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A note from the Editors

Welcome to the inaugural issue of *McKinsey on Finance,* a newsletter for corporate leaders written by experts and practitioners in McKinsey & Company's Corporate Finance & Strategy Practice.

Each quarter, *McKinsey on Finance* will aim to provide insights into strategies that create value and ways to translate those strategies into stock market performance. Our subject matter and scope will be broad. Some articles will cover creating value through transactions, including mergers, acquisitions, alliances, IPOs, equity carve-outs, and spin-offs. Others will address issues such as investor communications, capital structure, risk management, and approaches to managing performance. Periodically we will also provide perspectives on valuation and stock market events.

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We are confident that you will find *McKinsey on Finance* useful and thought-provoking reading.

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Mastering revenue growth in M&A

Mergers seldom live up to expectations. Research from a recent McKinsey study suggests why: companies too often neglect revenue growth to focus almost exclusively on cost synergies.

Matthias M. Bekier, Anna J. Bogardus, and Timothy Oldham

Making a merger work is an acid test for any executive team. Study after study has shown that up to 80 percent of M&A deals completed during the 1990s failed to justify the equity that funded them.[1]

Research from a recent McKinsey study suggests that a key problem is the tendency for integrating companies to pay too little attention to revenue growth and to focus almost exclusively on cost synergies. As one integration manager put it, "the CEO told me to put a knife between my teeth, dive down, slash deep, and not come up until it was done."

And while growth may be a stated objective in three out of four mergers,[2] a study of 193 transactions between 1990 and 1997 worth at least $100 million found that only 36 percent even maintained revenue growth through the first quarter after announcement.[3] By the third quarter, 89 percent had succumbed to a slowdown, with a median revenue decline of 12 percent. Underperformance of target companies with a history of growth rates lower than their industry peers explained only half the post announcement result. Unsettled customers and declining staff productivity explained the rest.

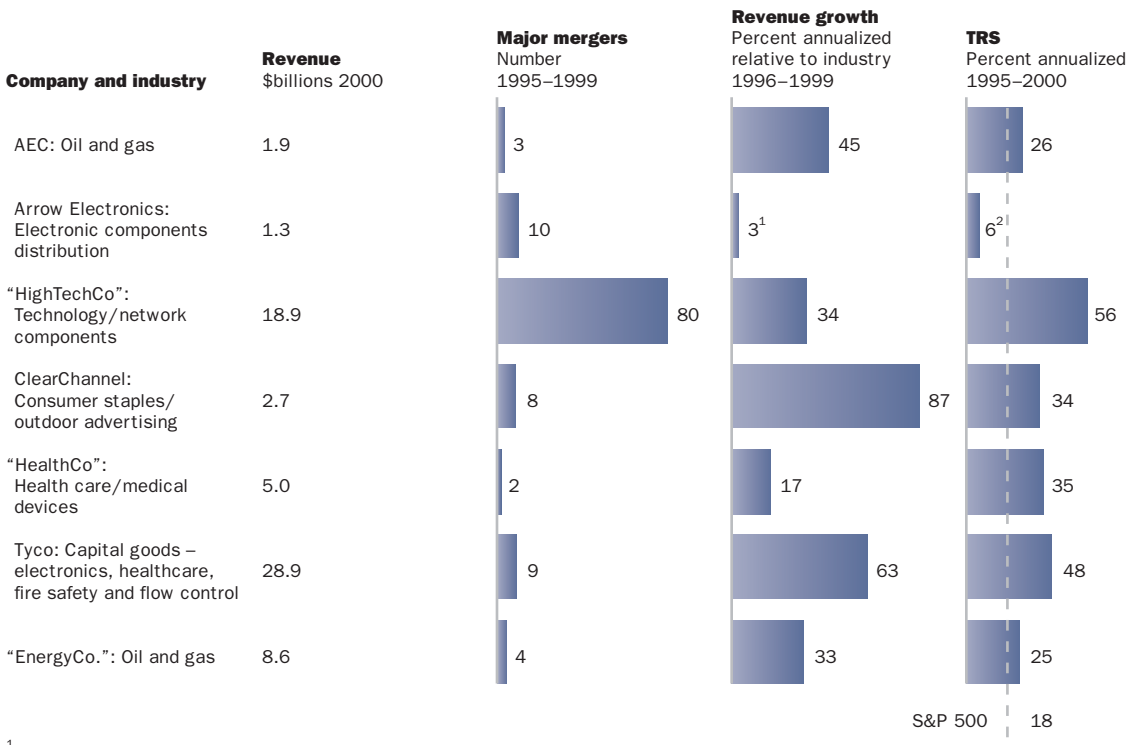
In the end, flat or declining revenues may hurt a company's market performance far more than a failure to nail costs. If balance is to be restored, the merger approaches of companies that maintain or accelerate revenue growth can be a useful starting point.

Identifying merger masters

To understand the impact of mergers on revenue growth, McKinsey researchers examined 160 mergers worth $100 million or more between 1995 and 1996 across 11 industry sectors, plus another 25 of the 100 biggest mergers between 1995 and 1999. The sample was then screened down to 80 companies where it was reasonably possible to isolate the growth attributable to acquisitions between 1995 and 1996. Of these, only seven companies were able to accelerate revenue growth over the following three years and deliver strong total returns to shareholders (TRS) (Exhibit 1).

In fact, most sloths remained sloths, while most solid performers slowed down. Overall, acquirers posted organic growth rates 4 percent below their industry peers, with 42 percent of acquirers losing ground. These results were evident across a range of circumstances, including some commonly believed to enhance the probability of a successful merger. Mergers in fast growing sectors were as susceptible as any, smaller acquisitions were not significantly more successful than larger ones, and experienced

Exhibit 1. Merger master profiles



[1] Arrow grew revenue 2.4 standard deviations faster than their industry.

[2] While Arrow's 1995 to 2000 TRS did not exceed the S&P 500, we include it here because during that period Arrow's TRS increased by 6 percent per year while its competitors' TRS decreased on average by 2 percent per year.

Source: Datastream; Hoovers; Analysts; McKinsey analysis.

acquirers did not demonstrate better success than novices.

Maintaining or improving revenue growth in a merger is by no means easy. And while revenue growth is not the only factor for merger success—some companies may achieve high postmerger TRS through such means as asset rationalization or cost reduction—it clearly matters. Declining revenues are a red flag to skeptical markets ready to question the price paid for an acquired company. Moreover, revenue growth is a powerful tool to offset cost savings shortfalls for the 20 to 40 percent of companies that fail to realize the synergies they identify premerger. Finally, growth creates positive dynamics both internally and externally that can help retain customers and talented staff.

The seven companies that emerged during our research generated impressive revenue growth and created shareholder value following their mergers. These "Merger Masters" grew revenues an average of 40 percent faster per year than industry peers, driving annual shareholder returns an average of 22 percent higher than the S&P 500 between 1995 and 2000 (Exhibit 2). While these companies came from a variety of industries and had very

different merger experiences, we found through interviews with them that they all made conscious decisions to ensure future revenue growth. Furthermore, they did not compromise long-term value creation for the sake of short-term cost savings.

While their specific approaches to executing mergers vary, the common pattern among these top performers was to naturally emphasize four different priorities in executing postmerger management.

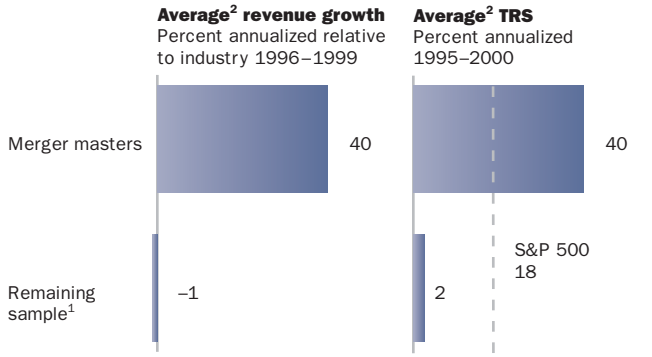
Planning for growth early in the merger process

Performance following the announcement of a merger can decline quickly, even before changes to finalize the integration are made, as the uncertainty that accompanies all mergers damages momentum.

One trait we witnessed in most of the "masters" was a bias for planning their moves well in advance. Before a merger announcement they systematically analyze all possible sources of cost and revenue opportunities and risks—including the impact of planned cost reductions on revenue aspirations. Such forecasting produces a payback during integration by easing the difficulty of making decisions on sequencing and providing resources for cost and growth initiatives, rather than focusing solely on cost.

Regulatory constraints do not make such early analyses easy. Some companies do everything possible to speed up the process. Several use clean teams—trusted third parties who will not pass sensitive information if the merger does not proceed—to start identifying cost synergies and revenue opportunities as early as possible.

Exhibit 2. Merger master performance



[1] Revenue information for 73 companies, TRS information for 48 companies in sample

[2] Equal weighted averages

Protecting existing revenues first

The uncertainty that sweeps in with a merger announcement brings risks to revenues. Senior staff are distracted, and with good reason: on average 50 to 65 percent of target company senior executives are replaced.[4] Substantial frontline changes can also occur. Headhunters typically target key employees within 5 days of announcement.[5] And customers begin wondering if service levels will decline, often seeking alternative suppliers to mitigate supply risk. The results can be disastrous. Analysts estimate that US banks lost an average of 5 to 10 percent of their customers following 1990s mergers.[6] But our research turned up several strong performers that made a priority of securing relationships with key customers and staff, and by extension, those existing revenues.

The stakes are high. Employees who own customer relationships or who are key to delivering the service can "take their eye off the ball." Tyco CEO Dennis Kozlowski observes, "People are normally productive for about 5.7 hours in an 8-hour business day . . .

any time a change of control [such as a merger] takes place, their productivity falls to less than an hour."[7]

Customers may also defect if they sense that the merger will constrain their bargaining power, change their security of supply, reduce service levels, or even cause a loss of key relationships. We found that to address these risks the merger masters start with strong communication. They create a stream of communications to ensure customers know exactly how the merger will affect them. Sales representatives for Arrow Electronics, for example, hand-deliver letters to all customers outlining the merger process and its eventual benefits.

We found several CEOs who invest considerable time personally visiting key customers. Others ensure that the target customers receive tangible benefits immediately after the merger is consummated in order to retain them. One oil and gas pipeline operator, for example, ensures that the customers of a merger target are given access to its proprietary product management software at little or no cost, enabling them to quickly identify ways to save money.

Explicitly balancing cost and revenues

In most mergers, quickly cutting costs makes sense. Cost savings, which may be necessary to enable growth, are the easiest opportunities to quantify, and their variables are all internal. And markets frequently demand rapid savings. However, cost savings have a habit of never quite making it to the bottom line. Up to 40 percent of mergers fail to capture their identified cost synergies.[8] The danger is that cutting too deeply can depress future earnings: "In the rush to save costs, [one US bank] . . . really hurt revenue growth . . . they didn't just take out the fat, they took out muscle."[9]

Paradoxically, revenues actually hit the bottom line harder, since fluctuations in revenue can quickly outweigh planned cost savings.

Understanding the opportunities a merger creates and deciding where to focus integration team efforts are critical in balancing cost and revenue targets. The most effective merger players make careful decisions about whether to attack revenue or cost synergies—or both. Some even launch separate revenue and cost teams. At Arrow, for example, the focus during integration is on revenue because CEO Steve Kaufman believes "you only get one chance at revenue, but you can always have another go at cost."

In contrast, Alberta Energy focuses almost entirely on cost, deliberately buying underperforming assets where the existing performance culture cannot be relied on to deliver cost savings. At the same time, the company ensures growth by buying only those oil and gas production assets that complement their existing distribution assets, thus quickly and inexpensively exposing those newly acquired assets to a wider distribution network.

Instilling a performance culture geared for growth

Focusing on growth in a merger can help a company build a positive internal dynamic that makes it easier to achieve other merger objectives, including cost reductions. Why? A focus on growth is a far more attractive proposition and more powerful motivator for key talent on both sides of a merger. The

merger masters we encountered nurture the autonomy of high-performing entrepreneurial teams and set aggressive targets and generous incentives.[10] They typically commit to growth targets early, often during the deal stage. One result: responsibility for achieving growth moves from the deal team to the integration team to the line as soon as possible. Even in mergers where cost reductions are a priority, incentives are structured to require some growth or, at a minimum, to prevent managers from jeopardizing future growth. Arrow Electronics, for example, found that setting up a competition between the sales force of a target company and Arrow's own reps to claim "top dog" honors at a mergers' close boosted sales growth in the first quarter after the merger announcement.

Similarly, Tyco business unit managers have aggressive EBIT targets that require both acquisition and organic revenue growth. This drives managers to find deals. To obtain capital approval, managers must commit to additional specific targets for each deal. Performance bonuses are uncapped for exceeding EBIT targets and are reduced when targets are not met. As a result, ease of integration becomes a criterion for evaluating deals, those executives leading the integration effort are in closer touch with the sources of value from the start, and growth is high on the merger agenda.

Companies that pay closer attention to revenues instead of focusing exclusively on cost cutting are likely to boost their chances of pulling off successful mergers. Practitioners that grow revenues and deliver on TRS stick to a few basic principles. They plan early for growth, protect existing revenues, balance revenues and costs, and creating a growth performance culture. Companies that employ these steps can build a reputation that fosters loyalty, tolerance for short-term disruptions, and faith in long-term outcomes among target employees, customers, and the financial markets. **MoF**

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[1] McKinsey & Company, 2000; Ernst & Young, 1999; AT Kearney, 1998; Mercer, 1996; Coopers & Lybrand, 1996; Mitchell Maddison, 1996. Failure was defined variously as "no net growth" or "share performance below the industry average," and was assessed over time frames between an "announcement window of 3 to 5 days" to up to 2 years postdeal.

[2] The Conference Board, New York, 2000; McKinsey analysis.

[3] Randolph P. Beatty, Hemang Desai, and Steven L Henning, "The importance of corporate control mechanisms in take-over execution," Southern Methodist University (unpublished), 2000.

[4] Randolph P. Beatty, Hemang Desai, and Steven L Henning, "The importance of corporate control mechanisms in take-over execution," Southern Methodist University (unpublished), 2000.

[5] Ira T. Kay and Mike Shelton, "The people problem in mergers," *McKinsey Quarterly,* 2000, Number 4, pp. 26–37.

[6] Rodgin, Cohen, Sullivan & Cromwell. "US bank mergers: when cutting costs is not enough," *Euromoney,* November 1999.

[7] "A CEO roundtable on making mergers succeed," *Harvard Business Review* May–June 2000, p. 145.

[8] Haarman Hammered Management Consultants, *Stahl und Reisen*, 119 Number 8, p. 131.

[9] Rodgin, Cohen, Sullivan & Cromwell. "US bank mergers: when cutting costs is not enough," *Euromoney,* November 1999.

[10] Ira T. Kay and Mike Shelton, "The people problem in mergers," *McKinsey Quarterly,* 2000, Number 4, pp. 26–37.

What happened to the bull market?

Fundamental analysis can explain why the market went up—and why it went down again. It also gives us some pretty good clues about what will happen in the future.

Timothy M. Koller and Zane D. Williams

By the time the NASDAQ index reached its peak in the recent bull market, many financial commentators had begun to accept the idea that stock market valuations were no longer driven solely by the traditional economic factors of earnings growth, inflation, and interest rates. Instead, they suggested, new factors like structural changes in the economy, new rules of economics, and the value of intangible assets justified the lofty stock prices. Today the fundamental question remains: has the market changed what it factors into share values? Using a simple model based on changes in earnings, inflation, and interest rates, we found that these traditional factors alone explain most of the medium- and long-term movement in S&P index of 500 stocks over the last 40 years. We uncovered scant evidence that the market had changed what it consistently factors into stock prices.

Clearly the market can deviate from fundamental values; a strong case can be made that the performance of Internet and high-technology stocks during the second half of the 1990s added up to a "bubble." But such deviations tend to be short-lived. The economy and the market are closely connected, making the market's long-term aggregate performance quite predictable. Given that connection, we can be confident that real long-term returns from stocks will not exceed about 7 percent a year.

The record, clarified

What happened to the bull market? When we examined the performance of the S&P 500, we discovered that the bulk of the index's rise from 1980 through May 2001 resulted from the natural and expected growth of the market; only a small portion could be assigned to the amazing run-up in the Internet and high-tech sectors, which some investors came to believe had rewritten classical theories of how markets behave. Yet the plunge in the prices of a few "megacapitalization" stocks did play a major role in driving the markets down.

Between January 1, 1980 and December 31, 1999, the S&P 500 rose to 1,469 from 108, representing a compound annual growth rate of almost 14 percent (excluding dividends). In the 17 months that followed the S&P 500 fell to 1,256.

We identified three factors responsible for almost all of the change in the index. The first two, growth in earnings and changes in interest rates and inflation, are precisely the factors that would traditionally have been expected to drive share prices. The third is the temporary and somewhat irrational emergence of megacapitalization stocks.[1] Together, these three factors account for over 80 percent of the run-up in stocks from 1980 to 1999 (Exhibit 1). The retreat in the values of mega-cap stocks accounts for 50 percent of the

decline in the market from January 2000 through May 2001.

Earnings growth per share for the S&P 500 rose from $15 in 1980 to $56 in 1999. If the forward price-to-earnings ratio[2] had remained constant, earnings growth alone would have boosted the index by 302 points. This annual growth in earnings of 6.9 percent (3.2 percent in real terms) is not exceptional, since the nominal US gross domestic product grew by 6.6 percent over the same period. As a result, corporate profits remained a relatively constant share of overall GDP.

Simultaneously, US interest rates were falling dramatically, as was inflation. Long-term US government bond yields peaked at nearly 15 percent in 1981 and then fell, more or less steadily, to 5.7 percent by 1999. Falling interest rates reduced the cost of capital for corporations, enabling them to earn a larger premium for their shareholders.

To quantify the impact on valuations of falling interest rates and expected inflation, we built a simple model shaped by current earnings, inflation, interest rates, long-term earnings growth, and returns on equity. The model showed that falling interest rates and inflation accounted for an increase in the S&P's forward P/E ratio of nearly 8 points, corresponding to a 440-point increase in the index. Combined, the increase in earnings and the decline in inflation and interest rates accounted for 742 points (or 55 percent) of the increase in the S&P 500.[3]

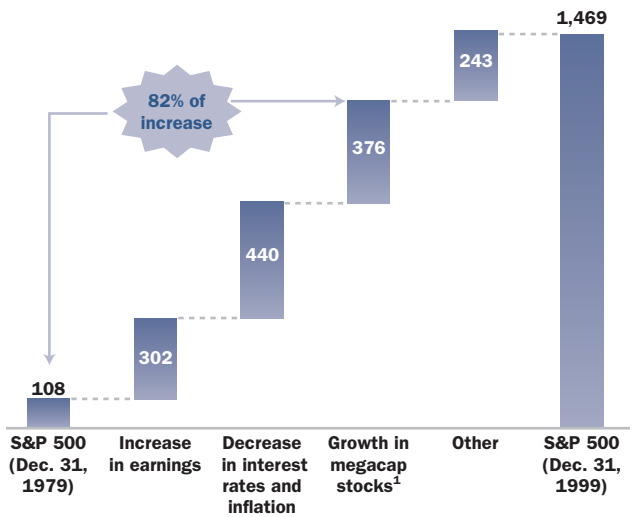
The megacapitalization boost and bust

Much of the remaining increase can be explained by the uneven distribution of value within the index.[4] Between 1997 and 1999,[5] a handful of companies, including Cisco, EMC, and GE, attained huge market capitalizations as well as very high P/E ratios. By 1999, the P/E of the 30 largest companies was double that of the other 470 (Exhibit 2). Such a divergence was new: in 1980 and 1990 the average P/E ratio of the largest 30 stocks in the index (measured by market capitalization) was close to that of the other 470 companies and of the index as a whole. In fact, the outsized gains of the largest stocks from 1997 to 1999 had no precedent in the previous 40 years. The forward P/E ratio increase resulting from the emergence of this gap accounted for an additional 376 points of the increase in the S&P 500 from 1980 to 1999.

Taken together, earnings growth, inflation and interest rates, and the megacapitalization phenomenon explain more than 80 percent of

Exhibit 1. Back to basics: Fundamental forces spur bull market

Change in S&P 500 index, Dec. 1979–1999



[1] Measured as change in spread between average and median.

the 1,361-point increase in the S&P 500 from 1980 to 1999. The rest of the change reflects a combination of other factors, such as the impact of the bubble on the index as a whole, the simplicity of our model, and the imprecision with which variables such as earnings are measured. Whatever the source of this residual, it largely vanished between 1999 and 2001.

The same factors explain the drop in the S&P since the end of 1999 (Exhibit 3). While an increase of more than $1 in earnings per share boosted the index level by 34 points, other factors produced a net decline.[6] The impact of a small increase in long-term interest rates and inflation was minor. However, the closing of the gap between megacap stocks and the rest of the index caused the index as a whole to lose 106 points.

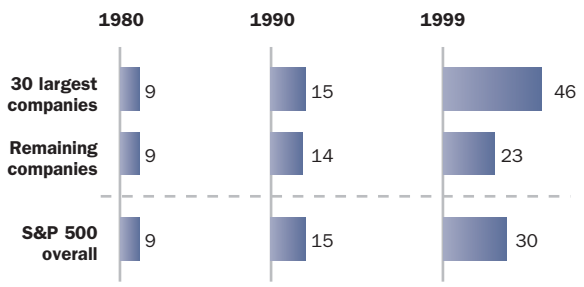
Fundamental economic forces drive share prices

Our conclusions about market behavior, derived from analysis extending the period from 1962 to the present, apply to intervals as short as 3 to 5 years and as long as 40 years. Whatever the duration, the primary factors driving the aggregate market are earnings, inflation, and interest rates, just as economic theory suggests. (Notwithstanding economic theory, the market isn't driven by returns on capital, since in aggregate they are remarkably stable.) It is reassuring that the market actually works the way theory predicts it will.

Even so, the market does sometimes deviate from fundamental values; the behavior of Internet and high-tech stocks over the past several years makes it hard to argue otherwise. A strong case can be made these stocks did go through an upward deviation, or bubble. Academic researchers continue to identify such deviations, though we cannot yet predict when they will begin or end—or even know with certainty when we are in the middle of one. Fortunately, in the United States these deviations have tended to be concentrated in a small number of stocks. By contrast, the

Exhibit 2. The megacap gap

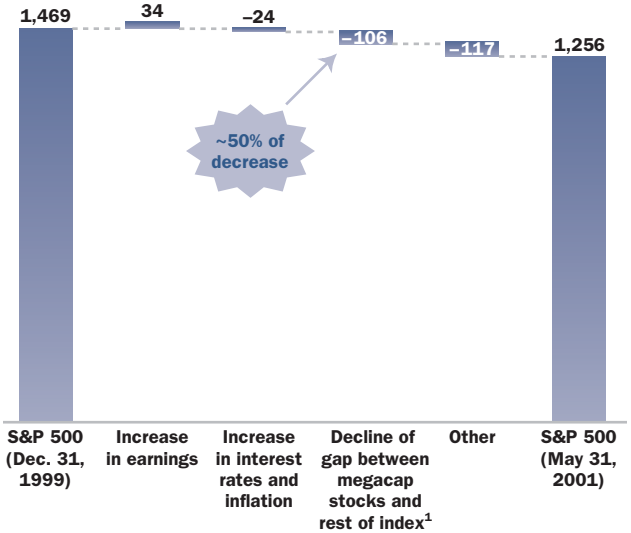
Average price-to-earnings ratios of S&P 500 companies by size[1]



[1] As measured by market capitalization.

Exhibit 3. The gap closes

Change in S&P 500 index, Dec. 1999–May 2001



[1] Measured as change in spread between average and median.

behavior of the typical, or median, company is remarkably true to theory.

Predicting the future, broadly

If the past can be explained relatively easily, forecasting the future shouldn't be extremely difficult—at least within broad bands. Although our analysis says nothing about short-term fluctuations, it can explain longer-term movements.

In light of past performance, the most one might expect from investing in stocks is a return of about 7 percent a year in real terms. Why? In the aggregate, future returns from stocks will be driven by earnings growth, changes in P/E ratios, and dividends. We have observed that US corporate profits have remained a relatively constant 5.5 percent of US GDP over the past 50 years. Assuming that aggregate earnings increase along with GDP, history suggests that real corporate earnings will grow at a rate of 3 to 4 percent a year.

If long-term interest rates don't drop further, aggregate P/E ratios are about as high as they can be. Currently, expected inflation and interest rates are quite low; in fact, long-term rates haven't been so low since the late 1960s, when, not coincidentally, P/E ratios were about the same as they are today. Assuming, optimistically, that P/E ratios remain constant and that earnings grow by 3 to 4 percent a year in real terms, stock prices alone should also increase by 3 to 4 percent per year.

The current dividend yield of roughly 1.5 percent and annual share repurchases of 1.5 percent[7] of outstanding shares generate an additional 3 percent of the return on stocks, for a total expected real return of 6 to 7 percent. Once again, this finding is in line with history. Jeremy Siegel, of the University of Pennsylvania's Wharton School of Finance, has shown that the long-term real return on stocks during the past 200 years has averaged about 6.7 percent a year.

Stocks could exceed a real return of about 7 percent only if the GDP were to grow significantly faster than it has in the past or if the real cost of capital for companies were to decline. McKinsey research has found that the real cost of capital has been stable over the past 40 years. Real GDP growth has averaged 3.5 percent over the past 70 years or so and has been nearly 3.3 percent for the past 20. If economic growth slows significantly or if inflation and interest rates rise, returns from stocks could trend lower. MoF

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[1] The impact of the return on capital was not included. Returns on capital are remarkably stable and have little impact on aggregate performance.

[2] The current share price divided by the forecast earnings per share for the following 12 months.

[3] The impact of falling inflation and interest rates already reflects the multiplier effect of combining them. The impact of lower interest expenses was excluded, because the impact is not material.

[4] Because the S&P 500 is a value-weighted index, the largest companies have a disproportionate impact.

[5] To estimate the impact, we multiplied the index's earnings per share by the spread between the index's value-weighted P/E and the P/E of the median company.

[6] The size of the "other" category reflects the fact that our approach works best over longer time spans.

[7] See G. Grullon and R. Michaely, "Dividends, share repurchases, and the substitution hypothesis," at www.ssrn.com.

Thriving in discontinuity: An excerpt from *Creative Destruction*

Why, with the sole exception of General Electric, have even the best-run and most widely admired companies been unable to sustain their market-beating performance over the long term? Drawing on McKinsey analysis of the performance of more than 1,000 corporations in 15 industries over a 36-year period, the authors of the best-selling book explore the imperative that to survive, executives must learn to run companies more like markets. *Excerpted from* ***Creative Destruction****, Doubleday, April 2001.*

Richard N. Foster and Sarah Kaplan

In 1917, B. C. Forbes formed his first list of the one hundred largest American companies—ranked by assets, since sales data were not accurately compiled in those days. In 1987, Forbes republished its original "Forbes 100" list and compared it to its 1917 list of top companies. Of the original group, 61 had ceased to exist.

Of the remaining 39, 18 had managed to stay in the top one hundred. These 18 companies—including Kodak, DuPont, General Electric, Ford, General Motors, Procter & Gamble, and a dozen others—had clearly earned the nation's respect. Skilled in the art of survival, these enterprises had weathered the Great Depression, World War II, the Korean conflict, the roaring '60s, the oil and inflation shocks of the '70s, and unprecedented technological change in the chemicals, pharmaceuticals, computers, software, radio and television, and global telecommunications industries.

They survived. But they did not perform. Collectively, these great companies earned a long-term return for their investors during the 1917 to 1987 period 20 percent less than that of the overall market. Only one, General Electric, performed better than the averages.

An examination of the Standard & Poor's 500 index supports the same conclusion. Of the 500 companies in the original index in 1957, only 74 remained through 1997. If today's S&P 500 were made up of only those 74 companies, the overall performance of the index would have been about 20 percent less *per year* than it actually has been. Of those 74, only 12 outperformed the S&P 500 itself over the 1957 to 1998 period.

For decades we have celebrated the big corporate survivors, praising their "excellence" and their ability to last. These bedrock companies of the American economy are the ones that "patient" investors pour money into, investments that would certainly reward richly at the end of a lifetime. But our findings—based on the 38 years of data compiled in the McKinsey Corporate Performance Database—have shown that they do not perform as we might suspect. Investors patiently investing

money in these survivors will do substantially less well than an investor who merely invests in market index funds.

The gales of creative destruction

Managing for survival, even among the best and most revered corporations, does not guarantee strong long-term performance for shareholders. In fact, just the opposite is true. In the long run, markets always win.

How could stock market indexes like the Dow Jones industrials or the S&P 500—which, unlike companies, lack skilled managers, boards of experienced directors, carefully crafted organizational structures, the most advanced management methods, privileged assets, and special relationships with anyone of their choosing—perform better over the long haul than all but one of *Forbes*'s strongest survivors? Are the capital markets, as represented by the stock market averages, "wiser" than managers who think about performance all the time?

The answer is that the capital markets and the indexes that reflect them encourage the creation of corporations, permit their efficient operations (as long as they remain competitive), and then rapidly and remorselessly remove them when they no longer perform. Capital markets are built on the assumption of discontinuity; their focus is on creation and destruction. The market encourages rapid and extensive creation, and hence greater wealth building. It is less tolerant than corporations of long-term underperformance.

In contrast, corporations operate with management philosophies based on the assumption of continuity and a focus on operations and are unable to change at the pace and scale of the markets. As a result, in the long term, they do not create value at the pace and scale of the markets. Outstanding corporations do win the right to survive, but not the ability to earn above-average or even average shareholder returns over the long term. Corporations that lose their ability to meet investor expectations (no matter how unreasonable these expectations might be) consume the wealth of the economy. The capital markets remove these weaker performers at a greater rate than even the best-performing companies.

Joseph Alois Schumpeter, the great Austrian-American economist of the 1930s and '40s, called this process of creation and removal "the gales of creative destruction." The essential difference between corporations and capital markets is in the way they enable, manage, and control the processes of creative destruction.

Origins of modern managerial philosophy

The distinction between corporations and capital markets is not an artifact of our times or an outgrowth of the dot-com generation. The market turmoil we see today is a logical extension of trends that go back centuries. The origins of modern managerial philosophy can be traced to the 18th century, when Adam Smith argued for specialization of tasks and division of labor in order to cut waste. By the late 19th century, these ideas had culminated in an age of American trusts, European holding companies, and Japanese *zaibatsus*. These complex giants were designed to convert natural resources into food, energy, clothing, and shelter in the most asset-efficient way.

By the 1920s, Smith's ideas had enabled huge corporations to flourish, exploiting the potential of mass production. Peter Drucker's seminal guidebook, *The Concept of the Corporation* (1946), laid out the precepts of contemporary 1920s corporations, based on the specialization of labor, mass production, and the efficient use of physical assets.

Change came slowly in the '20s, when the first S&P index of 90 important US companies was formed. In the '20s and '30s the turnover rate in the S&P 90 averaged about 1.5 percent per year. The average new member of the S&P 90 could expect to remain on the list for more than 65 years. Companies built on the assumption of perpetual continuity were in business to transform raw materials into final products and to avoid the high costs of interaction between independent companies in the marketplace. This required them to operate at great scale and to control their costs carefully. These vertically integrated configurations were protected from all but incremental change.

But the 70-year period of corporate development that began in the 1920s has come to an end. By 1998 the turnover rate in the S&P 500 was close to 10 percent, implying an average lifetime on the list of 10 years, not 65. While some may discount a single year's performance as an aberration, we predict that it is not, and that by 2020, a 10-year average lifetime of a corporation on the S&P will be the rule rather than the exception.

The age of discontinuity

A wave of change is under way that began in the 1980s when the S&P began substituting new high-growth and high market-cap companies for slower-growing and even shrinking-market-cap older companies. When the markets collapsed in the late '80s and a short-lived recession hit the American economy in the early '90s, the rate of substitution in the S&P 500 fell. But even at its lowest point, the rate of turnover was higher than it had been during a decline in the 1970s. The minimum level of change in the economy had been quietly building and was increasing again. This was even more evident as the technology-charged 1990s kicked into gear, accelerating the rate of the S&P index turnover to levels never seen before. By the end of the 1990s, we were well into what Peter Drucker calls the Age of Discontinuity.

Incumbent companies have an unprecedented opportunity to take advantage of these times. But if history is a guide, no more than a third of today's major corporations will survive over the next 25 years. To be blunt, most of these companies will die or be bought out and absorbed because they are too slow to keep pace with change in the market. By 2020, more than 75 percent of the S&P 500 will consist of companies we don't know today—new companies drawn into the maelstrom of economic activity from the periphery, springing from insights unrecognized today.

Becoming masters of creative destruction

Corporations have to become masters of creative destruction—built for discontinuity, remade like the market. They must increase the pace of change to levels comparable with the market. Reorganizing the corporation to evolve quickly rather than simply operate well requires more than simple adjustments (Exhibit). The fundamental concepts of operational excellence are inappropriate for a corporation seeking to evolve at the pace and

Exhibit. Seven key elements of changing at the pace and scale of markets[1]

Creating: Companies must regularly and systematically create sustainable new businesses. They must find and nurture businesses internally and also look to the market periphery for smaller companies to acquire.

Destroying: Companies must learn to exit a business before it peaks in growth—not after it turns downward. Exiting includes trading to other companies that can propel a business to new levels. Planning should start in the earliest stages of a new business proposal with the questions of "Who will buy this business? "How much will they pay?" and, "When will they buy it?"

Managing risk, not eliminating it: Everyone knows the old parable, "no risk, no reward" but few internalize it. Too often corporate strategy planning takes on the role of eliminating risk rather than managing the appropriate level of risk.

Controlling what you must, not what you can: Companies in the midst of rapid change lose control when complexity or operations increase too fast. At the same time, tightly controlled companies can squelch the innovation necessary to remain ahead of the curve.

Deploying talent: Many companies deploy their best people against their largest cash businesses. Instead, deploy the best talent against the future of the organization, not the past.

Forcing radical decentralization: Most corporations adopt the spirit of decentralization, but corporate expenses, assets, and liabilities are still centralized. Contrast that with the capital markets, where all financial elements are decentralized.

Refocusing top management: Top managers spend much of their time on operations. Instead, they should spend the majority of their time managing the cycle of entry and exit, leaving day-to-day operations to trusted managers.

[1] Exhibit was synthesized from *Creative Destruction* and other materials by the authors.

scale of the markets. One cannot just "add on" creation and destruction; one has to design them in. Corporations must be redesigned from top to bottom based on the assumption of discontinuity. Management must stimulate the rate of creative destruction through the generation and acquisition of new firms and the elimination of marginal performers—without losing control of operations. If operations are healthy, the rate of creative destruction within the corporation will determine the continued long-term competitiveness and performance of the company.

The increasing pace of change in the markets requires a new operating model, one that encompasses both creating and trading. Certainly, there are variations of ownership structures, as exemplified by private equity firms, that have demonstrated an improved ability to change at the pace and scale of the market, and that have sustained superior returns for doing so over the past 20 years. Private equity firms embrace the "create, operate, trade" model, as does General Electric. Regardless of the type of company, mastering creative destruction will be a prerequisite for strong, sustained performance. And, as we've seen, there are already too few examples to look to. MoF

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Valuing dot-coms after the fall

Last year's fall reminds us that stock prices eventually reflect a company's fundamental economic performance. Here are the key questions to ask.

Timothy M. Koller

It was inevitable. Last year's decline in the NASDAQ composite index brought a sudden halt to a heady—some would say reckless—time for investors and acquisition-minded companies, particularly those focused on anything and everything connected with the Internet. Predictably, this slump has now sent the pendulum swinging in the other direction; many investors are staying away from the sector entirely, and established brick-and-mortar companies are scaling back their on-line initiatives. The survival of even leading Internet firms is being questioned.

The Internet roller coaster may rank as the market's most dramatic upheaval over the past 20 years,[1] but it certainly hasn't been the only one. Remember biotech? Real estate? Leveraged buyouts? What about Japan Incorporated? Each fad was accompanied by the conviction among market bulls that somehow, this time, classical notions of value creation, such as approaches that emphasized a company's cash flow, were hopelessly out of touch with the new vision of investing. In fact, investment values always eventually revert to a fundamental level based on cash flows.

Although investors and companies can no longer throw money at every dot-com idea, they shouldn't abandon the Internet. As they ponder the reality of a greatly reduced NASDAQ, they should cast a gimlet eye on the real sources of the sector's value. Such an analysis, together with an understanding of the basic principles of value creation, will generate new insights into the potential value of Internet opportunities.

Cash flow is king

In an earlier article on valuing dot-coms, several colleagues and I argued that solid investment analysis has never really been about shorthand metrics such as price-to-earnings multiples or multiples of revenue or traffic.[2] These approaches, in vogue during the Internet boom, do not consider a company's particular characteristics, nor do they account for the way investments in intangible assets (such as the cost of acquiring customers) flow through the income statement rather than the balance sheet.

Our approach involved applying a long-term discounted cash flow (DCF) analysis supplemented by three twists. First, instead of starting with the current level of performance—the usual practice in DCF valuations—start by thinking about what the industry and the company would look like in a state of sustainable, moderate growth, and then work that estimate back to current performance. For Internet businesses, this plateau of economic stability is probably at least a decade away.

Second, instead of a single forecast, use probability-weighted scenarios of future performance—an approach that can help highlight the inherent uncertainty in valuing high-growth technology companies. These scenarios should include extreme outcomes, such as very high returns and, conversely, bankruptcy. Finally, use tools such as customer value analysis to understand more fully how value is actually created.

Few industries in the Internet world have the structural characteristics needed for high returns on capital. One exception may be those B2C and B2B marketplaces whose customers naturally gravitate to the biggest site.

Spotting the value creators

The development of a fundamental economic perspective for analyzing companies with no profits and negative cash flows must begin with a focus on the way companies create value. The ultimate drivers of value creation are the potential revenue of a company and its ability to convert that revenue into cash flow for shareholders—an ability best measured by its long-term return on invested capital. People who are looking for real value in an Internet sector that has fallen down to Earth can begin by asking three questions.

How will the company generate revenues?

Getting money from customers is an obvious place to start—right? Yet only a short time ago, investors were buying companies without a clear sense of how they would generate such revenue. In fact, most of the ways to generate revenues have already been unearthed. In business-to-consumer (B2C) markets, companies can sell physical products, services, information, entertainment, and financial products; they can earn revenue from advertising and collect fees for facilitating transactions. In short, B2C companies must collect their revenue either from consumers or from other businesses that use their sites to reach consumers. Sources of revenue are similar in the business-to-business (B2B) market.

Be cautious about business models based on future revenue for anything that people wouldn't pay for today. America Online managed to build its business on membership fees from the start by offering consumers something they were willing to buy. Yet too many so-called lifestyle sites first aim to build a user base and then try to figure out how to generate revenue from sources beyond mere advertising. Similarly, Internet banks that use low prices and little else to lure customers could well see cost-sensitive customers go elsewhere when prices rise.

What will be the average return on capital once the industry matures?

In the Internet world, it has too often been assumed that successful companies would earn very high returns on their fixed assets and working capital—perhaps 20 percent or more after taxes—because they rely on intangible rather than tangible assets or because network effects create effective monopolies. This blanket assumption is dangerous. Industries earn high returns on capital if their products,

such as patented pharmaceuticals, are nonsubstitutable and legally protected; if branding is important and consumers are indifferent to price; and if a product, such as Microsoft's Windows operating system, becomes more valuable to customers as more people use it.

One reason to be skeptical about claims that Internet companies will earn high returns is that intangibles don't necessarily earn them; the industry structure does. Consider investment banking and movie production, two industries with considerable intangible capital. In both, most of the value goes to the talent—bankers, actors, and directors—not to the shareholders.

Few industries in the Internet world have the structural characteristics needed for high returns on capital. One exception may be those B2C and B2B marketplaces whose customers will naturally gravitate to the biggest site, thus creating a winner-takes-all opportunity for high returns. But most B2C and B2B marketplaces will earn returns that are close to or only marginally above their cost of capital. Internet retailing, for example, doesn't exhibit any of the traits associated with high returns. Products are substitutable, and consumers are sensitive to prices; they may, for example, seek information at one World Wide Web site but shop at another or off-line. (My wife loved one site for its toys, but once she found a product she would often buy it elsewhere; that site has since closed.) A similar logic applies to on-line financial services and entertainment sites.

How big is the relevant market?

Most analysts focus on the size of a market, but these estimates can be inflated or even irrelevant. Many Internet companies, for example, rely on advertising for revenue, but it is fairly certain that ad expenditures will be a relatively small part of the total economy—though they might rise somewhat over time.

Be wary, too, of the way companies assess the size of the relevant market or even measure their own revenue. In airline travel services, for example, the relevant market isn't the entire revenue of the airlines but rather the much smaller fees that they pay to on- or off-line agents.

Finally, ask yourself if the management, technology, brand, and head start of a company will allow it to beat the industry average. Keep in mind that few companies do so for long.

This fundamental approach to valuation is by no means a panacea. For starters, it won't eliminate uncertainty. Continual innovation and an inability to predict consumer behavior will ensure that volatility and risk remain important parts of the dot-com landscape. Yet investors and companies following these principles will at least be asking the right questions. They will have a better chance of success than they would if they simply followed the herd. MoF

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[1] As reckoned by value.

[2] See Driek Desmet, Tracy Francis, Alice Hu, Timothy M. Koller, and George A. Riedel, "Valuing dot-coms," *The McKinsey Quarterly*, 2000 Number 1, pp. 148–57.

Viewpoint

Shed no tears for pooling's demise

The US Financial Accounting Standards Board has eliminated "pooling" accounting for business combinations. How can companies make the most of "purchase" accounting?

Neil W. Harper, Robert S. McNish, and Zane D. Williams

When the US Financial Accounting Standards Board (FASB) on June 30 eliminated the "pooling" method of accounting for business combinations, the usually staid world of accounting rules saw the curtain fall on one of its most vociferous and political dramas in recent memory. In taking aim at pooling, which had been one of two accepted ways to account for combining businesses, FASB sought to bring greater clarity and consistency to accounting rules. But its effort drew the ire of corporate executives and venture capitalists, some of whom went so far as to invoke the national interest to preserve an accounting method they considered a dynamo of M&A activity and economic prosperity. Even members of the US Congress jumped into the fray over the otherwise arcane accounting topic.

True, the new rules, which dispatch pooling in favor of the alternative "purchase" method of accounting, represent a compromise. But we believe it is a step forward, particularly for those companies that prepare themselves for the post-pooling world.

Pooling's supporters liked the method because using it for M&A transactions could result in higher reported earnings and, they argued, greater value creation than would be possible using purchase accounting. The debate centered on "goodwill," or the amount paid for an acquired company above the fair value of its book assets. In pooling accounting, the book value of the acquired company is carried over as is, with no goodwill. In contrast, under the new version of purchase accounting, goodwill is to be recorded as an asset that must be periodically tested for a loss in value—or impairment. If it is judged to have fallen in value, the difference must be written down and charged against earnings. Both methods result in identical cash flows, since any write-down of goodwill would result in a noncash charge.

The new rules accommodate those who objected to the change by eliminating the earlier purchase accounting requirement to systematically amortize goodwill via annual charges to the income statement. Instead, FASB agreed that companies be required to test the goodwill balance for impairment only periodically, and to take a charge against earnings only when such impairment is found to have occurred.

Our view is that purchase accounting does not destroy value, as its critics charged, regardless of whether or not it requires

Executives can take advantage of the opportunity to engage investors on more critical topics such as cash flow, growth, and synergies. Some companies are already breaking new ground in discussing "cash earnings" or "cash EPS" with investors.

systematic goodwill amortization. Substantial evidence suggests that analysts, investors, and ultimately capital markets see through accounting treatment—and that the form of accounting for combining businesses has no impact on shareholder value. For example, it has been shown that price-to-earnings ratios of companies that have entered into purchase transactions tend to rise to offset goodwill amortization (Exhibit).[1] It has also been demonstrated that market-to-book ratios of acquirers remain constant once accounting treatment is taken into account.[2]

Indeed, there are many examples of deals that have been well received by the market despite the fact that purchase accounting drove significant earnings dilution. For example, the market celebrated Viacom's proposed $37 billion purchase of CBS by increasing its stock price 12 percent,[3] despite a projection that the way the combination was accounted for would dilute earnings per share (EPS) by $0.33, or 43 percent.[4]

Finally, although McKinsey research has found little statistical difference in how purchase and pooling deals perform, we have seen many cases where pooling accounting actually destroyed value. Companies expend significant hard costs to qualify for pooling treatment and subject themselves to a range of hidden costs, for example, forgoing restructuring options for up to two years following a transaction in order to comply with pooling regulations that limit significant divestitures.

Getting the most out of purchase accounting

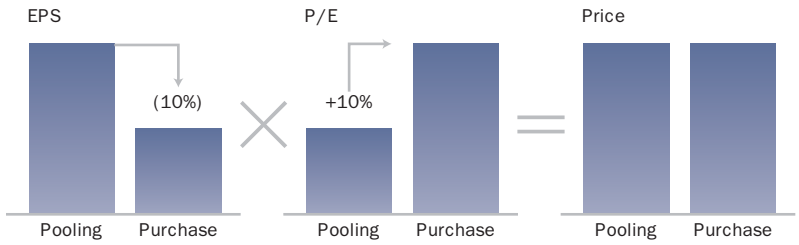
The compromise thus represents a significant step forward in bringing clarity and consistency to accounting and avoiding the risk of significant value destruction. However, the change requires corporations to prepare for purchase accounting to help ensure continued value creation from strategically rational business combinations. Executives looking to make the most of the new regime will need to reevaluate internal deal evaluation processes, prepare for a greater set of external communication challenges, and minimize time and money spent in testing goodwill for impairment.

Reevaluate internal deal evaluation processes

Rethinking the processes used to evaluate deals is a good place to start. To succeed in the post-pooling world, it will be important to understand where dilution is coming from and to focus only on what is most important to the market—the sources of true value and their impact.

Internal M&A processes frequently gauge the attractiveness of prospective deals by forecasting whether the deal will bolster or dilute EPS. This created an implicit bias toward pooling accounting. We have

Exhibit. Evidence suggests that investors and analysts see through accounting treatment



	Percent increase in P/E for 10% point increase in amortization[1]
All industries	11.8%
P/E industries[2]	12.2%
Cash flow industries[3]	10.5%

P/E's increase to offset lower EPS

[1] Significant at 99 percent confidence level.
[2] Industries where there is a small variation in P/Es across firms.
[3] Industries where there is a small variation of EV-to-EBITDA multiples across firms.
Source: E. Lindenberg and M. Ross, "To purchase or to pool," *Journal of Applied Corporate Finance*, Summer 1999; and McKinsey analysis.

participated in many discussions with senior management where there appeared to be unanimous agreement regarding the strategic rationale and value creation potential for a transaction, only to see the deal killed because it looked likely to dilute near-term earnings.

The fact is, not all dilution is created equal. Earnings dilution is an important consideration in deal evaluation—but only when it is caused by two factors. The first is the premium paid in excess of clear synergy value. The other is the prospect of uncertain future growth in the acquired business. When a deal dilutes earnings for these reasons, shareholders are right to ask pointed questions. However, dilution caused by accounting treatment is irrelevant, and the market knows it. Moreover, dilution caused by choice of financing, such as how much debt is taken on or how much equity is issued, should be considered and discussed as a separate effect that does not complicate the decision to go ahead or back off from an acquisition.

Prepare for greater external communication challenges

Moving to purchase accounting will provide some companies with a valuable opportunity to improve their overall dialogue with investors. Over time, continued discussions of EPS accretion and dilution and earnings estimates are likely to prove unsatisfying. But executives can take advantage of the opportunity to engage investors on more critical topics such as cash flow, growth, and synergies. Some companies are already breaking new ground in discussing "cash earnings" or "cash EPS" with investors. Wells Fargo, for example, followed its acquisition of First Interstate by issuing a special report to shareholders focusing on "cash earnings" and disaggregating the impact of the purchase method on the transaction.

Cash EPS is a more elusive concept, with several possible definitions. Typically it is calculated as standard EPS plus goodwill amortization. The move toward cash EPS is a positive development. Still, it falls short of

what every company's aspiration should be—a robust dialogue around long-term value creation potential and the free cash flows that drive it. Briefly stated, the problem with cash EPS is that it is neither cash nor EPS.

In a mature business generating positive earnings and cash flows, a good first step would be to move toward true cash measures. Corporate America already reports substantial cash flow information. Moving the dialogue toward measures such as operating cash flow per share or free cash flow per share is just as easy and more robust than moving to cash EPS. Better yet, executives should focus discussions with investors on growth in free cash flow and the spread between return on capital and cost of capital as the simplest and truest drivers of value creation.

Minimize time and money spent in testing goodwill for impairment

Finally, executives would do well to keep an eye on the time and money they spend meeting the new FASB standards. The rules eliminate the need for companies to systematically amortize purchase accounting goodwill. Instead, they require companies to periodically test such balances for impairment and to take a charge against earnings whenever such impairment has occurred. In practice, companies will have the option of avoiding a charge to reported earnings if they can meet one key test—that the fair value of each relevant reporting entity is greater than book value, including goodwill. If this test is not met then any impairment is calculated by valuing goodwill in essentially the same manner as at the time of the initial business combination. While companies must spend some time evaluating the carrying value of goodwill, we believe that extensive and costly efforts to avoid an earnings charge should be avoided. We have found no evidence that such charges have any impact on shareholder value.

We should note, however, that executives must be mindful of what annual goodwill write-offs may suggest to investors. A high write-off could be interpreted as a signal that an acquisition has failed or as an attempt to make future profits look better against lower future write-offs. Furthermore, large goodwill writeoffs could turn corporate net income into a loss, triggering debt covenants that were not constructed to consider such circumstances.

The new FASB accounting rules emerged from an uncharacteristically vocal debate over the value creation inherent in accounting methods. Now CEOs and CFOs must ensure that their companies are well positioned to continue reaping the benefits of transactions that create value, as well as reposition internal processes and external communication with investors to take advantage of the opportunity created by the new accounting landscape. MoF

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[1] E. Lindenberg and M. Ross, "To purchase or to pool," *Journal of Applied Corporate Finance*, Summer 1999.

[2] Vincent, "Equity valuation implications of purchase vs. pooling accounting," *Journal of Financial Statement Analysis*, Summer 1997.

[3] Measured over the 7-day period prior to announcement.

[4] Sanford C. Bernstein & Co., "Viacom, CBS grab each other," September 10, 1999.

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