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Living with the **limitations of success**

Once companies reach a certain size, setting realistic performance aspirations gets a bit trickier.

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Even good managers can be notoriously bad when it comes to understanding the limitations of size. We've heard many outstanding managers at large companies earnestly promise to double their share prices in five years or to beat market returns by percentage point gains that even small upstart competitors would envy. These executives' intentions, such as setting high aspirations to encourage performance, are almost always the best. But outperforming markets poses special challenges for large companies—even those that already have strong market positions—and setting lofty goals can tempt them to make risky bets and demoralize employees charged with hitting unrealistic targets.

That's why, in our experience, a solid understanding of what kind of performance a big company can really expect from its current business model is an essential starting point for setting performance aspirations in the most effective way. It's not that large companies can't do exceedingly well; our research on both US and global market leaders[†] reveals that among the top 25 companies by market capitalization, some do continue to outperform the S&P 500 by more than 5 percent (exhibit).

More telling, for the astute executive, is exactly how they did it. The bottom line:

outperformance by large companies is neither easy to achieve nor always at management's discretion. Among the companies that beat the market after joining the top ranks, all of those that repeated their early success (in value creation and size) did so by sticking to or refining their existing business model. None went beyond or revamped the one that first catapulted them into the top ranks. Furthermore, many that continued to beat the market benefited from factors beyond their immediate control.

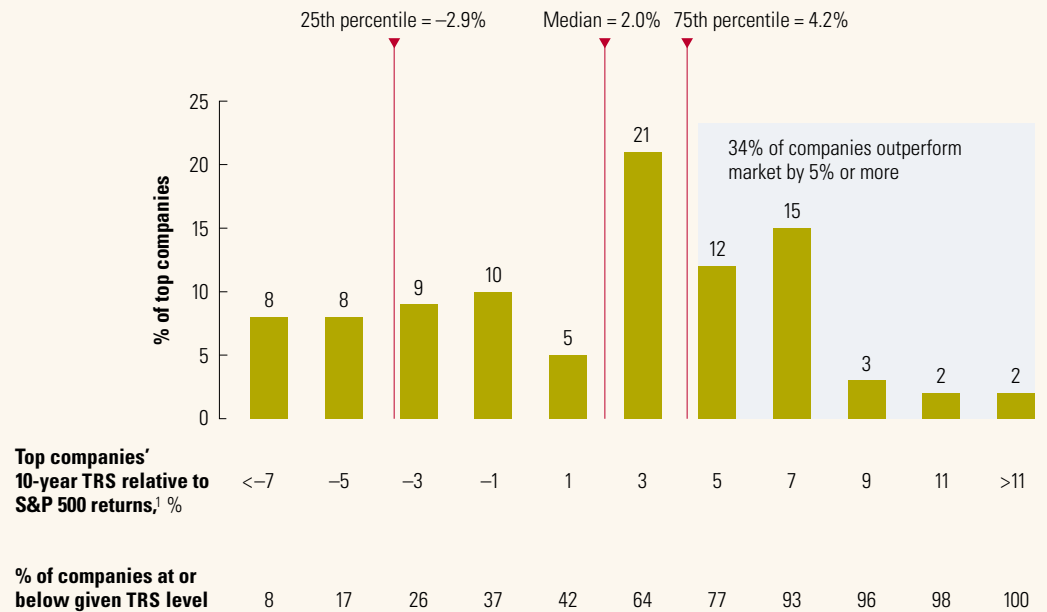
Many variables, including economic cycles and degrees of market saturation, help

[†] To learn what we could about the world's most successful companies (as measured by market capitalization), we examined the performance of the top 25 largest nonfinancial companies in the United States over each of the past four decades—a total of 100 companies. Ninety-seven of them survived a full decade in the top 25. To make their performance comparable across time as underlying general market conditions fluctuated, we adjusted their total returns to shareholders (TRS) for market returns. We also looked at both the average and trends in operating margins, growth, and returns on capital over each decade to understand what drives TRS performance.

Exhibit

Top companies—lackluster performance

Some top companies continued to outperform the S&P 500 in shareholder returns by more than 5 percent.



¹TRS = total returns to shareholders; 10-year rolling average (1965–2005) of TRS for each of the 25 largest nonfinancial companies by market cap minus 10-year rolling average (1965–2005) of TRS for S&P 500; data represent 25 largest nonfinancial companies by market cap in decades beginning in 1965, 1975, 1985, and 1995; no adjustment for beta.

a company to enter the top stratum and remain there. What follows is a closer look at four ways companies outperformed the market's returns to investors. Our research leads us to believe that even the most successful large companies aren't likely to outperform over time if they don't find themselves in one of these situations. The message for executives: be careful about letting pronouncements on performance goals exceed your company's ability to meet them.

Perfecting the business model

Some companies held onto their top positions for at least a decade by continuing to perfect the business model that made them initially successful—and not going beyond it. This group includes a number of high-tech players, as well as retailers and

pharmaceutical companies. For most, the core business was still in its high-growth phase thanks to one or more breakthrough products or services. Other companies in the top 25 were already growing at a much slower pace than they had in the previous decade but created significant shareholder value by riding out the late stages of their product or service life cycle.

Obviously, management plays a key role in guiding these businesses to innovate and to capture opportunities. But without the undercurrent of real growth in a segment, it becomes very challenging for even a strong management team to deliver outsized performance. Most companies come upon a big idea only once or twice in their entire existence. A global high-tech company,

for example, has generated new ideas as its leading breakthrough products slowed down, but the new ones have had a much smaller impact on the overall business.

Consequently, the company's stock performance has lagged behind the market in the past five years. Very few companies have produced a steady stream of new and substantial growth opportunities by aggressively reshaping the business portfolio.

Telecom companies experienced a variation on this pattern during the late 1980s. In the decade after the breakup of AT&T, in 1984, the regional Bell companies that emerged from it enjoyed monopoly power in exchange for universal service access and strict regulatory oversight. By the early 1990s, uncertainty about new technologies and a shift in regulatory philosophy made investors very optimistic about this sector's growth prospects. Most large telecom companies outperformed the market from 1986 to 1995, first by taking advantage of regulatory protection and then as likely beneficiaries of deregulation. Subsequent events, though, did not unfold as investors expected. The emergence of wireless technology and the Internet forced telecom players to invest heavily at a time when revenues from new products were too small to compensate for the rapid erosion of their traditional revenues.

Extending the business model

A second group of companies, largely in consumer products and pharmaceuticals, outperformed the market by taking advantage of intangible assets such as brands or patents to increase their profit margins and returns on capital. But though owning strong intangible assets was a necessary condition for their performance, it was insufficient on its own. With that as their

base, they differentiated themselves from competitors through strategic clarity and consistently strong execution.

As a result, these companies earned high and increasing returns on invested capital: indeed they raised their ROIC by more than 20 percent over the decade, to a ten-year average of 47 percent, compared with an average of 10 percent for the S&P 500. The accumulation of strong brand capital enabled companies in this group to erect effective barriers to price-based competition—barriers that in turn helped them improve their margins constantly. This group of companies also appears to have grown, after adjusting for inflation, at a rate faster than the growth of GDP, probably by taking more market share from competitors.

Rising commodity prices


Many companies owe their sustained outperformance largely to increases in the price of whatever commodities they produce. The price of commodities, such as oil, steel, and commodity chemicals, in turn reflects a number of complex economic, political, and competitive factors beyond the control of most businesses. From the standpoint of fundamental performance, commodity producers do not necessarily stand out: their returns cover their cost of capital but not much more. Their margins remain steady, and their growth is on par with the expansion of real GDP. At the same time, their TRS performance can be volatile as commodity prices swing. The performance of companies in this group of commodity producers may differ widely as a result of the quality of their assets and, to a much lesser extent, of their operating strategies. Over a 40-year period, a majority of commodity

players did not outperform the market. Only one of them outperformed it in all four decades.²

Turning around large underperformers

A small group of companies managed to outperform the market over a decade by dramatically improving their hitherto poor operations. These companies, from diverse industries, regained their vigor after a prolonged period of suboptimal performance and margin erosion. Against the backdrop of low market expectations,

their operating margins and returns on capital improved substantially—often under the leadership of new managers—which led to better-than-market returns. For this group, revenue and profit growth tended to be lackluster.

For executives at large companies, understanding the limitations of size more fully can better the chances of setting realistic growth aspirations. 

² Based on a 40-year compound annual growth rate.