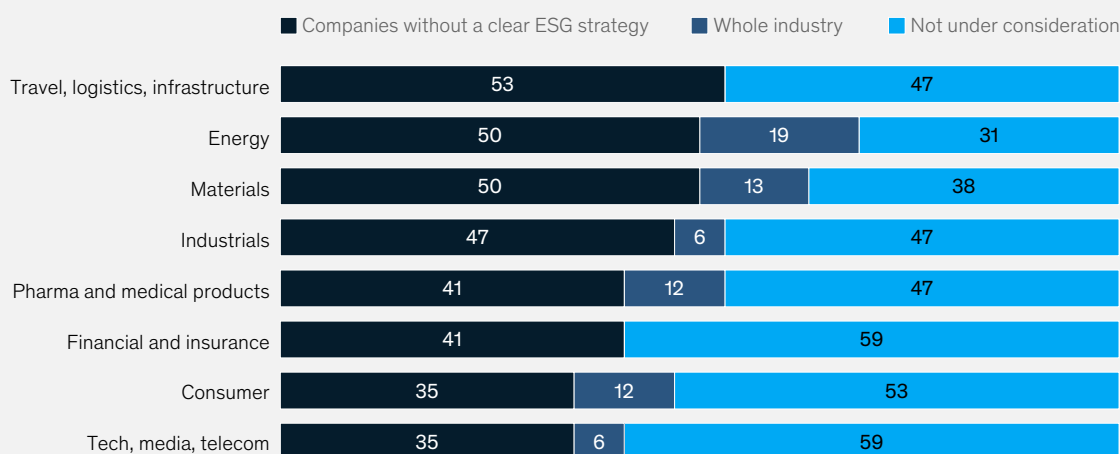
investment officers we surveyed report, for example, that for capital-heavy industries, environmental issues are the most crucial dimension; in the pharmaceutical and medical industries, social issues matter most; and for financial and insurance companies, governance is the most important.

When asked to rank different elements among E, S, and G categories, chief investment officers identify climate change and greenhouse gas emissions as most important, followed fairly closely by governance structure, material use and waste, and labor practices. But the importance of those individual elements, again, vary depending on industry and company context. It's crucial for chief investment officers to understand the company's unique equity story, and for the company to make clear how its ESG initiatives tie into and enable its strategy.

Exhibit 1

Many surveyed investors are considering reducing their exposure to companies in certain industries due to environmental, social, and governance concerns.

Considering decreasing exposure due to ESG¹ concerns, by industry, % of respondents



Note: Figures may not sum to 100%, because of rounding.
¹Environmental, social, and governance.
 Source: McKinsey Investor survey (Q3 2022); n = 18

How intrinsic investors look at ESG initiatives (continued)

The result is less of an argument and more of a conversation: whether and to what extent elements of ESG matter to a company—and an investor’s decision to

allocate capital to that company—depends on the circumstances and strategy of the company itself. Just as they do in other aspects of investment decisions, intrinsic

investors will wade into the details, and identify the granular drivers that are most important to the company to create and sustain value for the long term.

Exhibit 2

Investors rank the environmental, social, and governance categories about equally for financial impact, but differentiate widely by elements and industry.

Top 3 elements of the ESG¹ framework by financial impact, by industry, % of respondents

	Energy	Consumer	Financial and insurance	Industrials	Materials	Pharma and medical products	Tech, media, telecom	Travel, logistics, infrastructure	Average
Environmental									
Climate change and GHG ³ emissions	83	64	17	50	67	22	17	38	45
Material use and waste	67	45	0	60	44	33	33	25	39
Water usage/reduction	42	18	8	40	11	0	25	13	20
Social									
Organizational culture, diversity, and inclusion	17	27	67	20	33	22	42	50	35
Community impact	8	27	42	0	0	44	33	50	26
Labor practices	17	45	17	40	44	56	42	38	37
Governance									
Business ethics	17	18	50	30	22	44	33	38	32
External position and advocacy	25	18	50	20	33	33	17	13	26
Governance structure	25	36	50	40	44	33	58	38	41

¹Environmental, social, and governance.

²Factors ranked in top third, middle third, or bottom third for each industry.

³Greenhouse gas.

Source: McKinsey Investor survey (Q3 2022); n = 18

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Know your audience

“Know your audience”—a key tenet of communications in any context—is critical for corporate communications on ESG. Too often, the media tend to refer to “investors” as a homogenous group with similar interests and needs. Seasoned CFOs, however, know that different shareholders have different strategies, and that no widely held

company can satisfy every investor. A clear segmenting exercise can help senior leaders understand who their target audience is and what to emphasize in their investor communications.

In prior articles, we’ve suggested a practicable way to segment investors: intrinsic investors, traders, indexers, closet indexers, and retail investors.³ Our

³ Robert N. Palter, Werner Rehm, and Jonathan Shih, “Communicating with the right investors,” *McKinsey Quarterly*, April 1, 2008; Robert N. Palter and Werner Rehm, “Opening up to investors,” McKinsey, January 1, 2009.

research suggests that intrinsic investors drive long-term share prices and should be the primary audience in mind for crafting strategic communications that lay out the long-term value creation of the company (as opposed to next quarter's performance).⁴

ESG can be a compelling part of this intrinsic value story. From a top-down perspective, we now see some investors use rankings or other rules to screen out companies. For example, some investors simply avoid oil and gas companies. They seem to be in the minority, however, and there is usually little a company can do when individual investors apply an industry-wide embargo.

Intrinsic investors who do not dismiss industries out of hand because of ESG considerations can be grouped into two basic segments:

— *Long-term investors who consider ESG an important consideration* and use it to add a layer of additional analysis and judgment for their decisions. For example, rather than screening out oil and gas companies, these investors might differentiate among such companies based on their rates of reduction in carbon emissions and invest only in those they deem most able to reduce emissions.

— *Investors who focus strictly on the economic impact of ESG initiatives*, particularly on cash flows and value creation. For example, these investors might avoid oil and gas companies with a higher chance of having stranded assets, or real estate companies with a greater risk of having their properties flooded based on the assets' geography. These investors might also consider whether the company is well positioned to create value from new opportunities created by the energy transition (for example, capabilities in hydrogen or in carbon capture, utilization, and storage). Our survey suggests that many investors seem to fall into this second category.

For purposes of crafting an ESG equity story and investment case, the two categories are sufficiently similar that a clear story about how ESG links directly to sustained financial performance and long-term value creation should satisfy both intrinsic investor segments. As a company conveys its ESG initiatives into its equity story, it should bear in mind that its target investor audience is sophisticated, long-term oriented, and relentlessly focused on sustainable competitive advantage.

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⁴ Rebecca Darr and Tim Koller, "How to build an alliance against corporate short-termism," McKinsey, January 30, 2017.

Getting to the ‘how’ of sustainability communications

How then should companies incorporate ESG into their equity stories and strategic communications? Part of the “how” is relatively easy: CEOs and CFOs should communicate that they recognize what is happening in the market and spell out what the company is doing about it.

Of course, if ESG communications were that easy, one would expect that more companies would do it well. They don’t. Part of the challenge is that market and societal forces develop rapidly; there are many unknowns, and companies can fall back on vagueness and platitudes to try to cover multiple potential outcomes. But clear strategy is marked by decisive choices. Effective equity stories acknowledge competitive and macroeconomic changes; they address how the company’s strategy will enable it to benefit from the changes, and they address the risks. Experienced senior leaders will explain why the strategy works, and only then will they proceed to targets and risks.

In our experience, a compelling ESG equity story addresses the following issues.

What is changing in the market? This description could be as simple as laying out management’s view on how quickly an already shifting market will move (for example, the share of electric-vehicle sales in five, ten, and 20 years) and the impact those shifts are having. In many energy-intensive businesses, the impact and range of responses can be highly uncertain (for example, the role of hydrogen or carbon capture). Again, a detailed management perspective and explanation are essential: Will the company bet now on a specific scenario (such as a full transition to hydrogen and electricity for refinery energy), or will it seek to keep more options open (perhaps by making some smaller bets, or by testing the waters with joint ventures)? There will also be businesses where the impacts of ESG initiatives are more bounded. For example, while future frying pans might be made out of zero-carbon steel, it’s unlikely that the total number of frying pans sold worldwide will exceed historical demand levels relative to market size. Here,

executives will need to explain why they believe an investment now into low-carbon metal is needed (for example, through customer surveys).

What is the company’s strategy? For some businesses, linking ESG strategy to value creation is straightforward at a high level. Many car manufacturers, for example, have announced whether and how quickly they intend to shift to full electric-vehicle portfolios, regardless of whether they will support charging networks or other components of an ecosystem. For businesses that face greater uncertainty (for example, carbon-intensive businesses such as building materials, where companies experiment with solutions but there is not yet clear movement in the overall market with announced strategies to change products), executives should lay out their views on the levers they intend to address. These companies could explain, for example, how much R&D effort is being put into new materials like recycled plastics for construction and less-carbon-intensive concrete, as opposed to decarbonizing existing processes. For businesses with greater exposure across their supply chains, initiatives could be more preliminary (“finding the right suppliers”), or more immediately pressing (“working now with our suppliers to invest in joint ventures to do the following”). All companies in high-emissions industries, however, should be able to articulate the new opportunities that they intend to pursue to create value from the energy transition.

How does this strategy create value? Executives should be able to identify the direct link between a company’s ESG strategy and its value creation strategy. To be credible, that connection should not be a checklist recitation of initiatives with a high-minded vision. Rather, companies should be able to walk investors through, in a reasonably granular way, why they chose the ESG initiatives they did, and how they will create value in terms that investors traditionally understand. That is: How will this ESG strategy enhance (or sustain) cash flows, return on capital, and margins; mitigate risks; affect top-line growth; and attract and retain the talent needed to produce these results? Examples of clear communication include a food company that laid

out differences in customer demand for sustainably sourced products by region. In another case, an electric utility anchored its strategy on decarbonization and pivoted to renewable energy, showing investors that doing so reduces customer costs and operating expenses in wind- and solar-power generation.

What's the evidence that the strategy works?

Investors want proof points that the ESG strategy is generating desired results. CEOs and CFOs should be able to provide clear facts that their company can “win” in an ESG element. Those details are quantitative as well as qualitative: What specific competitive advantages does the company hold, and how are we managing them for success? Why should investors allocate capital to this multibusiness company instead of to pure plays? Companies can demonstrate links to value creation in various ways. For example, a global consumer-packaged-goods company ties its ESG strategy to financial metrics including earnings growth and cash generation growth from new products. The food company mentioned above, for its part, highlights the rapid sales growth of plant-based food products, as well as sales of affordable, accessible products in emerging markets, as it describes present and future cash flows.

What are the risks—and opportunities? Intrinsic investors are well experienced in approaching valuation based on probability-weighted scenarios, both on the upside in terms of opportunities and on the downside, including risk. An effective equity story improves investor understanding of how the company is using ESG to raise the odds for outperformance and address risk. One technology company, for example, takes a holistic approach to mitigating and managing climate-related risks on its business strategy, including in operations, working with suppliers, and by offering sustainable products. Another company conducts and shares a materiality assessment, based on a 2x2 matrix of the expected impact of opportunities and risks across external and internal stakeholders, to sharpen its insight and make its ESG strategy more transparent.

Investors recognize that ESG can be an important factor in choosing whether to invest in specific companies. It may be time for executives to step up and fully integrate ESG into their equity story, making sure to connect ESG to value creation, and differentiate themselves from their peers based on ESG value impact.

Jay Gelb (Jay_Gelb@McKinsey.com) is a partner in McKinsey's New York office, **Rob McCarthy** (Rob_McCarthy@McKinsey.com) is a senior knowledge expert in the Boston office, **Werner Rehm** (Werner_Rehm@McKinsey.com) is a partner in the New Jersey office, and **Andrey Voronin** (Andrey_Voronin@McKinsey.com) is a consultant in the Almaty office.

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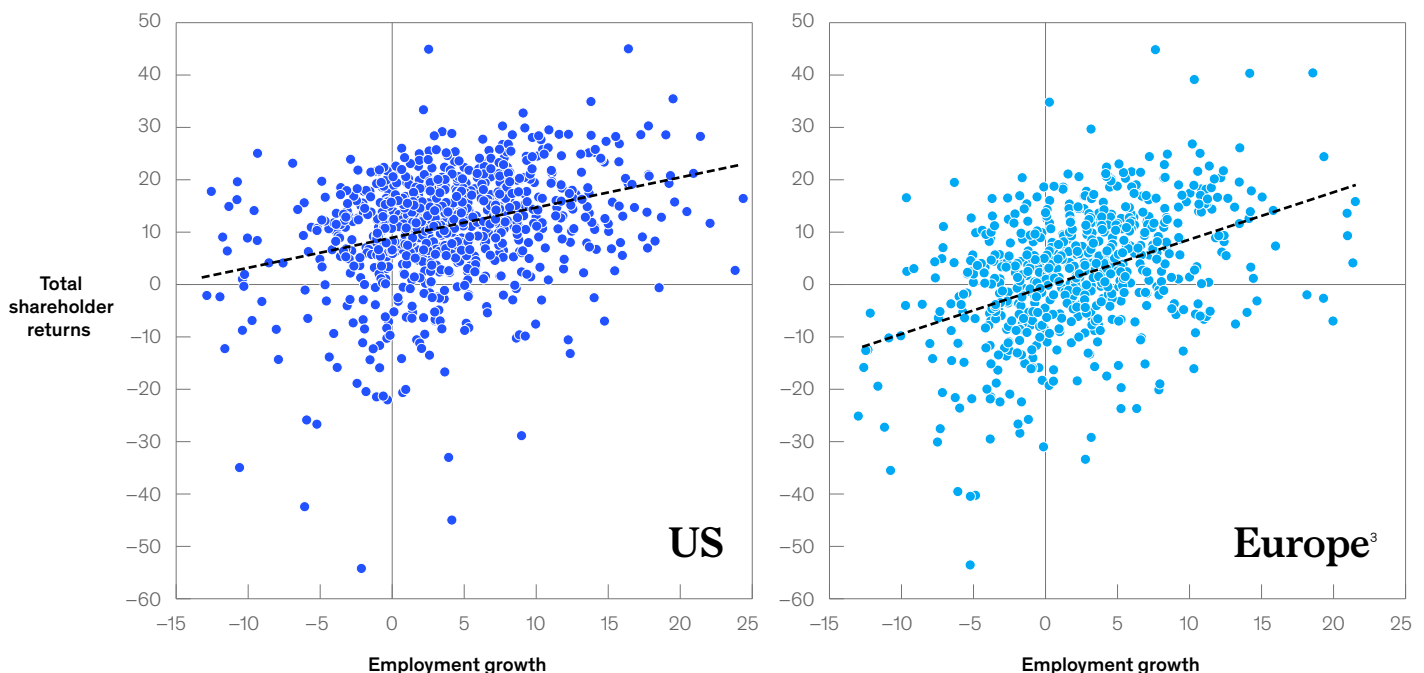
Looking back

More shareholder value leads to more jobs.

Exhibit

Companies that create more shareholder value create more jobs in the economy.

Correlation between total shareholder returns and employment growth, 2009–19,¹ CAGR² %



¹This chart is an updated version of the original, which appears in Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, 2020, p. 13.

²Sample includes companies with real revenues greater than \$500 million and excludes top 2% and bottom 2% outliers in employment growth.

³Includes companies from EU-27, Switzerland, and UK.

Source: Corporate Performance Analytics by McKinsey

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Reading the press, it's easy to conclude that companies focused on maximizing shareholder returns aren't doing much for employment, and if anything, new business models and innovations such as generative AI and other automation technologies tend to systematically kill jobs.

The data, however, tell a different story. When we compared shareholder value creation and employment growth—as measured by public companies' full-time equivalent (FTE) figures—between 2009 and 2019, we saw a clear correlation (exhibit). Strong market performance goes hand in hand with economic and social prosperity.

Why? High-performing companies need to grow their workforces, which leads to more attractive wages to recruit and retain employees and, in turn, higher consumer spending. To stay competitive and maintain high morale, those companies also invest in upgrading their employees' skills, which benefits everyone.

The slope of the correlation is not the same for all industries or time periods, of course. Metrics such as a ratio of FTEs to revenue will change over time, and companies may sometimes cut jobs to improve efficiency. However, the alternative would be disastrous to job creation, as businesses with uncompetitive cost structures would fall into a downward spiral: no innovative products, no profits; no profits, no investors; no investors, no jobs.

It is up to corporate managers to balance competitiveness and efficiency with developing a thriving workforce. Using TSR as a metric to measure both can offer an effective method for finding that balance.

Pedro Catarino (Pedro_Catarino@McKinsey.com) is a capabilities and insights analyst in McKinsey's Lisbon office, **Marc Goedhart** (Marc_Goedhart@McKinsey.com) is a senior knowledge expert in the Amsterdam office, **Tim Koller** (Tim_Koller@McKinsey.com) is a partner in the Denver office, and **Rosen Kotsev** (Rosen_Kotsev@McKinsey.com) is a director of client capabilities in the Waltham, Massachusetts, office.

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