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Multiple choice for the chemicals industry 1

A long-term look at the industry shows that many factors assumed to increase value really do not.

Living with lower market expectations 7

Should executives delay strategic moves because the market is volatile? An historic perspective may help.

Managing your integration manager 12

An integration manager can help make a merger more successful, but only if the top team knows how to choose and install one.

Accounting: Now for something completely different 16

It's not the bottom line, but how the bottom line is calculated, that really counts.

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Multiple choice for the chemicals industry

A long-term look at the industry shows that many factors assumed to increase value really do not.

Thomas Augat, Eric Bartels, and Florian Budde

In the chemical business today, with more than 7,000 products fragmented into dozens of geographic markets, very little seems simple or predictable. There are so many possible strategies in so many markets that industry analysts and executives alike struggle to form a clear sense of just what creates shareholder value.

While past performance is no guarantee of future returns, a careful look at corporate performance in this \$1.6 trillion industry¹ can illuminate opportunities for value creation in the years ahead. Having reached maturity about 20 years ago, the industry's average supply and demand cycles are now more predictable. And unlike in the pharma and telecom industries, no new technologies or regulations seem imminent that will transform the industry.

We compiled 25 years of financial and stock market data on 130 publicly traded chemical companies in the United States and Europe² and searched for links between strategy and value creation. The results of our research suggest that, for the industry as a whole, none of the factors commonly regarded as drivers of value creation in the industry—scale, geography, market position, or focus—make much of a difference.

The only strong correlation is with a firm's product portfolio—i.e., whether it is a

commodity, specialty, or diversified chemical company. *Within* the product segments, however, the research delivered some clear messages about how to create shareholder value.

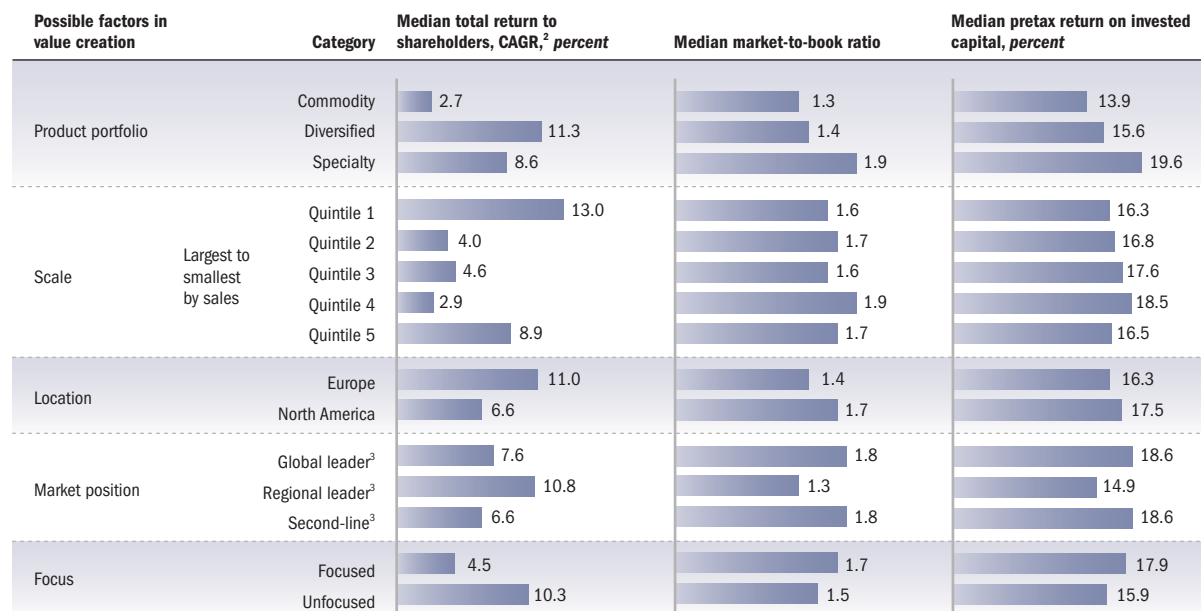
Listening to the capital markets

The long-term data show that the industry's reputation as sluggish and slow-growth is largely unjustified. To begin with, although the chemical industry continues to shrink as a percentage of overall economic activity—from 4 percent to less than 2 percent in the United States over the past 25 years—shareholder returns are on par with the broad market indexes in the United States and Europe over the past 25 years. For example, the US chemical industry and US markets grew annually at about 13 percent,³ a more robust rate of growth than other asset-heavy industries, including oil and gas, airlines, and pulp and paper.

The chemical industry also affords more opportunity for more individual companies to distinguish themselves than do many other cyclical, capital-intensive businesses. In June 2002, for example, the top quartile of US chemical companies had a market-to-book ratio 3.3 times greater than the bottom quartile. This is a far wider spread than in other asset-heavy industries like oil and gas (2.6), automotive (1.9), and pulp and paper

Exhibit 1. Product portfolio matters most

Comparison of North American and European chemical companies, 1992–2000



¹2001 excluded to cover exactly 1 cycle and to avoid bias due to effects of September 11, 2001.

²Compound annual growth rate.

³Global and regional leaders derive >50% of revenues from businesses ranking first or second in global or regional sales, respectively.

Source: McKinsey proprietary chemicals-performance database

(1.8),⁴ which operate in more transparent and global commodity markets with fewer strategic options.

There is also significant mobility among the upper- and lower-performance quartiles—demonstrating value creation (as well as value destruction) and the careful attention with which stock markets are following individual company performance. For example, among today's top quartile companies, fewer than half were in the top quartile a decade ago. And of today's bottom quartile companies, 22 percent performed above average as recently as a decade ago. That mobility reflects the nature of this complex and fragmented industry, where companies enjoy options to make myriad changes, such as factor prices or end-user demands, that can

redefine their products and services in specific markets and geographies.

What drives chemical performance?

But what strategy, if any, correlates with strong performance? Since chemical companies' strategies are hard to classify, competing as they do in a range of product and geographic markets, we chose to examine performance relative to some easily measurable dimensions of how a company operated—such as scale, product focus, or geography. That analysis let us test a number of hypotheses about what drives value creation—defined as total return to shareholders (TRS), market-to-book valuation, and returns on invested capital (ROIC). Using data from the most recent cycle (1992 to

2000), for which the most complete financial records are available, some surprising insights emerged:

Scale. For the industry at large, size alone does not influence TRS. Within the commodity and diversified segments, however, there are some economies of scale.

Geography. Any advantage that North American chemical companies enjoyed in higher market-to-book valuations and TRS compared with their European competitors has virtually disappeared over the past decade.

Market position. Companies with market-leading positions⁵ do not yield superior TRS relative to second-tier players.⁶

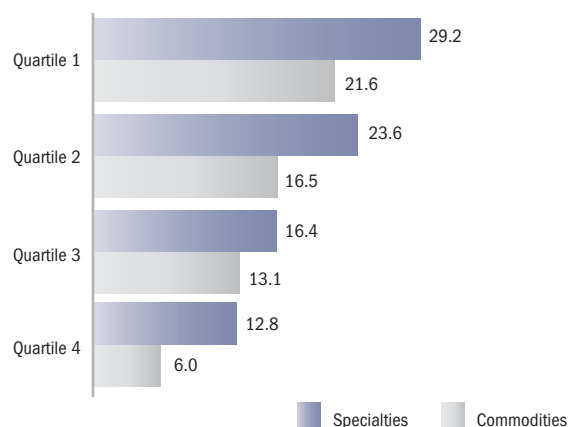
Focused vs. unfocused companies. Companies with focused corporate portfolios⁷ do not perform better than those with diversified portfolios.

In fact, the only statistically significant characteristic that correlates with employed measures of performance—TRS, market-to-book valuation, and ROIC—is a company’s product portfolio: commodity, specialty, or diversified (Exhibit 1).⁸ In the period studied, diversified companies generated higher TRS (11.3 percent) than specialty companies (8.6 percent), which in turn outperformed commodity companies (2.7 percent). In terms of ROIC and market-to-book ratios, specialty companies were the strongest performers.

That doesn’t mean companies should rush to modify their portfolios—some specialty companies perform dreadfully, and it’s better to be an above-average commodity company than a poorly performing specialty company (Exhibit 2). Rather, the wide range of

Exhibit 2. Median pretax ROIC by product portfolio

North America and Europe, 1992–2000, percent



Source: McKinsey proprietary chemicals-performance database

performance within each segment proves that portfolio choice alone won’t guarantee success. On the other hand, there appears to be a diverse set of opportunities—some relatively overlooked—for creating value within each respective market’s niche.

Looking more closely into the commodity and specialty segments

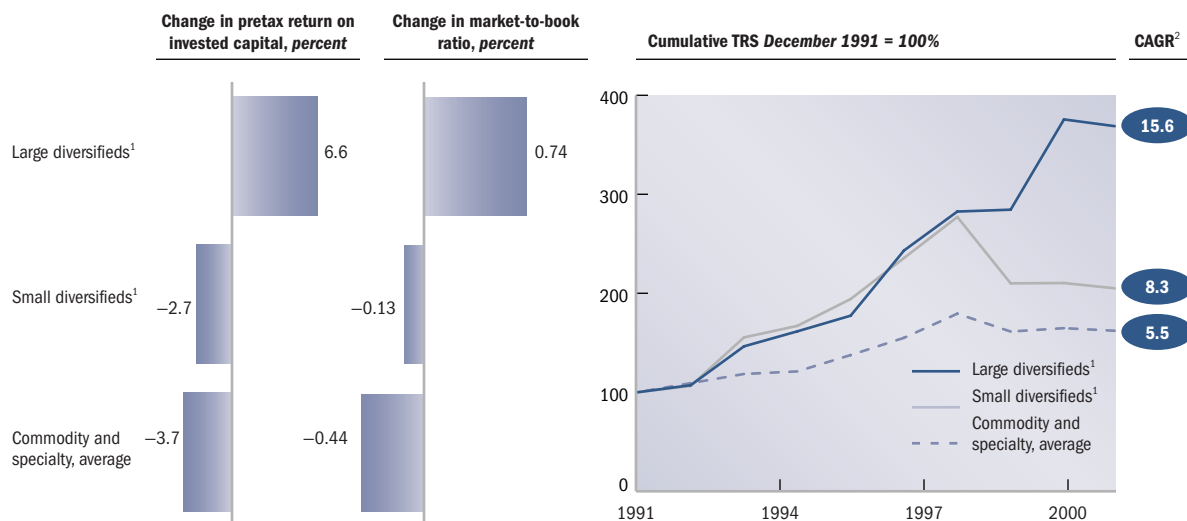
The data identified some clear messages about how commodity and specialty companies can improve their performance. The results were more ambiguous for diversified companies.

Commodity chemicals

Although this segment lagged behind the specialty and diversified segments from 1992 to 2000, there are still opportunities for commodity companies to find the right strategies to create shareholder value—or at least avoid destroying value. And while many of these findings confirm accepted beliefs about key success factors for commodity

Exhibit 3. North American and European chemical company performance, 1991–2000

North American and European chemical companies, 1991–2000



¹ Large diversified companies in top quintile of industry sales on average from 1991 to 2000; all others are classified as small.

² Compound annual growth rate.

Source: McKinsey proprietary chemicals-performance database

chemical companies, very few companies seemed to heed them.

The first finding for the commodity segment is that while size matters, growth does not; larger companies had lower cyclical ROIC, which correlates (albeit mildly) with higher TRS (Exhibit 3).⁹ Indeed, investors have not rewarded a premium to firms that have tried to grow their way to profitability, either organically or through acquisition. In our sample, companies with less-than-average profitability and higher-than-average revenue growth had paltry market-to-book ratios of 0.5. For example, at the end of December 2002, Terra Industries was trading at roughly \$2 per share, less than 50 percent of the book value of its assets.

Many companies that sought to acquire scale seem to have overlooked the importance of

ROIC in the process. The clearest finding of the research reinforces this basic point: ROIC matters far more than does revenue growth. Firms with above-average ROIC had the same market-to-book ratio regardless of how fast they were growing. In fact, there were no significant differences in revenue growth among firms, suggesting that ROIC is the only thing that drives a firm's market-to-book valuation.

The analysis also confirmed an issue that industry executives struggle with continuously: that the timing of capital investments, rather than fluctuations in demand or changes in economic conditions, is to blame for the industry's volatile cycles. Since most firms make the majority of their capital investments during the cycle's upswings (when everyone else does the same), prices quickly fall as the new supplies flood the market.¹⁰

Few commodity chemicals companies have found the formula for breaking out of the trap of simultaneous industry investments. Yet executives who *can* defy conventional wisdom and withstand pressure from their boards, bankers, and investors by investing in new capacity countercyclically (or at least independent of the cycle) could generate substantial returns. A related McKinsey study estimates that firms could potentially double their returns on new capital investments by pursuing an independent approach.¹¹ Of course, privately held commodity firms—without the conforming pressure of the markets—might stand a better chance of breaking out of the industry’s self-destructive investment cycles.

Specialty chemicals

There are two distinct periods in the evolution of the specialty segment over the 1990s. Until 1997, the specialty segment enjoyed robust returns, showing real and sustained sales growth, higher ROIC, and greater TRS—all without higher operating margins. This is somewhat counterintuitive, as specialties are thought to be higher-margin businesses than commodities. In fact, despite higher prices and lower depreciation the research found specialty companies to have a higher cost base in areas such as R&D, marketing, and technical support, and thus comparable margins to commodity companies over the commodity cycle.

Instead, specialty companies achieved higher returns than commodity companies because they had higher levels of capital productivity,¹² which led to higher ROIC. Higher ROIC, when coupled with revenue growth, created shareholder value. As high capital productivity was the underlying driver of shareholder value

creation in this segment, it was essential that specialty players preserve it.

Thus, it came as some surprise to see a massive decline in the segment’s capital productivity since 1997. The decline is in part due to rising levels of invested capital, most notably from a string of industry acquisitions laden with goodwill, such as Clariant’s acquisition of BTP or ICI’s purchase of Unilever Specialty Chemicals. Falling revenues made things worse. As specialty products faced increased competition and commoditization from low-cost producers in China and India, prices fell. Vitamin C is a good example: from 1990 to 2000, the global market share of producers from China rose from 0 to 10 percent while at the same time prices per kilogram dropped 69 percent, from \$16 to \$5, despite the existence of a price-fixing cartel.

In the late 1990s, when investors noticed the combination of declining growth and deteriorating capital productivity, many lost faith in the segment. As companies seek to regain investors’ confidence, they should bear in mind the need to increase capital productivity. Some highly successful players in the industry, like Ecolab, have focused on organic growth through new business models and extending capital light services lines, such as food-industry cleaning services. Companies that avoid the high goodwill from acquisitions will have an advantage in maintaining their capital productivity rates and positioning themselves for stronger performance.

Diversified companies

Diversified players’ performance during the most recent cycle present a much more puzzling picture. High TRS was driven, as mentioned, by the unexpectedly strong

financial performance of diversified companies. But not all diversified companies performed well. From 1992 to 2000, large diversified players (defined as the companies in the top quintile of sales) actually had higher returns than both commodity and specialty companies. Smaller diversified companies, on the other hand, have not recovered from the combined effects of an industry downturn and the Asian economic crisis in 1997, and the research did not identify any clear performance drivers for this segment.

We believe, but cannot prove, that large diversified companies have thrived as a result of a disciplined attempt to rationalize their business portfolios to focus only on the segments where they can be major players. While market position was not a value driver for the industry in general, within the diversified segment it had a moderate correlation with higher returns. This discipline might have helped transform these companies' fundamental financial performance over the past decade. For example, DuPont increased its return on invested capital before tax from 9 percent in 1992 to 20 percent in 2001, driving its capital market valuation up by over 50 percent over the same time period.

Having outperformed specialty players in terms of median ROIC, large diversified players are now looking for new ways to create value. The challenge continues to be management of both a low-cost commodity business and a high-value-added specialty business within the same organization. Exactly what smaller diversified companies should consider doing was unclear from the research.

The highly complex and fragmented chemical industry is more dynamic than many give it

credit for. By looking carefully at how the pieces of the industry puzzle fit together over the past 25 years, a much clearer picture has emerged about how commodity and specialty companies can create shareholder value in the years ahead. **MoF**

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¹ Total year 2000 revenues.

² McKinsey's long-term performance database includes all of the publicly available financial data on the largest North American firms from 1963 to 2002, and was supplemented by data for European chemical companies for 1998 to 2002 for this study.

³ The chemicals industry grew at 12.9 percent and the US market at 13.5 percent. *Source:* Thomson Financial Data Stream.

⁴ While measuring the market-to-book ratio requires looking at a specific point in time, there was a comparable spread between the top and bottom quartile performers over the entire period of the study.

⁵ Companies that derive >50% of revenues from businesses ranked first or second in global or regional sales.

⁶ Companies that derive <50% of revenues from businesses ranked first or second in global or regional sales.

⁷ With more than 80% of revenues coming from only two kinds of businesses.

⁸ Diversified companies sell both commodity and specialty products, with neither product type accounting for more than 70% of total revenues.

⁹ The r^2 equaled 0.49 in a linear regression of average TRS versus standard deviation of annual ROIC from 1992 to 2000.

¹⁰ See Philipp M. Nattermann, "Best practices ≠ Best strategy," *The McKinsey Quarterly*, 2000 Number 2, pp. 22–31.

¹¹ See Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies*, New York: John T. Wiley & Sons, 2000, pp. 334.

¹² The higher capital productivity is a result of the smaller physical plants needed to produce the smaller volumes of specialty chemicals in unique manufacturing processes; at the same time, customers are willing to pay a higher price.

Living with lower market expectations

Should executives delay strategic moves because the market is volatile?
An historic perspective may help.

Marc H. Goedhart, Timothy M. Koller, and Zane D. Williams

After living through the stock market's extreme behavior in recent years, predictability may be the scarcest resource corporate strategists can draw on. In mid May, the Standard & Poor's 500 index rode a springtime rally to briefly touch its highest level in nine months, but still remained 13 percent below its level of a year earlier. For executives pondering critical acquisitions or divestitures, the market's intense mood swings are particularly nerve-racking and may keep strategic decisions in limbo.

Of course, no one can forecast markets with complete confidence, particularly when the Federal Reserve and other central banks are increasingly wary of the risk of deflation. Yet it may be constructive to consider the market's performance in an appropriate context, from the standpoint of the real economy's long-term performance, including gross domestic product, corporate profits and interest rates, as well as the linkages between the real economy and financial markets. Executives who pause to understand these economic empirics may take some assurance that current valuations are broadly consistent with long-run economic fundamentals.

In short, the market has already recovered—from a period of excessive valuation limited to a few share classes. Future long-run returns will likely be tied primarily to the performance of the economy. If GDP and

corporate earnings continue to grow at historical rates from current levels, we believe investors should expect real annual returns of roughly 6.5 to 7 percent over the next 10 years, which is what they have earned over the past 100 years.

A market model

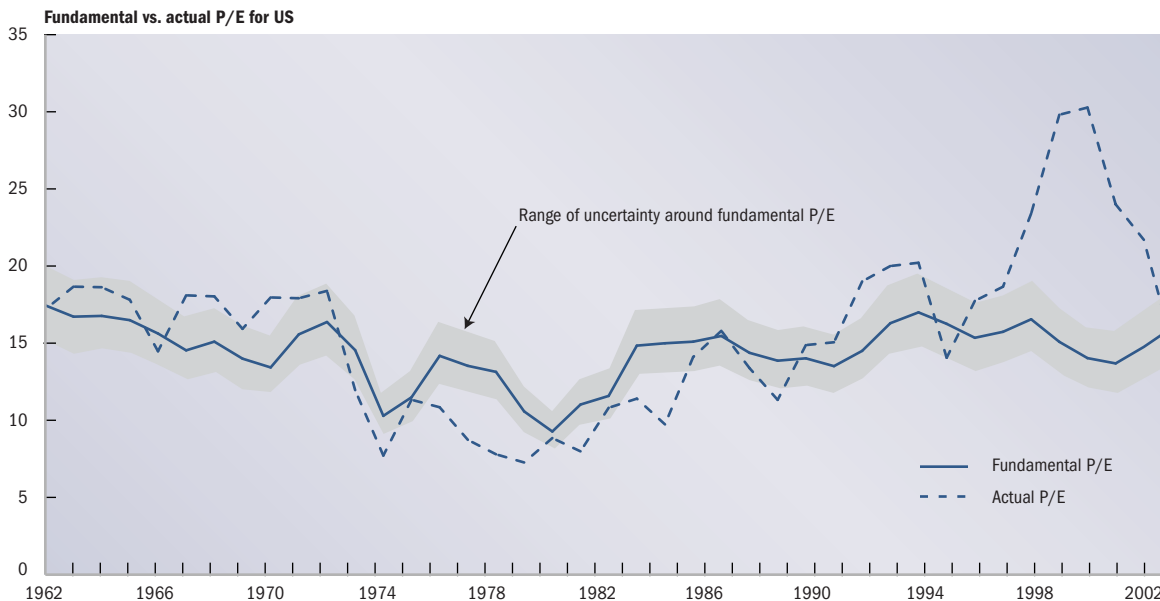
As we have illustrated previously,¹ corporate profits have remained a relatively consistent 5.5 percent of US GDP over the past 50 years. That makes GDP a good proxy for long-term corporate profit growth. Real GDP growth has averaged about 3.5 percent per year over the past 50 years for the United States. The stability of the implied inflation-adjusted cost of equity is also striking. Despite a handful of recessions and financial crises since 1960, equity investors have continued to demand about the same return on equity investments of around 7 percent in inflation-adjusted terms.

The stability of the real economy is what underpins the stock market.² That means that stock market values should be driven by basic economic drivers such as expected corporate profit growth, interest rates, inflation, and expected returns on investment.

To verify whether the market actually behaves the way theory would predict, we built a simple model to test it. Our model converts

Exhibit 1. The market's long-term average aggregate P/E ratio is ~15

Percent



Source: McKinsey research

corporate profits to cash flows, using expected returns on capital to drive investment rates. It then discounts these expected cash flows to estimate fundamental price-to-earning ratios (P/E).³ Using the model, we estimate that the long-term average aggregate market P/E is around 15 (Exhibit 1). Of course, short-run cyclical movements in the same economic factors will cause the P/E to fluctuate around this average level. In the same simplified valuation model, the impact of the economic cycle can also be taken into account to arrive at a fundamental level for P/Es over time. That is, these levels do not deviate from the long-run fundamental P/E by a wide margin or for many years. The impact of the economic cycle on market valuation levels is probably smaller than many practitioners would think.

The exhibit also illustrates that for the US stock market in most periods, the actual P/E is

within this fundamental range. Over the past 35 years, P/E appeared to be out of range in only two periods. In the late 1970s, markets were apparently overpessimistic during the severe recession following the 1974 oil crisis. P/E ratios were lower than our modeled fundamental levels. In the late 1990s, markets apparently overestimated the impact of the Internet “new economy,” which led to overpricing in terms of P/E ratios. However, in both cases, the P/E returned to our estimated fundamental levels within a couple of years. We found similar results when applying the same model to UK stock markets.

This chart also illustrates the impact of changing interest rates, even on “rational” valuations. When interest rates and inflation were at their peak in the early 1980s, they resulted in depressed valuations. In the late 1990s, low interest rates and modest inflation

corresponded with relatively high valuations. Thus, when comparing current valuation levels to historical levels, one must ensure that the effects of changes in interest rates and inflation are taken into account.

This is particularly crucial in light of the recent bull and bear markets. As we have demonstrated for the United States, both the bull market from 1980 to 2000 and the bear market that followed can be explained. The US bull market was driven by economic growth, declining interest rates, and the emergence of the bubble in tech, telecom, and megacap stocks.⁴ The bear market was primarily the bursting of the bubble in these three share classes.⁵

Applying our model to the current environment suggests that at current levels of interest rates, i.e., 10-year government bond yields, the median P/E for the US stock market should be in the range of 14 to 17. It is currently, at 15.7,⁶ well within this range. Of course, this does not necessarily imply that individual sectors and companies are all fairly valued as well.

What's next?

Over the next ten years or so, there are several factors that could affect the outlook for earnings per share (EPS) and P/E. The first is the level of current corporate earnings. Corporate earnings have varied between 4 and 7 percent of GDP over the past 50 years, with little trend in the series. In 2002, corporate earnings accounted for roughly 4.7 percent of GDP, below their long-term average of 5.5 percent. A return to the long-term average could thus add roughly 17 percent to current market valuations, all other things—including the P/E—being equal.

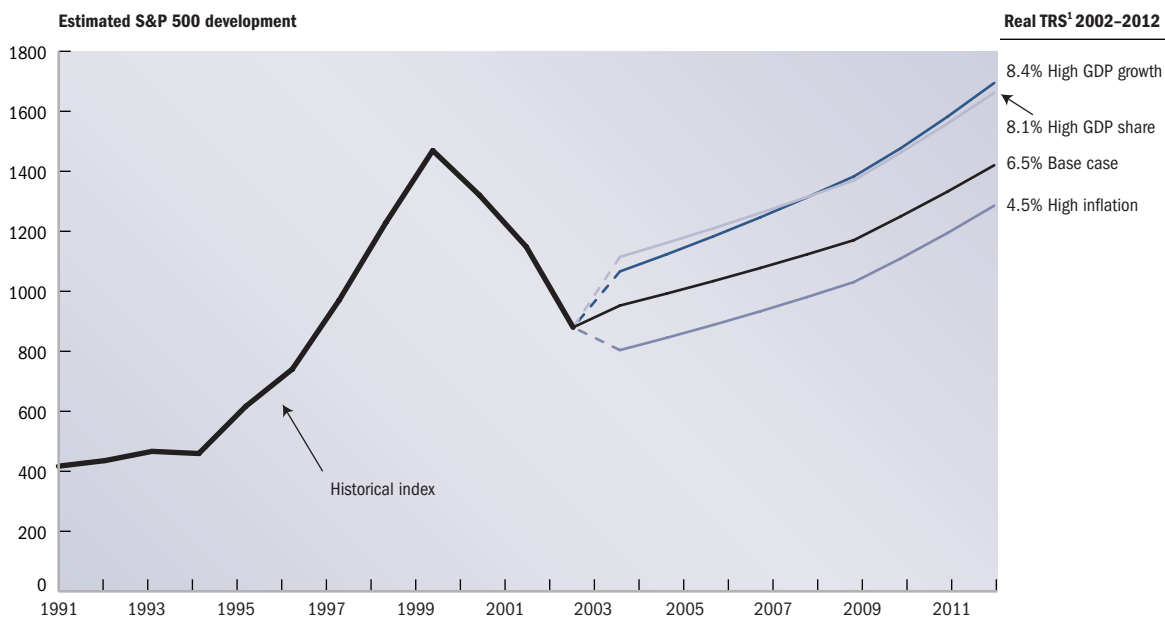
Returning to the S&P highs of the late 1990s will take many years. Although the results may differ somewhat across sectors and individual companies, this view also implies for corporate executives that there is little rationale to defer key decisions until a market “recovery” materializes.

A second factor is the rate of growth of corporate profits. As mentioned earlier, corporate profits have remained a relatively stable share of GDP over time. As such, they have grown at the same rate as GDP (3.5 percent per annum in real terms) over the past 50 years. Productivity growth, in turn, has largely fueled economic growth. While GDP growth has been fairly stable over time, some commentators have suggested that its rise in the late 1990s might continue, and could add up to 0.5 percent of long-run annual economic growth. A similar increase in expected profit growth would result in a one-time increase in valuation levels of 12 percent or so as P/E increases.

The third factor is the inflation rate. An increase in the expected inflation rate would increase the nominal cost of capital and also reduce corporate cash flows (relative to earnings) as investment becomes more expensive, thus reducing P/E and thereby valuation levels. Over the past 50 years, the rate of inflation in the United States has varied

Exhibit 2. Returning to the highs of the 1990s will take many years

Index



¹Total return to shareholders.

Source: McKinsey research

dramatically. Current inflation levels are roughly 1.5 percent or so, well below the median inflation level of 3.5 percent.⁷ Should expected inflation increase by 1.0 percent it would depress valuations by 15 percent.

What do these scenarios suggest about the level of the market going forward? Exhibit 2 highlights these results in terms of the level of the S&P 500. Based on the ranges of outcomes for our basic economic factors as already discussed, the S&P 500 would be between 1,000 and 1,300 in five years, and between 1,350 and 1,750 within ten years. Overall, these findings suggest that investors should expect roughly 6.5 to 7.0 percent real returns over the next decade—consistent with long-term historical returns. These returns could increase by 1.5 percent should corporate

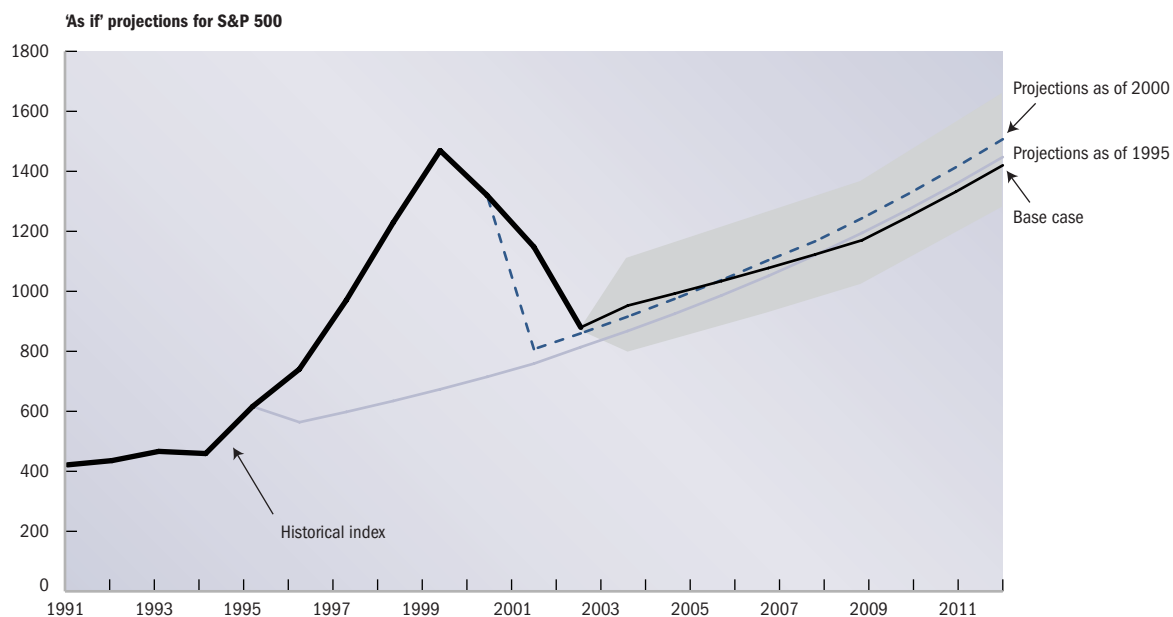
profits increase to 5.5 percent of GDP. A permanent increase in economic growth by 0.5 percent would also produce an additional 2 percent in real equity returns. An increase in inflation by 1.0 percent would reduce the real return over the next ten years by around 2 percent.

Speculative? Perhaps. At a minimum, however, this analysis may provide investors with a reasonable range for thinking about potential market performance in the long term.

Applying the same methodology as above, Exhibit 3 shows that our long-term predictions before and during the stock market boom of the late nineties would have been very similar in spite of very different market valuation levels. Predicting short-term stock market development is practically impossible because

Exhibit 3. Fundamental pricing model sees through market cycles

Index



Source: McKinsey research

of the impact of unforeseeable events such as, for example, the recent SARS outbreak or continuing terrorist attacks. However, we can predict what stock market returns over the long term should be, as economic fundamentals become the most dominant drivers. They suggest that returning to the S&P highs of the late 1990s will take many years. Although the results may differ somewhat across sectors and individual companies, this view also implies for corporate executives that there is little rationale to defer key decisions until a market “recovery” materializes. **MoF**

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is an alumnus. Copyright © 2003 McKinsey & Company. All rights reserved.

¹ Marc H. Goedhart, Timothy M. Koller, and Zane D. Williams, “The real cost of equity,” *McKinsey on Finance*, Number 5, Autumn 2002: pp. 11–15.

² Within a reasonable band and given the uncertainty of measuring economic variables.

³ Because of the stability of long-term profit growth and returns on capital, we can use historical trends to estimate long-term parameters for the model.

⁴ Timothy M. Koller and Zane D. Williams, “What happened to the bull market?” *McKinsey on Finance*, Number 1, Summer 2001: pp. 6–9.

⁵ Timothy M. Koller and Zane D. Williams, “Anatomy of a bear market,” *McKinsey on Finance*, Number 6, Winter 2003: pp. 6–9.

⁶ One year rolling forward looking P/E as of April 30, 2003, IBES.

⁷ Source: US consumer price inflation Datastream.

Managing your integration manager

An integration manager can help make a merger more successful, but only if the top team knows how to choose and install one.

Michael J. Shelton

For some years now, CEOs have turned to integration managers—usually mid- to upper-level executives relieved of their customary duties for six months to a year—to help lead the task of integrating companies after big mergers or acquisitions. Although an integration manager can contribute significantly to the realization of a merger's promise, the implementation of this important role often bedevils CEOs, few of whom have sufficient experience with mergers to hit on a plausible formula.

No surprise, then, that the effectiveness of integration managers varies widely. Many CEOs see them simply as process coordinators or project managers. But the best play a far more pivotal role, helping mergers to succeed by keeping everyone focused on the issues that have the greatest potential for creating value and by infusing integration efforts with the necessary momentum.

Unfortunately, however, too many integration managers never assume such a role or, if they do, find it hard to succeed in it. Our experience during the past five years with more than 300 integration efforts—most involving Global 500 corporations—suggests three reasons: CEOs fail to recruit the right people for the job; integration managers don't become involved in the merger process early enough; and CEOs fail to give them adequate support.

Recruit the right person

Some CEOs aim too low: for them, the integration manager's role resembles that of any other process-leadership position a company might create to drive its large systems-implementation or performance-improvement initiatives. Admittedly, much of the role does involve project management. Yet effective integration managers do much more. They not only report to steering committees but also help set the agenda.

What's more, effective integration managers don't just track whether synergies are being captured; they help capture those synergies by breaking the deadlocks that inevitably occur when two organizations merge. Such deadlocks and the resulting loss of momentum jeopardize many mergers. For example, during a merger executives may hesitate to make decisions about the merged businesses or departments they have been chosen to run because they lack information, fear taking risks, or think they don't have the authority to act. The integration manager accelerates the pace by anticipating problems, rapidly solving them, and, above all, constantly driving the decision-making process. Thousands of decisions must be made in a merger, but in an uncertain environment people often refer them to higher authorities, thus automatically creating a bottleneck. By intervening wherever possible to speed up the resolution of

problems, the integration manager keeps the process flowing—for instance, by ensuring that the steering committee quickly takes up issues requiring top-level input.

In one example, the information systems executive of a consumer products company involved in a merger refused to develop an IT plan that would have made it possible to migrate production capacity quickly from a facility slated for closure to a new location. The fast pace being imposed on him, he said, would compromise the flawless execution the project demanded—and his reputation as well. Delay, however, not only would have been costly to the company but also was sure to set off alarm bells for investors judging its ability to capture value from the merger. The integration manager briefed the company’s president and invited the systems executive to describe his relatively time-consuming plan to the steering committee. After the presentation, however, the president told the systems executive that the facility definitely would close quickly and that he should come up with a suitable solution and a cost estimate.

A week later, the executive returned with a new, faster proposal that met his own quality standards. It cost several times more than the initial plan but won quick approval because it enabled the facility to close on the target date, thereby generating savings that a delay would have squandered. These savings, and the positive signal they sent to financial markets, made the onetime systems costs relatively unimportant.

As this example shows, an integration manager may not have the authority to resolve everything alone but does serve as the eyes and ears of top management. At a time when CEOs are stretched to the limit, the

integration manager decides when the CEO does and doesn’t have to take part in a decision. Effective integration managers are strong general managers who have excellent decision-making instincts and are comfortable working cross-functionally. They are also courageous, politically astute, and capable of influencing corporate opinion. And they must be people top management respects and trusts, since they will often act as its proxy and confidant. Where can individuals with this level of skill be found?

Look within

To fill the post, a CEO shouldn’t look to outsiders, to the acquired company, or to high-level executives whom the merger might make redundant. The CEO needs someone who already knows the acquirer’s organization and systems and is committed to the merged entity’s future. An old hand—a general manager who has 15 or more years of experience with the company, including frontline operating experience—is often a safe choice. But what if such people are indispensable, especially at companies short on top talent? A riskier alternative is to pick a less experienced rising star, but in this case there must be compelling evidence of unusually well-developed general-management potential.

Organizations that actively manage their talent pipeline will have an easy time identifying candidates: they can quickly pull up lists of “A” players, many of whom will be suitable for the role. Other companies will need more time—a scarce resource in mergers. Serial acquirers should therefore have a strong talent-management system that makes it easy to identify potential integration leaders.

Get your candidate on board

Identifying suitable candidates is one thing, persuading them to take the job quite another. Many will be reluctant to give up important positions for a 6- to 12-month stint of intense work, at the end of which their previous job may have been eliminated or given to someone else and numerous attractive positions created by the merger will probably have been filled. CEOs can appeal to the candidates by explaining the importance of the integration-management role and by assuring them that they will remain in it only as long as they are needed to maintain the momentum of integration. Other people in the integration office can track the progress of capturing synergies once the key decisions have been made, the detailed plans have been approved, and the heads of business units and departments have accepted accountability for specific targets. Sticking to these promises will help CEOs recruit integration managers for coming mergers.

Ideally, the integration manager should know what position he or she will assume after successfully completing the job. If it isn't possible to promise a specific one, the CEO should sketch out some realistic possibilities and describe the process for choosing among them as the integration effort unfolds.

Finally, the integration manager should have a senior-executive sponsor to help with his or her next career move. It is easier to offer such support in a company where highfliers periodically move around the organization. In a company where advancement takes place mostly in functional or business-unit silos, the CEO may need to offer a personal assurance that the prospective integration manager is taking a prudent career step. An integration

manager who has a clear picture of his or her future will also be more effective in the job.

Install the integration manager early

Timing is crucial. After recruiting an integration manager, the CEO must have him or her in place a month or so before the deal is announced—something that often fails to happen when the CEO is inexperienced, overwhelmed by more pressing merger demands, or eager to minimize disruption.

Yet if integration is to proceed effectively and efficiently, the integration manager must be installed early enough to have a detailed understanding of the goals of the merger. Suppose, for example, that using the acquirer's superior distribution system to disseminate the target company's products represents a major portion of a merger's value and that it is therefore important to carry out this part of the integration effort rapidly. An integration manager who knew this could identify—before the deal was announced—the sales, marketing, and logistics specialists whose services were needed to achieve that goal. No time would be lost getting them to address the problem as soon as the merger became public.

In addition, working early on with the CEO and with the team supporting the negotiations for the deal allows the integration manager to learn which customers, personnel, and projects will be critical for the success of the combined business and to take steps forestalling problems that involve them. Identifying employees whom the company can't risk losing to competitors and headhunters, for instance, enables the integration manager to make sure that senior executives approach these valuable people, to suggest the messages the executives

deliver, and to learn whether the conversations are having the desired result.

Furthermore, deals often involve informal, unwritten understandings, and integration managers should know what they are before the merger announcement. There may, for instance, be off-the-record agreements about which business-unit heads will stay in place and which features of the existing organizational structure can't be touched. The CEO may have expressed a view about whether the merged company should adopt the acquiring one's systems, operating practices, and organizational structures. During the negotiations, certain executives may have signed on to specific performance targets, and an integration manager who knows about such commitments early in the game can hold these executives to them.

Any merger involves countless understandings of this kind, and without some degree of participation in the deal-making process an integration manager might not know of them. Without these details, the manager starts at a disadvantage. With them, he or she can create a road map of the principles that will guide the integration process and the teams that drive it. Developing such a map, and communicating it to key senior executives before the merger announcement, helps the integration manager obtain the leadership alignment needed to force a rapid pace from the outset.

Support the integration manager

To succeed, the integration manager will need the CEO's support in several key ways. First, the CEO has to trust the integration manager. It isn't uncommon for a CEO to appoint a good one and then fail to build this trust, for the CEO must confide in someone who may

not be very familiar but who will nevertheless provide an invaluable set of eyes and ears throughout the integration process. The CEO should therefore keep the door to the executive suite open at all times for the integration manager, who must be trusted to recognize that since time is a scarce resource for CEOs, conveying only targeted information is appropriate.

Then too, the CEO must give the integration manager the authority to do the job and make it clear, at the integration kickoff meeting, that the integration manager will be serving as the CEO's proxy in many meetings over the course of the merger. The integration manager should also be authorized to lead discussions in the steering committee and to enforce a truly rigorous decision-making process. That approach may make the CEO uncomfortable, but it is essential if the integration manager is to be seen as more than just an order taker or process leader.

The appointment of an integration manager can be instrumental to the success of a merger, but it requires diligent attention from senior management. A chief executive officer who knows how to recruit and install the integration manager is more likely to make both the holder of that position and the merger itself successful. **MoF**

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¹ For information about talent and customer-retention issues, see Ira T.Kay and Michael J. Shelton, "The people problem in mergers," *The McKinsey Quarterly* 2000 Number 4, pp. 26–37; and Matthias M. Bekier and Michael Shelton, "Keeping your sales force after the merger," *The McKinsey Quarterly* 2002 Number 4, pp. 106–15.

Accounting: Now for something completely different

It's not the bottom line, but how the bottom line is calculated, that really counts.

Timothy M. Koller

Accountants, regulators, and corporate executives are again embroiled in debate, this time over the best way to figure the expense of stock options, which can change dramatically in value between when they are issued and when they are cashed. It's the latest act in a recurring drama to try and glean a more accurate assessment of a company's value by focusing on a particular item's effect on net income. A few years ago the topic was whether changing the method of accounting for goodwill in acquisitions would damage corporate earnings and investor appeal. As baby boomers grow ever grayer, the value of stated pension reserves is certain to be next.

Unfortunately, this kind of financial reductionism is a pale substitute for the kind of disclosure investors really need. Their trust has been battered by an era of stunning corporate greed, ethical lapses by accountants, and malfeasance on the part of high-profile executives and analysts. Faced with political backlash, regulators are right to try to restore investor trust. But unless they and boards of directors start insisting on providing the information and transparency that reveals underlying performance and how it relates to future performance, investors can't be blamed if they continue to withhold that trust.

Executives regularly sweat meetings with analysts in which the focus is on whether or not a single number—quarterly net income—is met. And many apparently think that a good earnings number can boost share prices even if the earnings don't represent real underlying economic change. Armed with proper disclosure, however, markets easily see through this. For example, concerns that eliminating “pooling” accounting of acquisition goodwill would hammer share prices proved unfounded when new rules were adopted. The elimination of goodwill amortization increased some companies' reported net income by 50 percent or more, yet their share prices didn't skyrocket compared to peers. Share prices didn't follow earnings upward because changing the accounting approach didn't alter cash flows. The market knew all along how much amortization was in those companies' income statements, where it was already displayed.

The same thing will happen if new rules for accounting for stock options are adopted. At a recent private meeting with venture capitalists and academics, one top ranked sell-side technology analyst confessed to caring little whether or not stock options were listed as an expense at all on corporate income statements, much less what value is assigned to them. His personal bottom line: as long as the income

statement or its footnotes provide him with sufficient information on the number, exercise prices, and duration of options, he could independently judge the impact of the options on the value of the company.

But what can happen when the market does not have adequate disclosure to work with it? Savvy as it is, the market cannot be expected to ferret out information that is not disclosed. For example, when one multinational corporation first reported its results under US generally accepted accounting principles (GAAP) in order to list its shares on American markets, its share price dropped by 11 percent in two days. Yet when Daimler-Benz took the identical step in 1993, its share price relative to the market remained untouched—even though its US earnings showed a loss of DM 1.8 billion versus a profit of DM 600 million under German accounting rules.

The critical difference between the two cases was the history of information each had already disclosed. When Daimler reported under US GAAP, the major accounting differences mostly related to changes in reserves, pension items, and goodwill amortization, which had already been discernible to investors in the details of the company's annual reports. When the multinational corporation in question first reported its earnings under US GAAP, it unexpectedly disclosed that a significant portion of its profits for the previous year were actually one-time gains from real estate transactions and derivatives, rather than from recurring operating profits.

Toward genuinely helpful disclosure

As investors try to develop predictions about future cash flow and profits, past performance

becomes an essential foundation for a credible forecast. From that standpoint, there are some areas in which most companies might focus if they truly wish to move away from simplistic “single-number” reporting toward disclosure that genuinely provides investors with helpful insights to assess underlying performance. They can start with more transparent, reorganized income statements, balance sheets and cash flow statements, along with clearer, more detailed business-unit disclosures. Finally, they can publish more insightful, perhaps standardized management analyses of reported results.

Details, details

Currently, most companies minimize the amount of detail in their financial statements, relegating much useful information to the footnotes. They also commonly mix up operating (recurring) with nonoperating (non-recurring) items. To make better forecasts, however, investors need to understand the details, particularly what is recurring and what is nonrecurring. Financial statements should be organized with more detail and with an aim to clearly separating operating from non-operating items. It's not easy. In fact, current accounting rules exhibit something less than common sense in defining operating versus nonoperating nonrecurring. As a start, however, company income statements should close the biggest gaps in the current system by separately identifying the following items.

- Nonrecurring pension expense adjustments. These often have more to do with the performance of the pension fund than the operating performance of the company. Investors would benefit from being able to assess a company's operating performance

Exhibit. What more helpful reporting would look like

<i>Income statement, current format</i>		<i>Income statement, proposed format</i>	
Revenues	1,000	Revenues	1,000
Cost of sales	(600)	Cost of sales	(600)
Selling, general and administrative expenses	(257)	Selling, general and administrative expenses	(307)
Other expenses	(20)	Recurring operating profit	93
Amortization of intangibles	(5)	Amortization of intangibles	(5)
Earnings before interest and taxes	118	Gains from asset sales	20
Interest income	2	Changes in restructuring reserve	25
Interest expense	(20)	Pension accounting adjustments	(15)
Earnings before taxes	100	Interest income	2
Income taxes	(40)	Interest expense	(20)
Net income	60	Earnings before taxes	100
		Income taxes—current	(30)
		Income taxes—deferred	(10)
		Net income	60

<i>Balance sheet, current format</i>		<i>Balance sheet, proposed format</i>	
Current assets		Operating working capital	
Cash and equivalents	75	Accounts receivable	150
Accounts receivable	150	Inventories	175
Inventories	175	Other current assets	50
Other current assets	50	Accounts payable	(160)
Total current assets	450	Accrued liabilities	(40)
Net property, plant, equipment	200	Operating work capital	175
Goodwill	60	Net property, plant, equipment	200
Other intangibles	50	Operating capital	375
Deferred taxes	20	Goodwill	60
Equity investments	30	Other intangibles	50
Total assets	810	Equity investments	30
Current liabilities		Cash	75
Notes payable	50	Total investor capital	590
Accounts payable	160	Notes payable	50
Accrued liabilities	40	Long-term debt	200
Dividends payable	10	Dividends payable	10
Total current liabilities	260	Pension obligations	50
Long-term debt	200	Net deferred taxes	40
Deferred taxes	60	Shareholders' equity	240
Pension obligations	50	Total investor capital	590
Shareholders' equity	240		
Total liabilities and equity	810		

compared to peers over time separately from its skills at managing its pension assets.

- Gains and losses from assets sales that are not recurring. Large companies like to bury gains from asset sales in operating results because it makes their operating performance look better, often arguing that the impact is immaterial. But investors should be the ones who decide what is material. Companies should also separate out gains from losses. Now companies sometimes sell assets to create gains to offset losses from asset sales, and some top-ranked multinationals are well known for doing this on a regular basis. This is a perverse incentive that would go away if companies were required to disclose gains and losses.
- Executive stock option expense should also be fully disclosed in a separate line item in the income statement, not because it is non-operating, but because the amounts are large and difficult to estimate.

In a more useful income statement, complex or nonrecurring items such as pension expenses, stock options, changes in restructuring reserves, and asset gains or losses would be separately disclosed, regardless of materiality (Exhibit). Similarly, balance sheets should separate assets and liabilities that are used in the operations of the business from other assets and liabilities, such as excess cash not needed to fund the operations, or investments in unrelated activities. The typical cash flow statement is in need of major reorganization, once again to separate operating activities from nonrecurring activities from financing activities. Also the reconciliation of the cash flow statement to the balance sheet should be more transparent.

A focus on business units

Today's large companies are complex, with multiple business units that rarely have the same growth potential and profitability. Sophisticated investors will try to value each business unit separately or build up consolidated forecasts from the sum of the individual business units. Yet many companies report only the minimum required information and often not enough for investors to understand the underlying health of the business units. Nearly always, business unit results are relegated to the footnotes at the back of the annual report.

Business-unit reporting should be much more prominent and detailed than it currently is. A good case can be made that business-unit reporting is in fact more important than the consolidated results and should be the focus of corporate reporting. At a minimum, companies should produce a clear operating income statement for each business unit in a format similar to the consolidated income statement (though it isn't necessary to allocate non-operating and financial items such as interest expense). Similarly, companies should disclose operating balance sheets, including working capital, property plant and equipment, goodwill, and any other operating assets. It isn't necessary to allocate cash, debt, pension liabilities or other non-operating items to the business units. Business unit financial statements should be clearly reconciled to the consolidated reports.

Analysis that counts

Under US accounting rules managers must publish with their financial statements a document called "Management's Discussion and Analysis of Results of Operations and Financial Position." Many of these amount to

little more than boilerplate disclosure. Other approaches, however, might bring investors real insights into company performance. For example, analysis might include separate discussion of results by business unit, rather than on a consolidated basis. Changes in business-unit measures are more useful than consolidated revenues and margins. Regulators might also require certain common analyses, such as an explanation of revenue changes caused by acquisitions and foreign currency effects, as opposed to organic growth. To attain a better baseline for forecasting, investors need to know that of a company's 8 percent revenue growth, 5 percent was from acquisitions, and therefore only 3 percent was organic.

Objections overruled

Such supplemental disclosure is already the norm in some industries. For example, many retailers break down how the combination of same-store sales growth and changes in the number of stores affect revenues. Similarly, pharmaceutical companies routinely disclose the sales of their major products.

But such disclosure isn't as widespread as it should be. And as with other accounting debates, it's likely that any movement toward expanded, more detailed accounting would spark criticism that it would prove too expensive, too complex, and result in a giveaway of competitive information.

We disagree. As for expense, there should be no significant added costs to produce information that is—or should be—already prepared for management and the board of directors. If companies don't have this information, it raises questions about their financial systems.

Complex? Sure, and it's likely that some investors will neither understand nor appreciate more detailed disclosures. But the fact is that large public companies are complex operations with complex financial performance. Understanding their real performance prospects can come only with understanding the underlying complexity of their operations. Disclosures can be oriented to the sophisticated investors who ultimately drive share prices, with an expectation that transparency will ultimately prove more valuable to less sophisticated investors than simpler, yet more opaque, financial statements.

Companies should rightly be allowed to protect competitive information. In limited cases, some companies may need to opt out of certain disclosures that could damage their competitive position. Yet, we believe any argument that more complete financial reporting will produce widespread leakage of competitive information is, for the most part, bogus.

Chief executives and senior executives like to be able to smooth out their performance. They like to have the option of offsetting poor performance in one part of the company with good performance elsewhere. They like to be able to hide low organic growth by making acquisitions. But we are convinced that investors will be better served, and will trust companies more, only when companies drop their preference for accounting designed to produce a smooth, simple bottom line and opt to open up to investors the true complexity of their business. **MoF**

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