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# McKinsey on Finance

Perspectives for CFOs and other finance leaders

The more things  
change . . .

**Inside:** Macro scenarios, inflation navigation, headwind communication, and market responses to deals.

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# Table of contents

## 3 Item 1: This edition

---



## 4 2023: A look at macro scenarios

Inflation and global structural challenges could play out in a variety of ways.

---



## 32 Communicating headwinds and tailwinds

Investor relations should always address business-critical headwinds and tailwinds. But which do companies refer to more—and how does that choice affect market performance?

---



## 14 A playbook for navigating inflation

Managing through high inflation poses unique challenges. Lessons from effective leaders can help companies rise to the occasion.

---



## 36 ESG scores: Does change matter?

Changes to ESG scores seem to be correlated to total shareholder returns, but the result is not conclusive.

---



## 22 Why you can't tread water when inflation is persistently high

Inflation destroys value across almost every industry. When high inflation is persistent, companies that merely maintain the same margins and returns are likely to destroy value.

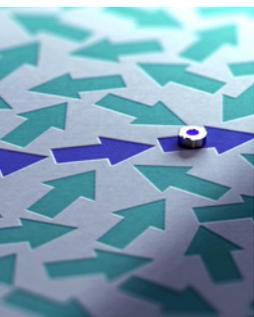
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## 40 Five insights for public company CFOs from private equity

CFOs of public companies can draw enormous insight from PE's focused, proactive approach to value creation—but they have to take the initiative themselves. Here are five lessons to get started.

---



## 27 Markets versus textbooks: Calculating today's cost of equity

Inflation is high and interest rates are climbing. But if you think the real cost of equity rises in lockstep with government bond yields, think again.

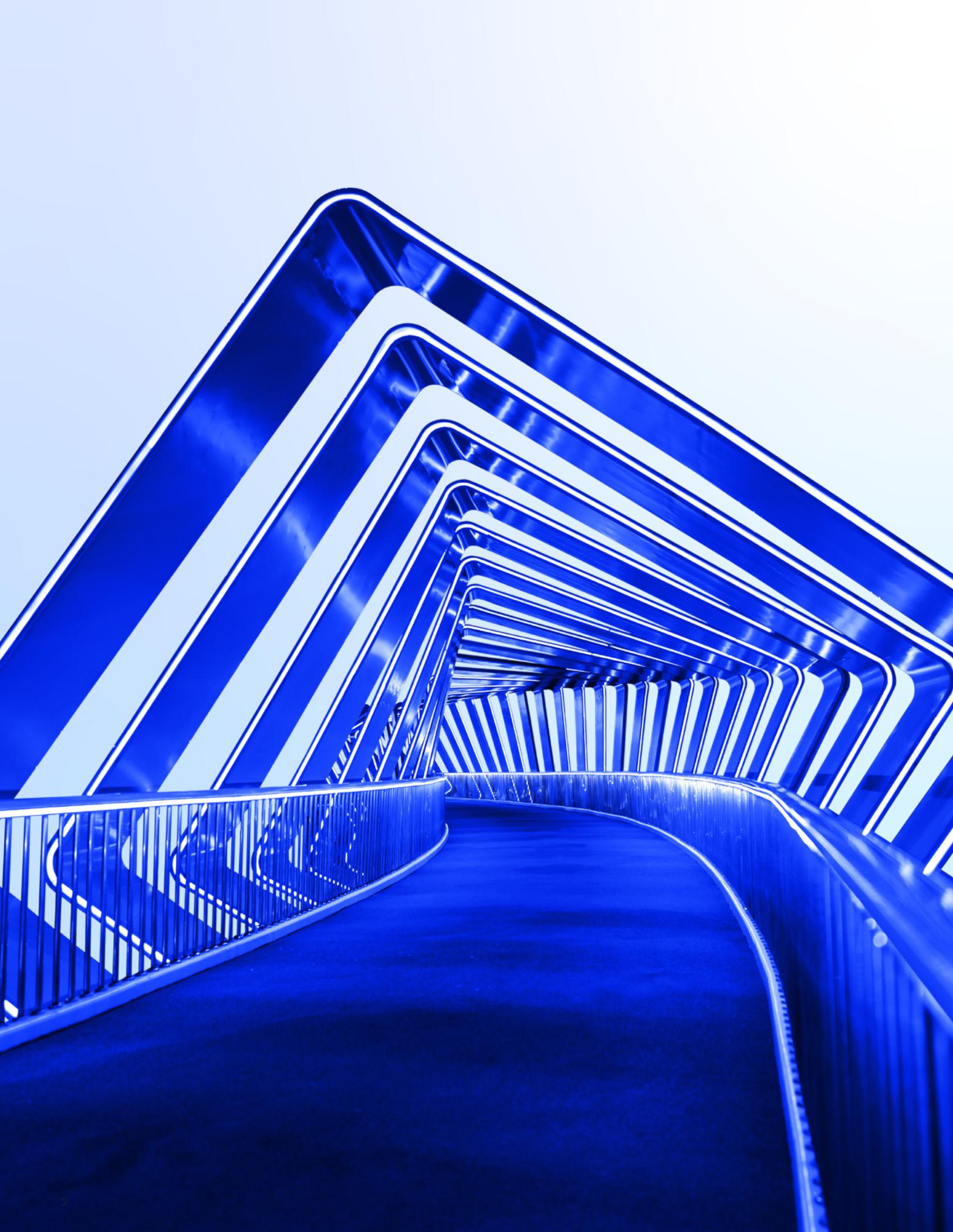
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## 46 Looking back

Initial reactions to M&A announcements

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# Item 1: This edition

**“There’s never one sunrise the same,”** Carlos Santana observed, “or one sunset the same.” It’s natural to look for historical parallels; there’s a good reason they’re called “history lessons.” But over the long term, every short-term period will be unique. A different set of priorities—similar but never identical to what’s come before—rapidly becomes immediate, and more distant challenges suddenly don’t seem too far away.

Today, it’s impossible to ignore inflation. In “2023: A look at macro scenarios,”<sup>1</sup> McKinsey experts examine the state of inflation in the wake of the challenging prior year and consider possible outcomes ahead. This edition of *McKinsey on Finance* also presents “A playbook for navigating inflation,”<sup>2</sup> highlighting practicable actions that senior leaders can take. My colleagues examine how *persistent* inflation can affect value, as well (“Why you can’t tread water when inflation is persistently high”). And “Markets versus textbooks: Calculating today’s cost of equity” explores the fallacy that government bond yields are a reliable proxy for the risk-free rate.

Speaking of markets—or to them—McKinsey experts have analyzed years of data and found that corporations, in their external communications, overwhelmingly tend to blame headwinds rather than give credit to tailwinds. That research, presented in “Communicating headwinds and tailwinds,” shows that even the companies that created the most value blame external developments, just like their peers.

Few developments have been under greater scrutiny lately than environmental, social, and governance (ESG) concerns. As a foundational matter, underlying ESG principles are essential for long-

term value creation. But what does that mean in practice? How important is it, from a value-creation perspective, for companies to improve their ESG scores? When in doubt, it never hurts to do some math. My colleagues compared changes in companies’ ESG scores with their total shareholder returns (TSR). The short answer to the question “ESG scores: Does change matter?” is that changes to ESG scores do seem to correlate mildly with market performance. A number of measurement challenges and caveats, however, make continued study a must.

For years, we’ve also been studying the lessons that private equity offers for public companies. Some of the most critical takeaways have become increasingly important for CFOs today, as my colleagues share in “Five insights for public company CFOs from private equity.” These best practices can inform a CFO’s business-specific plan.

All of which leads back to Santana’s observation on uniqueness: every development should be assessed on its own merits. In this edition’s concluding section, “Looking back,” we observe that initial market reactions to an announced deal can be imperfect indicators of whether that deal will actually create long-term value.

Sustainable value creation should always guide CFO decision making. Every day *is* different, but the more things change, the more the time-tested principles of finance and economics stay the same.

**Tim Koller** (Tim\_Koller@McKinsey.com)  
*Partner, Denver*

<sup>1</sup> Adapted from “2023, a testing year: Will the macro-scenario range widen or narrow?,” McKinsey, January 16, 2023.

<sup>2</sup> Adapted from Roman Belotserkovskiy, Ezra Greenberg, Asutosh Padhi, and Sven Smit, “Navigating inflation: A new playbook for CEOs,” *McKinsey Quarterly*, April 14, 2022.

# 2023: A look at macro scenarios

Inflation and global structural challenges could play out in a variety of ways.

*This article is a collaborative effort by Michael Birshan, Arvind Govindarajan, Ezra Greenberg, Homayoun Hatami, Sebastian Kohls, Ida Kristensen, María del Mar Martínez Márquez, Asutosh Padhi, Sven Smit, and Andy West, representing views from McKinsey's Strategy & Corporate Finance and Risk & Resilience Practices.*

This article is adapted from "2023, a testing year: Will the macro-scenario range widen or narrow?," McKinsey, January 16, 2023.



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**Volatility from macroeconomic** and geopolitical factors has dominated the business environment lately and tested management teams in ways that may once have seemed unimaginable. However, at the outset of 2023, energy prices are off their peaks, inflation is no longer accelerating, and economic growth appears to be holding up. These positive signs make it tempting to expect a narrower range of potential macro outcomes and, as in any new year, seek a fresh start. We see 2023 as a test of whether such a fresh start is now possible.

With geopolitical tensions high, key supply–demand imbalances unresolved, and interest rates on an upward march, business leaders may be contemplating whether comparisons to the 1970s are appropriate or if the path forward will resemble more familiar business cycles.<sup>1</sup> The best approach, we believe, is to consider possible scenarios, as leaders make practical decisions to achieve key goals.

## How the world ended up with the highest inflation in a generation

From March 2020 to November 2022, consumer prices rose nearly 16 percent in the United States, 15 percent in the eurozone and the United Kingdom, 16 percent in India, and 21 percent in Brazil.<sup>2</sup> These increases are two to three times greater than what would have been expected based on pre-COVID-19 outcomes. Even in Japan, which has been fighting deflationary pressures for decades, prices in November 2022 were up 3.8 percent during the previous 12 months, the highest monthly inflation rate recorded in more than 40 years.<sup>3</sup>

Many competing views have been offered about the current inflation's origins and the reasons for its persistence, but we see the facts as much simpler than the debate suggests. Recent work by economists at the Brookings Institution and the Federal Reserve Bank of San Francisco provide a useful analytical framework to explain the origins of US consumer price inflation, which we adapt here.<sup>4</sup> In addition to approximately 2 percent normal annual inflation, the following three factors should be considered:

- **The direct impact of commodity shocks and supply chain dislocations:** disruptions in oil, gas, and basic food markets, and supply–demand mismatches (for example, when semiconductor shortages caused used-car prices to spike).
- **The pass-through of businesses' higher material costs:** commodity shocks and supply chain dislocations slowed production and raised business material costs.
- **The pass-through of higher wage costs:** the shock to labor markets led to a doubling of wage growth as businesses competed for scarce workers to meet surging demand.

Inflation over the past three years demonstrates the above factors in action. In 2020, the economic collapse, unprecedented stimulus programs, and surprise V-shaped rebound left US inflation at about 2 percent. Then, in 2021, inflation initially picked up steam as pent-up demand from pandemic lockdowns bumped up against commodity market and supply chain dislocations, and businesses began raising

<sup>1</sup> This analysis complements our published perspectives on global energy markets. See, for example, the role that US natural gas could play in solving the global energy crisis: Michael Dalena, Dumitru Dedi, Luciano Di Fiori, and Brandon Stackhouse, "How North American natural gas could alleviate the global energy crisis," McKinsey, November 16, 2022; how Germany might develop a safe, sustainable power supply by 2025: "Electricity price reduction to competitive level feasible by 2025," McKinsey, December 5, 2022; and our longer-term perspective on the energy transition: *Global Energy Perspective 2022*, McKinsey, April 26, 2022.

<sup>2</sup> McKinsey analysis of data from the Brazil Institute of Geography and Statistics, Eurostat, Haver Analytics, India Ministry of Statistics and Programme Implementation, UK Office of National Statistics, and US Bureau of Labor Statistics.

<sup>3</sup> Inflation in Japan reached 4 percent in January 1991, according to McKinsey analysis of Bank of Japan data.

<sup>4</sup> Laurence Ball, Daniel Leigh, and Prachi Mishra, "Understanding US inflation during the COVID era," Brookings Institution, September 7, 2022; Regis Barnichon, Luiz E. Oliveira, and Adam H. Shapiro, "Is the American Rescue Plan taking us back to the '60s?," FRSFB Economic Letter, Federal Reserve Bank of San Francisco, October 18, 2021.

prices. Energy prices were still elevated when concerns about a Russian invasion of Ukraine drove them even higher at the end of 2021, ultimately bringing US inflation close to 9 percent. In 2022, these factors were compounded by and eventually overtaken by demand-driven wage pressures, which became the dominant driver of inflation (Exhibit 1)—and inflation expectations rose.

If US inflation had increased each year along with 2.2 percent pre-pandemic annual expectations,<sup>5</sup> then by the end of September 2022, the level of prices would have been 6.2 percent higher. Only it wasn't. The total increase in the price level since January 2020 was 14.9 percent. Two-thirds of those extra 8.7 percentage points can be credited, either directly or indirectly, to commodity and supply chain

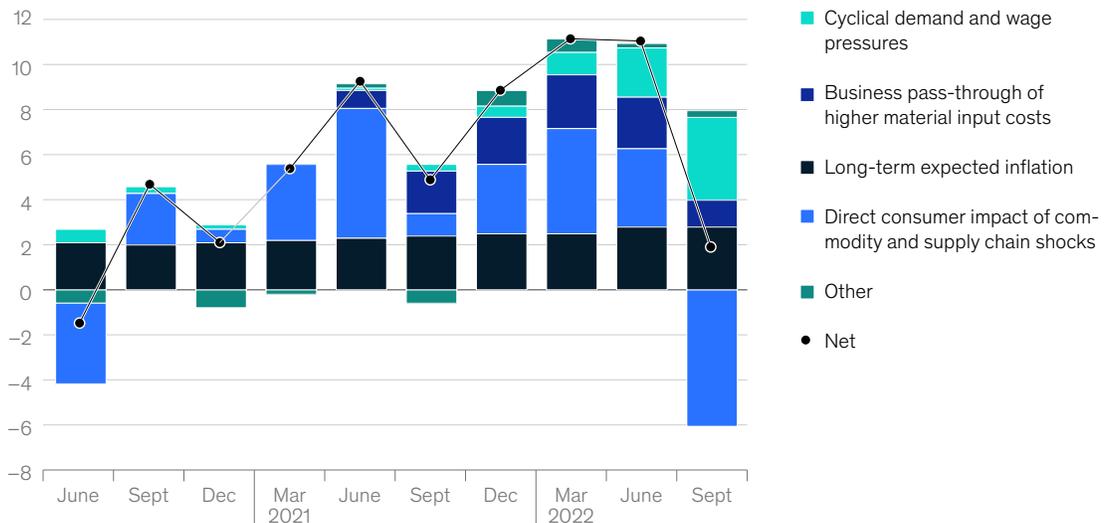
shocks (Exhibit 2). The remaining third was largely the result of an increase and shift in the composition of demand that outstripped companies' capacity to produce and the wage and price increases that followed. This demand was supported by stimulus programs, accumulated savings, and accommodative monetary policy.

The eurozone story starts in the same way, with inflation rising because of pandemic-era commodity and supply chain shocks. Unlike in the United States, policy makers and business leaders in the eurozone were able to keep workers attached to their jobs through existing furlough programs and job subsidy channels that reduced labor market disruptions and wage inflation.<sup>6</sup> However, the impact of the Ukraine invasion on eurozone inflation was

Exhibit 1

### Supply shocks and demand-driven wage pressures have taken over as dominant inflation drivers, and US inflation is no longer accelerating.

US consumer price inflation, % (3-month annualized change)



Source: Federal Reserve Banks of Cleveland and Philadelphia; Laurence Ball, Daniel Leigh, and Prachi Mishra, "Understanding US inflation during the COVID era," Brookings Institution, Sept 2022; Regis Barnichon, Luiz E. Oliveira, and Adam H. Shapiro, "Is the American Rescue Plan taking us back to the '60s?," FRSFB Economic Letter, Federal Reserve Bank of San Francisco, Oct 2021; US Bureau of Labor Statistics; McKinsey analysis

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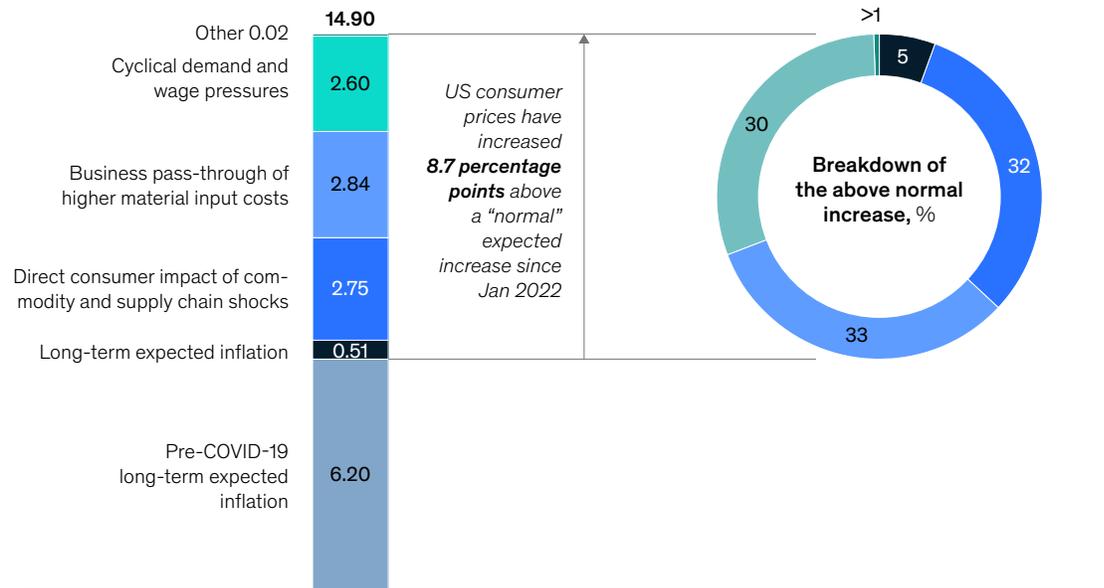
<sup>5</sup> McKinsey analysis of data from Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters.

<sup>6</sup> Thomas Klitgaard, "How have the euro area and U.S. labor market recoveries differed?," Liberty Street Economics, Federal Reserve Bank of New York, March 30, 2022.

Exhibit 2

**Nearly two-thirds of the ‘above normal’ price increase in the United States has been driven, directly or indirectly, by supply shocks to consumer prices.**

**US consumer price index (CPI) increase Jan 2020–Sept 2022, by source, percentage points**



Source: Federal Reserve Banks of Cleveland and Philadelphia; Laurence Ball, Daniel Leigh, and Prachi Mishra, "Understanding US inflation during the COVID era," Brookings Institution, Sept 2022; Regis Barnichon, Luiz E. Oliveira, and Adam H. Shapiro, "Is the American Rescue Plan taking us back to the '60s?," FRSFB Economic Letter, Federal Reserve Bank of San Francisco, Oct 2021; US Bureau of Labor Statistics; McKinsey analysis

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far greater than in the United States, dramatically raising energy prices across the continent. Consequently, eurozone inflation has been almost exclusively caused by the continued direct impacts of energy supply shocks combined with the aftermath of supply chain disruptions, and the pass-through of these costs by businesses.

**Scenarios for what could happen next**

When the pandemic struck, the primary sources of uncertainty for individuals, businesses, and governments were the impact of the virus’s spread and the effectiveness of responses. Other concerns just had to wait. When Russia invaded Ukraine, uncertainty regarding the duration and scale of the disruption, sanctions, and policy responses was the focus.

Today, a complex and varied set of forces is potentially introducing a new era, with multiple sources of risk, opportunity, and potential transformation. Leaders must weigh how the world order, technology, demographics, energy and resources, and capital will evolve and affect their businesses (see sidebar “The ‘cusp’ and McKinsey’s economic scenario framework”). With these forces in mind, there are two primary dimensions that define McKinsey’s new scenario framework.

- The first dimension is *the state of long-term structural balance and international cooperation*. This dimension captures how well the supply of materials and manufactured goods, and the people, data, and capital they require, can satisfy global demand at affordable prices. It is strongly influenced by local regulations that

## The ‘cusp’ and McKinsey’s economic scenario framework

### A McKinsey Global Institute (MGI)

article<sup>1</sup> published in October 2022 discusses five dimensions that capture the history of epochal shifts across three different eras: the postwar boom (1944–71), the era of contention (1971–89), and the era of markets (1989–2019). The article asks whether the evolution of these dimensions has put the global economy on the cusp of a new era. Questions include the following:

- **World order:** Is there a tendency toward multipolarity, which may lead to regionally and ideologically aligned groups? What does multipolarity imply for trade systems and global economic growth?
- **Technology platforms:** The key drivers of the most recent era’s digitization and connectivity may be approaching saturation, which could reduce productivity. Will already potent transversal technologies, particularly artificial intelligence and bioengineering, contribute to another surge of progress?
- **Demographics:** How will countries, institutions, and individuals adapt to demographic changes? Will people age “gracefully” and be able to maintain economic growth, even as populations’ proportions of retirees rise?
- **Resource and energy systems:** Underinvestment combined with geopolitical disruption have recently created real vulnerability. How will the world navigate an affordable, resilient, and feasible path to climate stability and energy security?

- **Capitalization:** Economic growth rates appear to be normalizing while asset valuations have risen considerably. What will the next productivity engine be to drive growth? Will the rise of the global balance sheet be reversed?

To design McKinsey’s macroeconomic scenarios, we focused on two dimensions to structure a set of scenarios that capture the macro factors most relevant to business leaders. The first dimension captures largely predetermined states, broadly framing the different operating environments businesses are likely to face. The second dimension accounts for the most important choices that individuals, businesses, and governments face. How these exogenous factors and choices come together and interact will determine the outcomes (through 2030) depicted in the scenarios.

Applying the MGI report’s five dimensions to this framework, *demographics* have both an exogenous component and are part of the outcome: everyone who will affect the economy through 2030 has already been born, but people will also choose how to build their lives and participate in the workforce depending on the opportunities presented. For any single country, world order can be considered largely beyond their control. Even though each country’s decisions affect the evolution of the *world order*, it’s the interaction of all decisions that creates the global operating environment.

The evolution of *technology platforms* and *resource and energy systems* depends upon the choices that individuals,

businesses, not-for-profits such as nongovernmental organizations (NGOs) and universities, and governments make to invest in the future. *Capitalization* is the outcome of a complex interaction of all these forces.

The first dimension of our scenario framework, *the state of long-term structural balance and international cooperation*, captures demographics and different states of the world order, which include broad international regulatory frameworks. The second dimension, *the short-term level of fiscal support and state of monetary policy*, will have a strong influence on the choices made by individuals, businesses, and not-for-profit organizations (including NGOs and universities) to invest in technology platforms and resource and energy systems. Both dimensions will affect capitalization.

<sup>1</sup> Chris Bradley, Jeongmin Seong, Sven Smit, and Jonathan Woetzel, “On the cusp of a new era?,” McKinsey Global Institute, October 20, 2022.

determine supply responses as well as by the institutions and frameworks that govern diplomatic relations and international exchange. A key example of an issue within this dimension is how effectively the world can establish the regulations and relationships required to deliver an affordable energy transition.

- The second dimension is *the short-term level of fiscal support and state of monetary policy*. This dimension captures how well government spending and market-based incentives are targeted. It also captures how central banks affect the availability of credit and overall financial conditions. It is strongly influenced by national political dynamics. A key example of an issue within this dimension is how effectively current moves by central banks can rein in inflationary pressures.

How these two dimensions vary and interact shape choices made by individuals, businesses, and

not-for-profits (including nongovernmental organizations [NGOs] and universities) to spend, invest, and pursue innovative solutions. The interplay between dimensions will largely determine the range of macroeconomic outcomes in McKinsey's new global scenarios, including how fast productivity, wages, and profits might grow; how labor force participation could rise or fall; how much consumers may spend and businesses invest; what heights inflation may reach; and how affordable the energy transition could be.

The following two scenarios, labeled A1 and C2, depict the range of outcomes that CEOs and their executive teams will most likely need to consider entering 2023. A third scenario, C3, portrays a sobering downside reminiscent of the economic experience of the 1970s (see sidebar "The C3 scenario: Deep recession, long-term growth limitations, and significant regime change in inflation management"). A recent tally of economic forecasts shows a wide range of GDP growth estimates for 2023, from a low of -1.4 percent

## The C3 scenario: Deep recession, long-term growth limitations, and significant regime change in inflation management

In the C3 scenario, commitments to global cooperation are in jeopardy. Divergent interests stymie the development of institutions and diplomatic frameworks that enable the global flow of goods, ideas, and capital. This severely limits access to critical sectors and hinders the expansion of global supply. The conflict in Ukraine and other international tensions continue and may escalate further, with negative implications for global markets.

In the face of continued supply shocks, policy makers in the eurozone and the United States find themselves unable to act

effectively. As political tensions and conflicts within countries increase, fiscal policy is ineffective at promoting the investment needed to resolve near-term energy supply-demand imbalances. Central banks raise interest rates further in an attempt to bring inflation under control. As political pressure in the face of economic challenges mounts, central-bank independence is compromised, and central banks abandon their low-inflation targets. This "regime change" allows inflation to settle at a higher level of around 7 percent per year.

The fracturing global order and lack of investment lead to continued supply shortcomings. The transition to permanently higher inflation proves costly, as many existing stabilization policies (such as tax structures and social transfers) are not designed to cope. As inflation outstrips wage growth, real wages and household incomes decline, deepening the downturn. This not only leads to a severe recession, but also limits growth post-2025. The US economy delivers no more than 1 percent annual real GDP growth, and the eurozone's GDP stagnates.

to a high of 1.2 percent in the United States, and –0.8 to 0.8 percent in the eurozone.<sup>7</sup> The McKinsey scenarios illustrate this range and include additional downside risks that should be considered.

### The A1 scenario: ‘Soft landing,’ accelerating into prosperity with target inflation

In the A1 scenario, individuals, businesses, and governments renew their commitments to accelerating global cooperation. Societies commit to absorbing the costs of ensuring resilience, reliable access to critical sectors, the vitality of local

economies and communities, and promoting regulations that expand affordable supply. The conflict in Ukraine and other international tensions escalate no further and perhaps even begin to wind down.

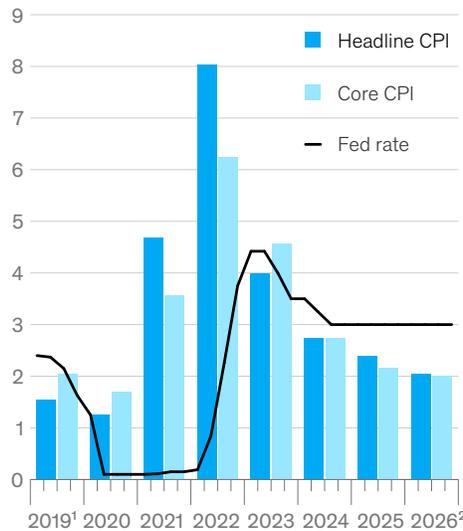
Economic policy makers in the eurozone and the United States create incentives to boost public- and private-sector investments that help resolve near-term energy supply–demand imbalances. Coordinated actions by central banks steer 2023 without a recession. Inflation begins returning to central bankers’ 2 percent targets (Exhibit 3), and real GDP growth accelerates to approximately 3 percent as growth returns.

Exhibit 3

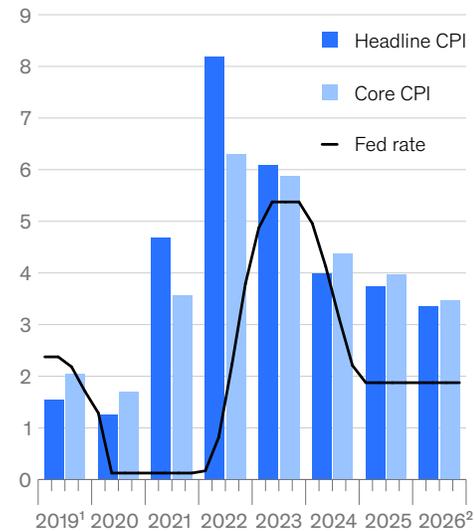
## US inflation will remain high in 2023–24 even if the Fed is successful in bringing longer-term inflation down.

Jan 2023 McKinsey scenarios for US consumer price inflation (CPI) and the US federal (Fed) funds rate

Scenario A1, %



Scenario C2, %



<sup>1</sup> CPI CAGR 2014–19 (Fed funds rate 2019 only).

<sup>2</sup> CPI CAGR 2025–30 (Fed funds long-term neutral rate 2026–30).

Source: National statistics agencies; McKinsey analysis, in partnership with Oxford Economics

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<sup>7</sup> McKinsey analysis of Bloomberg data as of December 20, 2022; 63 institutions for the United States and 30 institutions for the eurozone reported forecasts for 2023.

The commitment to global cooperation and effective economic-policy choices together create long-term incentives for investment and innovation and deliver strong productivity growth and supply expansion. This helps counter the demographic headwinds of aging societies and enables an affordable energy transition. Post-2025, a sense of shared prosperity emerges as the US economy delivers more than 3 percent annual real GDP growth, the eurozone maintains growth well above 2 percent, and the income from this growth benefits stakeholders across society.

rules to address the effect of outsourcing on local economies, the vulnerabilities of concentrated dependence on raw materials, and the system's lack of resilience. The conflict in Ukraine continues to reinforce these vulnerabilities.

Amid this more difficult international environment, central banks in the eurozone and the United States move more aggressively against inflation, tipping these economies into recession in 2023. Despite the purposeful slowdown, inflation comes down only gradually, forcing central banks to abandon their 2 percent targets to avoid a prolonged downturn. Inflation persists at 3.5 percent or higher, while growth in the short term recovers to about 2 percent in the United States and the eurozone (Exhibit 4).

The combination of stagnating global economic cooperation and more restrictive economic-policy choices create poor long-term incentives and slow the rates of investment and innovation. This

### The C2 scenario: Deep recession followed by anemic growth with entrenched higher inflation

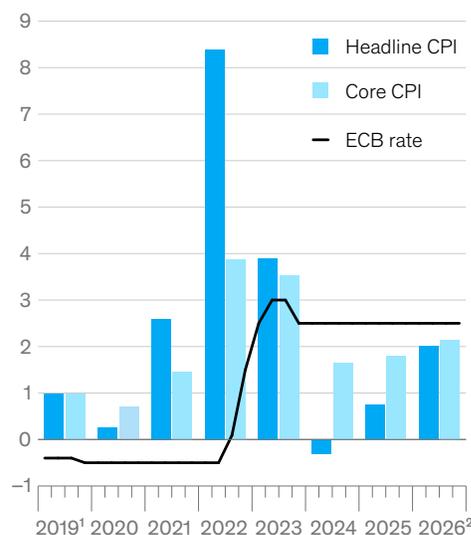
In the C2 scenario, individuals, businesses, and governments determine that the costs of global cooperation outweigh the benefits. Interregional flows stagnate amid disagreement over new

Exhibit 4

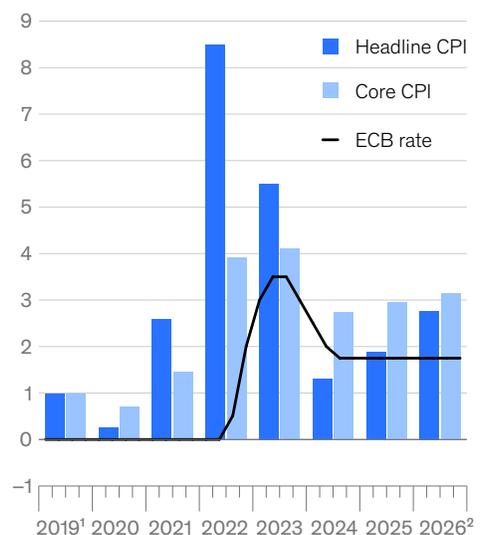
### Eurozone inflation has been heavily affected by energy prices, reflected in the split between headline and core CPI.

#### Jan 2023 McKinsey scenarios for eurozone consumer price inflation (CPI) and European Central Bank (ECB) policy rate

Scenario A1, %



Scenario C2, %



<sup>1</sup> CPI CAGR 2014–19 (Federal funds rate 2019 only).

<sup>2</sup> CPI CAGR 2025–30 (Federal funds long-term neutral rate 2026–30).

Source: National statistics agencies; McKinsey analysis, in partnership with Oxford Economics

# Business leaders can use scenarios to sharpen insights by analyzing longer-term success factors before zeroing in on the near term.

weakens productivity growth and makes it harder to produce the technology required for an affordable energy transition. In this scenario, investment in energy technology and renewables is insufficient to scale new technologies, creating more reliance on fossil fuels, so global oil prices reach \$130 a barrel. Slow growth after 2025 makes it harder to deliver on the promise of inclusivity. The US economy experiences only about 1.7 percent annual real GDP growth, while growth in the eurozone is stuck below 1 percent.

## Scenario-informed perspectives help build strategic insight, commitment, execution, and resilience

Management teams can thrive rather than merely survive in this volatile environment by building both resilience and boldness in their organizations. Leaders who are both prudent and bold hone their organizational performance edges in three ways: in being sharper on insights, deepening their commitment, and accelerating their execution.

Business leaders can use scenarios to sharpen insights by analyzing longer-term success factors before zeroing in on the near term. McKinsey's new scenarios show a wide range of potential GDP growth rates for 2025–30, and leaders need to understand whether alternative growth outcomes require a fundamental change in where and how they choose to compete. Consider two real-world examples, the first of which highlights a company for which strategy hinges on macroeconomic

outcomes, and the second of which demonstrates the opposite.

- A container shipping terminal operator is emerging from the pandemic surge in container volumes, which produced never-before-seen operational challenges along with record profits. This record volume won't continue, but there is a fundamental question about whether the terminal operator will see a permanent increase in volume momentum relative to the slowdown experienced since the financial crisis. How volumes are expected to play out will be critical to determining strategy for 2023 and beyond.
- A polyethylene manufacturer faces the prospects of an accelerating energy transition, carbon taxes becoming a reality, and increasing consumer demand for green products. How strong that demand will be is certainly a question, but the real strategic challenge is that the fundamental technologies to compete in this new world are still on the R&D bench. The critical question is whether the executive team and their stakeholders have real conviction that green plastics are the future.

Individual industry growth matters and will be influenced by overall GDP, but the moves a company chooses to make and how it responds to trends make the biggest difference to performance.<sup>8</sup> These scenarios can help provide the foresight that can improve the odds of success. Working with these scenarios can also help executive teams build

<sup>8</sup> Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds*, Hoboken, NJ: John Wiley & Sons, 2018.

shared conviction about their operating and competitive environment and, consequently, act more decisively when it's time to commit, be bold, and accelerate execution; or hold back, remain agile, and preserve optionality.

We believe that the effort to build commitment and resilience around scenarios and scale execution should be planned in a separate effort that reports directly to the CEO and by design avoids disrupting current operations. This plan-ahead team must also evaluate what new infrastructure and people may be needed to execute against multiple scenarios in existing business processes recognizing that key capabilities (for example, financial planning and analysis) may require additional resourcing. With the

right prioritization, leadership commitment, and shifts in organizational incentives in place, the new plan-ahead initiatives can be executed with confidence and speed.

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Many business leaders see 2023 as a continuation of the most challenging environment management teams have ever faced—and for good reason. The scenarios we have shared can help give you the insight into the range of operating environments you could face, the opportunities and risks of the commitments you make, and where you need the discipline and strength to accelerate execution and build resilience.

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# A playbook for navigating inflation

Managing through high inflation poses unique challenges. Lessons from effective leaders can help companies rise to the occasion.

*by Asutosh Padhi, Sven Smit, Ezra Greenberg, and Roman Belotserkovskiy*

This article is adapted from “Navigating inflation: A new playbook for CEOs,” *McKinsey Quarterly*, April 14, 2022.



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**In the first months** of 2022, it became increasingly apparent that inflation rates well above the approximately 2.0 percent that planners had come to expect (and central banks had targeted) would prevail for months to come. Whether and for how long high inflation will persist is still uncertain. Following a well-established inflation management playbook, central banks worldwide raised interest rates to temper demand and are regularly issuing statements to try to keep future inflation in check. Two years of higher inflation is a long time for business leaders. The ad hoc crisis response that many have been following thus far is reaching the end of its usefulness.

Like central bankers, senior leaders need an inflation management playbook. They can start scripting it by asking themselves and the senior leaders of key operational areas the following questions:

- Where will customers see value in this new environment? How can we design products, services, and experiences to deliver this value?
- What is the fastest way to stabilize and redesign stretched and, in some cases, broken supply chains? What capabilities will I need to increase my company's resilience and control costs?
- What direction should I give to help procurement leaders create value?
- How is the new talent landscape affecting compensation, benefits, and workplace norms? What can I do to attract and retain employees in today's shifting labor market?
- How should I pursue repricing in an inflationary environment? How can I form a through-cycle and strategic mindset for my customer relationships?
- How can I set priorities and organize to direct all this activity?

In this article, we draw upon our work with hundreds of companies and tap into deep research to construct an inflation playbook that should help senior leaders no matter what direction inflation takes. Remember, during the height of the COVID-19 pandemic, companies demonstrated their ability to reinvent

themselves more quickly and thoroughly than they had once thought possible. They can do that again.

## **Redesign product and service offerings for value and availability**

CEOs know that design choices for products and services are critical for responding to the volatility of commodities, the scarcity of components, and higher production and servicing costs—all while maintaining the core functionality customers require. Consider these examples of agile approaches that best-practice operators across sectors have used:

- **Rapidly redesign products and services to adjust to new realities.** One industrial-technology company redeployed more than 50 percent of a single unit's engineering capacity to rapidly redesign products so that they used semiconductors available in the market. Automotive manufacturers facing semiconductor shortages "de-featured" products to maintain production and sales in the face of these shortages.
- **Challenge specification orthodoxies.** Faced with historically high costs for lumber and other inputs, a manufacturer redesigned many products to specifications that overseas manufacturers could reliably meet. In this way, it reduced its dependence on high-cost regional suppliers—and dramatically simplified its product portfolio.
- **Redesign the way you provide service.** With transportation costs increasing rapidly, so is the value of loading trucks and containers efficiently. A manufacturer used its engineering expertise and tailored digital tools to completely rethink packaging and the loading of packages. It reduced costs significantly as a result of reduced freight demand.
- **Promote near-substitutes.** Consumer-packaged-goods companies identify product substitutes—often private-label equivalents that can be sold at lower costs than branded products. These substitutes maximize margins and increase the value to customers.

# In many cases, only the CEO can break down the barriers to innovation and reward the organization for taking risks counter to typical incentives.

Mobilizing cross-functional expertise to quickly identify and implement alternative solutions to product and specification challenges will be the key for companies that seek to mitigate scarcity and the impact of inflation. In many cases, only the CEO can break down the barriers to innovation and reward the organization for taking risks counter to typical incentives. Leading their organizations' reimagined design is an opportunity for CEOs to nimbly implement short-term tactics to cope with inflation and capture the longer-term opportunity to forge stronger relationships with customers.

## **Clean-sheet and build digital, integrated, transparent, and agile supply chains**

Well before the invasion of Ukraine in February 2022, new tariff regimes and increasing shipping and trucking rates that emerged during the pandemic had called into question the old-school thinking that made cost optimization the primary goal of managing supply chains.

In 2021, our research and discussions with hundreds of supply chain leaders found that an overwhelming majority had problems in their global manufacturing and supply footprints. Global shipping costs have risen significantly. In response, many companies moved to increase inventories and find new sources for raw materials. But far fewer have successfully tackled such difficult tasks as reducing the number of SKUs and diversifying their manufacturing base. The global response to Russia's invasion of Ukraine means that supply chains are further strained: air carriers are using alternate, often less-direct routes

because of airspace closures, shipping companies are suspending activities near the conflict zone, and many multinationals are scaling down or stopping operations in Russia.

The logistics of carriers and gnarly supply chain topics had once been the exclusive domain of backroom spreadsheet managers. Today they are standard topics around C-suite and boardroom conference tables. We see several critical issues that CEOs should push their teams to pursue aggressively.

### **Make your entire supply chain visible**

Just under half of the companies that we surveyed say they understand the location of their tier-one suppliers and the key risks those suppliers face. Remarkably, only 2 percent make the same claim about suppliers in the third tier and beyond. That matters because many of today's most pressing supply shortages, such as semiconductors, happen in these deeper supply chain tiers and can be solved only by understanding industry dynamics at the "tier-n" level.

CEOs must push their organizations to collect the data required to create this n-tier mapping and prioritize suppliers by the importance to their business. Who should the CEO be calling on personally to ensure they cement critical relationships?

### **Identify and manage potential supply chain risks**

Depending on a company's sector and needs, CEOs must factor in a range of risks, including those involving finance, regulation, reputation, and data security. Operational-risk management is

particularly important: examine the vulnerabilities inherent in the concentration of suppliers in the same area and the visibility of operations and processes, labor, manufacturing, and delivery. Do you have a transparent view of the parts of the value chain exposed to internal or external disruptions? Are you confident that controls are in place and options are available to minimize the impact of these risks?

### **Make seamless end-to-end planning a CEO priority**

End-to-end planning involves several things. On the supply and demand side, companies must plan for longer lead times and earlier ordering. The financial implications of increased transportation, energy, and materials costs on working capital must be understood. The reorder points and stock of critical materials in inventory have to be reviewed. Production programs must be reprioritized in the event of foreseeable shortages.

CEOs recognize that all of this entails investment for which there needs to be a return. Will customers pay a premium to ensure the availability of goods? Will suppliers accept cost sharing to lower the risk of disruption in demand for their products while balancing these costs by raising their own productivity? The CEO's most difficult task may be persuading investors to accept resiliency as the new table stakes and to change their view of expected risk-adjusted returns. The good news is that digitalization will likely play an important role in answering these questions, and digital efforts often pay back their costs in 12 months.

### **Transform procurement to create value, not just cut costs**

Over the past two years, critical supplies have been scarce or even unattainable at any cost within needed lead times. Prices for nearly all supplies have been rising in tandem globally, and labor market disruptions have affected nearly everyone. Procurement leaders have told us repeatedly that this is the toughest market environment in at least 20 or 30 years. New and changing circum-

stances have upended decades of procurement practices and management capabilities honed to globalization and just-in-time deliveries.

CEOs are beginning to recognize that purchasing leaders can be full-fledged strategic partners by expanding their focus from the cost of goods sold (COGS) to creating value and helping the enterprise succeed. In response to these needs, procurement leaders have implemented, in weeks, actions that previously would have taken months and years. Some examples follow:

- *Expanding focus to 'everything is in play.'* In response to the scarcity of contracted labor and higher prices from suppliers, the supply chain team of one electric utility partnered with procurement to redesign end-to-end engineering and construction workflows. This change tightened governance, maximized demand, simplified requirements, changed how work was allocated, and put in place new contractor management processes. These moves all helped to ease inflationary pressures.
- *Basing contracts on the current reality.* An industrial manufacturer faced across-the-board cost increases from suppliers. In response, it documented every such rise in fine-grained detail to better understand the exact cost drivers of each product or service, to improve internal cost models, and to build better contracts indexed to the right commodities and input costs.
- *Rethinking logistics and geographic sources.* Facing challenges to product deliveries from Asia, one electronics manufacturer increased sourcing of production in the United States and Mexico. Another purchased its own fleet of aircraft to deliver products from Asia to end-user markets.
- *Considering vertical integration.* Retailers are making acquisitions to control value chains for key products. Automotive manufacturers are contracting directly with foundries to reserve capacity. Energy producers and utilities

are exploring investments to onshore the manufacture of key production components for renewable energy.

— ***Investing in technology and process automation.***

Taking a page from law firms, a mining company shifted its technical-services contractors to 15-minute increments for billing and gave them the technology needed to track their time. By minimizing the rounding up of hours, the company saved 5 to 8 percent of costs across contractor trades.

CEOs can empower procurement leaders who are uniquely positioned to integrate a deep understanding of the business with supply market insights. These leaders can play a more central coordinating role across operations, finance, commercial, and other functions and thus help the broader enterprise become more efficient and resilient.

### **Adjust to the new talent game**

Employee wages and benefits are one of business's biggest costs. Wage increases put pressure on a company to maintain margins potentially by increasing prices. At the same time, wages and benefits are one of the most important levers employers have to attract and retain employees and help them ensure that they can provide for themselves and their families in a higher-inflation environment. The progression of wages and benefits are top of mind for CEOs and CFOs alike.

In a tight labor market, the departure and mobility of workers creates wage and inflation pressures as companies compete for workers.<sup>1</sup> Understanding why employees are leaving their jobs is the first move for CEOs trying to play the new talent game. Workers we surveyed across seven countries believe that the cost of switching jobs has gone down significantly and that there is much less stigma attached to gaps in a résumé. People who voluntarily left their jobs without having another in

hand cited factors such as uncaring leaders, unsustainable expectations of work performance, and a lack of career advancement. In the current labor market, employees believe they can find work whenever they are ready for it.

To rebuild relationships and retain current employees while attracting new ones, CEOs must guide their companies to take a new approach to talent, focusing on the following core principles.

#### **Don't believe it's enough to rethink compensation and benefits**

Market compensation and benefits packages are just the ante. To attract and retain disillusioned employees, companies can't just write one big check after another and expect that to be successful. Leaders must simultaneously pay constant attention to both compensation and cultural factors.

There is no one right way to reimagine compensation; some trial and error will be involved. With pay transparency at an all-time high, companies run the risk that a salary misstep could prompt even more departures. Think about how your company can help employees find the sense of purpose and belonging that can make it more attractive to join and, ideally, more attractive to stay. Subsidizing services such as childcare—in the office or in a hybrid setting—could help employees with some of the competing demands of work and home.

#### **Make your work model 'sticky'**

How can CEOs help their management teams shift focus to anticipating and addressing the concerns of employees by fostering a sense of inclusion, psychological safety, and community? Exit interviews won't go away, but why not add "stay interviews" that ask people how they're doing, what they need, and what aspirations they may have for other roles?

Frontline managers may be encouraged to try scheduling, staffing, and hiring innovations. Some companies have tried offering "well-being" bonuses to employees or providing them with extra days

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<sup>1</sup> Renato Faccini, Leonardo Melosi, Russell Miles, "The effects of the 'Great Resignation' on labor market slack and inflation," Chicago Fed Letter, No. 465, February 2022.

off for professional development or mental-health breaks. One theme park and entertainment company offered to pay 100 percent of the tuition costs for employees seeking higher education.<sup>2</sup>

### **Find nontraditional and ‘latent’ workers**

In the United States alone, tens of millions of people already in the labor force (either working or looking for work) don’t have four-year college degrees but have or can develop the skills that employers need to get the job done. These include students, part-time or contract (or gig) workers, people in one-person start-ups, and people who are not actively seeking traditional jobs at traditional employers but might want jobs under the right conditions. And this could be the moment to bring back the record number of women who left the workforce during the pandemic.<sup>3</sup> To reach these women and men, companies must actively challenge the barriers to entry, rethink role requirements, and change the process of searching for employees.

A CEO can signal the importance of these new possibilities by taking a lead role in reporting the feedback the organization is hearing, transparently setting the goals and aspirations for change, and directly participating in important hiring and retention activities with employees.

### **Set prices to strengthen customer relationships**

It’s a fundamental question in inflationary environments: What to do about pricing? As costs rise, repricing to sustain margins is nobody’s idea of a good time; it is typically unpleasant for companies and worse for customers. But CEOs have a chance to reframe customer relationships strategically by viewing repricing as an opportunity to forge deeper relationships with customers. The CEO can direct these conversations toward sharing common challenges and helping management to meet both their anti-inflation goals and those of their peers.

CEOs and CFOs can ask a number of questions to help surface opportunities for strategic repricing:

*How can we adjust discounting and promotions and maximize nonprice levers?* Companies that consistently address total customer and product profitability are likely to weather inflationary cycles better than those that focus solely on cost changes. A manufacturing company facing a surge in demand for high-cost, low-volume products, for example, lengthened its lead times, especially for custom products with lower margins. Sales teams were trained to explain the new service levels and encourage customers to opt for more standardized alternatives. The result was an overall productivity increase that maintained margins without price increases.

### *Can analytics help us personalize more effectively?*

Best-in-class companies typically ground their price increase recommendations in analytics. These organizations examine their customers’ end-to-end profitability, willingness to pay relative to a comparable peer set, and the margin performance (at a product and service level) expected from price changes. Retailers have long used personalization tools to tailor promotions; B2B companies now have dynamic segmentation tools that allow them to do the same.

### *Can we communicate our value more effectively?*

Raising prices in response to inflation is seldom a one-and-done move; it is full of unintended and unexpected consequences. Companies that manage price increases well often have a council of cross-functional decision makers who can respond quickly to feedback from customers and markets.

Taking advantage of the opportunity to forge new pricing relationships with customers in a higher-inflation environment will test many CEOs in their role as the ultimate integrator of the enterprise. Keep inflation high on the company’s agenda with

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<sup>2</sup> Timothy Bella, “Dolly Parton’s Dollywood says it will pay all tuition costs for employees pursuing higher education,” *Washington Post*, February 9, 2022.

<sup>3</sup> Kweilin Ellingrud, “What we lose when we lose women in the workforce,” McKinsey, June 3, 2021.

# Keep inflation high on the company's agenda with regular communication and role modeling, particularly with the leadership of sales and the frontline sales teams.

regular communication and role modeling, particularly with the leadership of sales and the frontline sales teams. Keep one eye on short-term margins and price fluctuations and the other on strengthening ties with customers and communicating value more effectively.

## **An inflation program management office**

Managing the implications of inflation across a broad operational landscape calls for a cross-functional, disciplined, and agile response. During the pandemic, many CEOs instituted response nerve centers, flexible structures with enterprise-wide authority to coordinate the response to and return from the pandemic and to test approaches to recovery. Similarly, some companies erected inflation nerve centers to manage the potential downside of inflationary pressures by breaking down silos, enhancing transparency between functions, and concentrating on the crucial leadership skills and organizational capabilities required to get ahead of events rather than react to them.

Failing to coordinate across functions can have expensive consequences. A company that relied on monthly meetings among supply chain, operations, and procurement teams needed more than 30 days to decide on its action plan to counter inflation. Then, an additional 30 days were required to execute. During those two months, raw-material prices

increased by almost 50 percent. Monthly business reviews or quarterly supplier workshops are not enough to handle fast-moving price changes, fluid negotiations with suppliers and customers, and the internal adjustments such pressures require.

We believe that CEOs should opt for a more proactive, durable management office for their inflation program. Such a center can benefit the entire enterprise by improving the pace and quality of its decision making and helping it to focus more on strategic action and less on firefighting. Achieving this goal requires a few important steps that only the CEO can take:

- setting a clear mandate and goals, communicated to the entire organization, for the inflation management office
- empowering the CFO or another direct report to coordinate these activities and carry out the CEO mandate
- selecting a team of functional leaders (for instance, HR, commercial, supply chain, operations, engineering, and finance) who have a bias for action and may not be department heads
- making it clear that decisions must often be taken in the face of significant uncertainty and that mistakes will undoubtedly be made

- insisting on a systematic, fact-based approach to transparently track execution, diagnose wins and losses, correct course, and learn

A nimble, well-informed decision process can keep up with rapid change by making it clear when certain thresholds are met and generating responses to problems. Many companies will find that they have most of what's needed to create such a center. These resources can be organized to form an agile capability in a few weeks rather than months or years. With the inflation program management office up and running, CEOs can be freed from the day-to-day details of the anti-inflation effort to focus instead on the issues they are uniquely positioned to address, from higher-level board and stakeholder discussions to shifting their strategies to best capitalize on the current environment.

Someone, somewhere, pays for every uptick in inflation. Customers pay at the end of the supply chain in higher prices. Suppliers pay when their customers derisk production by seeking alternatives to their products. Shareholders pay higher costs as the ante for competing and maintaining a viable business. With the right playbook as a guide, the best CEOs will successfully manage the impact of the current higher-inflation environment and establish a new level of organizational resilience no matter where prices move next.

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# Why you can't tread water when inflation is persistently high

Inflation destroys value across almost every industry. When high inflation is persistent, companies that merely maintain the same margins and returns are likely to destroy value.

*by Marc Goedhart and Rosen Kotsev*



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**Over the past** 12 months, inflation has approached 10 percent in the United States and exceeded double digits in the European Union and the United Kingdom. Central banks—including the US Federal Reserve, which has raised rates at the fastest pace since the 1980s—are responding forcefully, trying to tamp inflation down. There is no clear consensus on how long this period of high inflation will last.

Persistently high inflation presents challenges to value creation that haven't been seen since the bear markets of the 1970s. Yet the reasons *why* inflation affects value are often misunderstood. While merely understanding the underlying dynamics does not solve them, achieving greater clarity about the effects of persistently high inflation does make it easier for managers to achieve practicable solutions and to better set their expectations along the way.

### **Inflation does not significantly affect the cost of capital**

Books have been written about value creation.

We can distill our definition into one sentence:

“Companies that grow and earn a return on capital that exceeds their cost of capital create value.”<sup>1</sup>

It turns out that inflation does not affect the cost of equity capital very much. In fact, the cost of equity

is surprisingly stable in real terms; by observing more than 60 years of US stock market data, we can estimate the forward-looking cost of equity for the stock market as a whole from market P/E ratios, long-term economic growth, and return on capital. Throughout the oil crises of the 1970s, the double-digit inflation of the 1980s, the internet boom and bust, the credit crisis of 2008–09, and the COVID-19 pandemic, the cost of equity has remained at about 7 percent in real terms.<sup>2</sup>

Of course, the *nominal* cost of equity capital moves in line with inflation, because it equals the real-term cost of equity plus expected long-term inflation. We found no evidence, however, that investors actually include an additional risk premium in real terms to the cost of capital during times of higher inflation.

### **Inflation does erode corporate cash flows in real terms**

Since the cost of companies' equity capital is stable in real terms, the challenge shifts next to understanding the effects of inflation on companies' cash flows. Most companies are unable to effectively pass on to their customers the higher costs they incur. That pressure—expenses increase, but prices to customers can't increase as much—erodes

**Most companies are unable to effectively pass on to their customers the higher costs they incur. That pressure erodes free cash flow in real terms.**

<sup>1</sup> Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, 2020.

<sup>2</sup> Vartika Gupta, David Kohn, Tim Koller, and Werner Rehm, “Markets versus textbooks: Calculating today's cost of equity,” McKinsey, January 24, 2023.

free cash flow in real terms. Yet the consequences for value creation are not immediately evident from common financial performance indicators, such as operating margin and return on capital. The problem is that accounting doesn't handle inflation very well: depreciation and amortization tables were built for low-inflation times.

Consider the following example: the (illustrative) financials of a company that started out in year one and two with stable sales, at a constant operating margin (EBITA/sales) of 10 percent, and a constant ROIC of 10 percent. As a result, its free cash flow (FCF) is \$100 per year. Projecting unchanged cash flows into perpetuity and using a cost of capital of 10 percent represents a company value of \$1,000. However, to remain stable in real terms, the

company's free cash flows must keep pace with inflation (Exhibit 1).

Financial professionals will spot the challenge: net property, plant, and equipment (NPPE) and depreciation are based on historical purchase prices and, during high-inflation times, increase at much lower rates than they do in periods of lower inflation.<sup>3</sup> If a company can't fully pass on these expenses, free cash will suffer. Merely treading water on operating margins means that a company drifts backward; to keep up, it needs to (in this example) *grow* margins and returns on capital at 11.1 percent and 12.3 percent, respectively. That impressive feat merely ensures that free cash flow grows at 10 percent and stays constant in real terms.

Exhibit 1

## When inflation is persistently high, free cash flow is a better indicator of performance than EBITA or ROIC.

### Company key performance metrics, inflation adjusted, illustrative

	Year 1	Year 2	Year 3	Year 4	Year 16	Year 17
Sales, \$	1,000	1,100	1,210	1,331	4,177	4,595
EBITDA, \$	225	248	272	299	940	1,034
Depreciation, \$	-125	-125	-126	-128	-265	-291
EBITA, \$	100	123	146	171	675	743
Gross property, plant, and equipment, \$	1,875	1,888	1,914	1,955	4,369	4,806
Cumulative depreciation, \$	-875	-875	-876	-878	-1,537	-1,691
Invested capital, \$	1,000	1,013	1,038	1,077	2,832	3,115
EBITDA, \$	225	248	272	299	940	1,034
Capital expenditures, \$	-125	-138	-151	-166	-522	-574
Free cash flow, \$	100	110	121	133	418	460
EBITA growth, %	0.0	22.5	19.5	17.4	10.1	10.0
EBITA/sales, %	10.0	11.1	12.1	12.9	16.2	16.2
ROIC, %	10.0	12.3	14.5	16.6	26.2	26.2
Free-cash-flow growth, %		10.0	10.0	10.0	10.0	10.0

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<sup>3</sup> NPPE and depreciation will only gradually reflect inflation over the next years when assets are replaced at higher prices. In this example, the NPPE asset base is in steady state with a lifetime of 15 years.

As long as high inflation persists, margins and return on capital need to keep increasing. To illustrate, consider the (unlikely) case in which inflation persists at 10 percent for 15 years. The new equilibrium level for ROIC would be 26.2 percent—more than 16 percentage points above its real-term, pre-inflation level of 10 percent. Unless we can project the company’s nominal cash flows to grow at the 15 percent inflation in perpetuity (and then discount these cash flows at the nominal cost of capital of 26.5 percent),<sup>4</sup> the company’s value can’t exceed its current \$1,000 level.

In practice, the precise level of improvement will depend upon the rate of inflation, the asset lifetime, and the real (not nominal) return on capital in a

company. Nevertheless, from this simple illustration, we can better appreciate the challenges that companies face under persistent inflation. Growing operating profits, net income, and earnings per share at the pace of inflation are apt to destroy value in a high-inflation environment.

Yet history shows that when inflation picks up, companies typically find it hard to even stay in place. Sales—even on a nominal basis—may decline, pressures on margins increase, and returns on capital fall. We found that almost all industrial sectors in the United States suffered declines in returns, margins, and nominal revenues during rising inflation between 1970 and 1990 (Exhibit 2). Among the few exceptions were companies in the energy

Exhibit 2

### Almost all US industrial sectors suffered declines in returns, margins, and nominal revenues during the high-inflation period of 1970–1990.

#### Percentage-point change for each percentage-point increase in inflation, 1970–90

	Return on capital	Operating margin	Revenue growth
Communication services	-0.46	-0.18	-2.39
Consumer discretionary	-0.14	-0.08	-0.30
Consumer staples	0.26	0.10	-0.53
Energy	0.14	-0.02	-0.37
Healthcare	-0.19	-0.21	-1.69
Industrials	-0.28	-0.13	-1.39
Information technology	-0.17	-0.10	-0.80
Materials	-0.45	0.04	-0.12
Utilities	-0.08	-0.15	0.65
Total <sup>1</sup>	-0.13	-0.12	-0.66

<sup>1</sup>All companies in the sample, across all of the listed sectors, based on their Standard Industrial Classification codes. Source: S&P Global Market Intelligence; McKinsey analysis

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<sup>4</sup> Under 15 percent inflation, a cost of capital of 10 percent in real terms corresponds to a cost of capital in nominal terms of  $(1+10\%)(1+15\%) - 1 = 26.5\%$ . The value of the company is then  $115 / (26.5\% - 15\%) = 1,000$ .

sector, which benefited from higher prices in oil and gas, and in consumer staples, where strong brands enabled companies to pass on a larger amount of their costs to consumers. But even these sectors suffered declines in sales. For the average US company, each percentage-point increase in inflation caused a 0.15 percentage-point decline in return on capital and a 0.60 percentage-point decline in growth.

Remarkably, inflation sensitivity has been quite similar from 1990 to 2020, when the United States experienced historically low inflation. While declines of 0.15 and 0.60 percentage points may not sound like much, they may actually pose a major hindrance: just to keep cash flows and value stable in real terms, returns on capital, margins, and, of course, nominal revenues should all be moving up.

Not surprisingly, high levels of inflation in the 1970s and 1980s generated significant downward pressure on stock market valuations, with P/E ratios in the US stock market falling to levels between 5–10, well below long-term average P/E ratio levels of 15–17. Apparently, investors expected (correctly) that high levels of inflation would last for several years. Likely, investors also expected that companies could not successfully pass on the costs of inflation and increase returns; margins would erode, and growth rates would stall. Those outcomes all came true, and resulted in the erosion of cash flows in real terms.

## Bounding expectations

Temporary inflation is not likely to materially affect stock market valuations. But persistent inflation will. The main challenge is not some runaway increase

in the cost of capital beyond the control of managers; it is the potential decrease of cash flows, in real terms, as inflation rises. With that insight in mind, managers should not rely exclusively on reported operating margins and returns on capital; likely, these metrics are distorted by inflation. Even if profits increase in nominal terms, they may be falling on a real basis. Financial ratios should be inflation adjusted, and managers should closely monitor inflation-robust metrics, such as cash margins of profitability and operating metrics for capital efficiency (for example, inflation-adjusted revenues over capacity measures).

Clarity is a force multiplier. When managers understand what does—and doesn't—threaten value creation, they can more effectively allocate company time and resources and be much more precise in their external communications. While a positive outcome isn't assured, at least the unique difficulties become more clear, and the inclinations for merely treading water can be replaced with the urgency the circumstances require.

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While high inflation is hard enough for businesses to manage, persistently high inflation is harder still. The challenges are all the more difficult because they are not immediately apparent. When inflation rates stay high, maintaining even previously strong operating margins won't sustain long-term value creation.

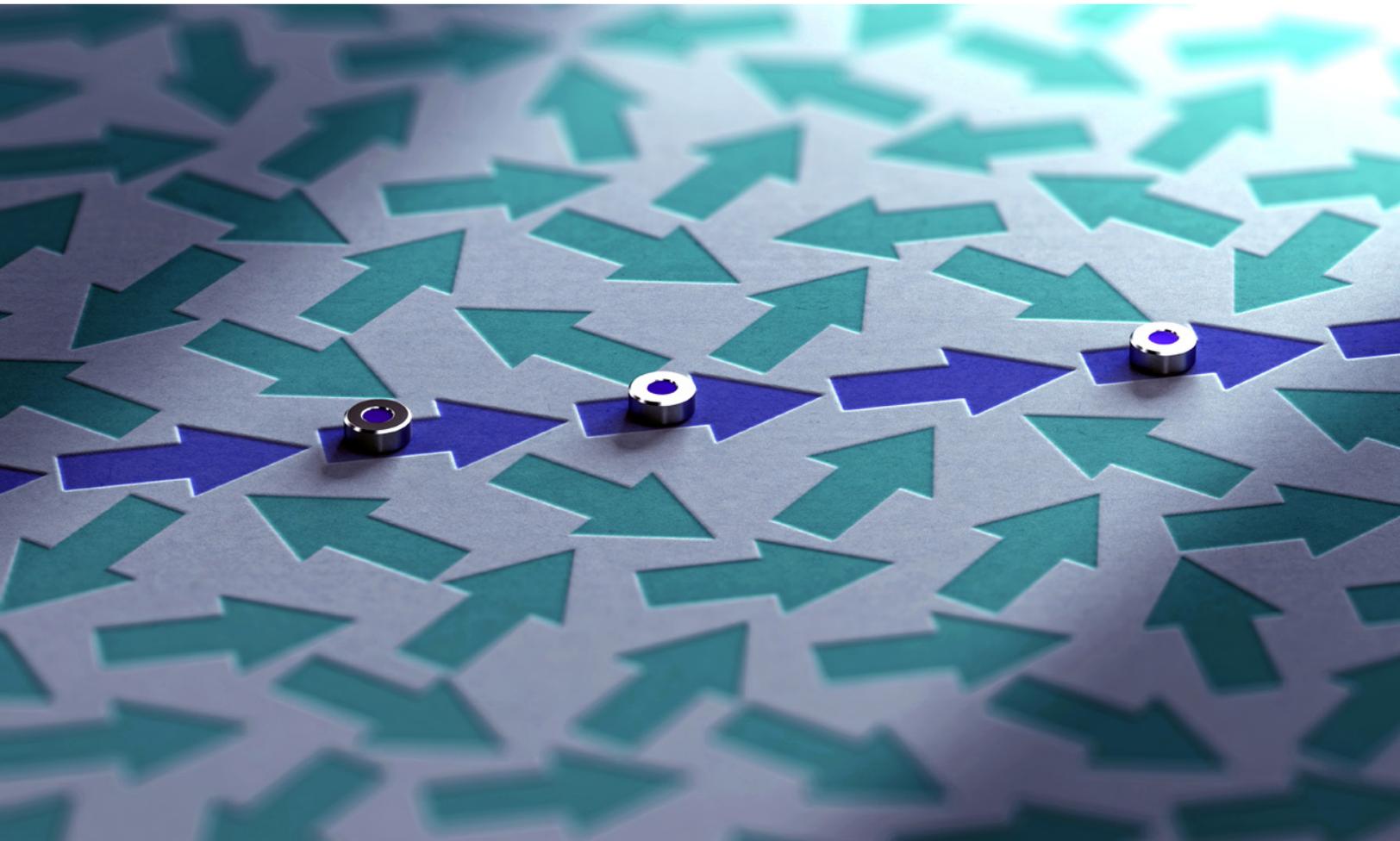
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# Markets versus textbooks: Calculating today's cost of equity

Inflation is high and interest rates are climbing. But if you think the real cost of equity rises in lockstep with government bond yields, think again.

*by Vartika Gupta, David Kohn, Tim Koller, and Werner Rehm*



**So much for** “transitory.” It turns out that inflation ran on the express tracks after all, and interest rates, though historically still low, were sharply ramped up. What does that mean for the cost of equity? The textbook answer would have it that higher interest rates translate seamlessly to a higher cost of equity. Declining stock returns throughout 2022 seem to bolster the case. Hearken back to your introductory course on finance, and it all looks fairly straightforward: start with ten-year government bond yields as the risk-free rate, and add a market premium. The market uses ten-year Treasuries as its risk-free proxy—right?

Actually, no. Our research shows that during approximately the past 15 years, the cost of equity has been decoupled from government bond rates; monetary policy has manipulated long-term rates to such an extent that Treasury yields no longer reflect what the market actually applies. By our analysis, even as central banks significantly ratcheted up rates in 2022, the cost of equity increased, but modestly, reflecting only slightly higher expectations of long-term inflation. Perhaps that’s because the cost of equity over the past 15 years did not decline to reflect the low cost of government debt.

### **Present, past, and future: The trouble with a textbook approach**

No one knows for sure what the actual duration and magnitude of inflation will be. Multiple forces are at work, including (1) supply and demand disruptions due to the COVID-19 pandemic and the Ukraine war; (2) the reluctance of many people to return to the workforce<sup>1</sup>; (3) a prolonged period of aggressive fiscal spending, particularly in response to the pandemic, that has contributed to unprecedented peacetime government deficits; and (4) extraordinarily expansive monetary policies since the Great Recession of 2007–08 that have resulted in historically low interest rates. Moving forward, it’s

unclear what additional steps governments will take to address inflation. Lack of clarity invites greater uncertainty.

It’s important to keep in mind that expected real interest rates on ten-year US government bonds are about 1 percent,<sup>2</sup> which is still very low by historical standards, and that investors currently expect long-term inflation to be modest, at about 2.5 percent.<sup>3</sup> By comparison, expectations about long-term inflation reached and exceeded 10 percent in the 1970s and early 1980s.<sup>4</sup>

You may have heard that rapidly rising interest rates over 2022 have *significantly* increased the cost of equity. Starting with a historical market-risk premium of about 5 percent, and using a beta of 1, the argument ultimately boils down to the effect of higher Treasury yields. If those yields really were a proxy for the risk-free rate, the cost of equity would change *a lot*, in line with the pronouncements of the Federal Reserve and other central banks.<sup>5</sup>

A textbook analysis maintains that lower interest rates during the COVID-19 pandemic were largely responsible for higher total shareholder returns (TSR) in 2020–21, and that higher interest rates over the course of 2022 from a more hawkish Fed drove down TSR during that year. But that approach considers only one period, in isolation. And facts don’t support the often-quoted assertion that rates were lower at the end of 2021 than in 2019. While interest rates declined in 2020 as the Fed took aggressive monetary-easing actions, interest rates *were back at their starting levels* by the end of 2021—before the stock market began to turn down: the yield on ten-year Treasury bonds was 1.8 percent at the end of 2019 and returned to 1.8 percent at the end of 2021. The S&P 500 index during that period increased from 3,240 to 4,766, up 47 percent. From the end of 2021 until October 2022, the yield on ten-year Treasuries increased from 1.8 percent to

<sup>1</sup> Aaron De Smet, Bonnie Dowling, Marino Mugayar-Baldocci, and Bill Schaninger, “Gone for now, or gone for good? How to play the new talent game and win back workers,” *McKinsey Quarterly*, March 9, 2022.

<sup>2</sup> The yield on ten-year Treasury Inflation Protected Securities (TIPS) as of September 15, 2022.

<sup>3</sup> The yield on ten-year Treasuries of about 3.5 percent as of September 15, 2022, less the yield on TIPS.

<sup>4</sup> See, for example, Jeremy M. Piger and Robert H. Rasche, *Inflation: Do expectations trump the gap?*, Research Division of the Federal Reserve Bank of St. Louis, March 2006.

<sup>5</sup> For more on calculating the cost of equity, see Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ: John Wiley & Sons, June 2020; and Marc H. Goedhart, Timothy M. Koller, and Zane D. Williams, “The real cost of equity,” *McKinsey on Finance*, October 1, 2002.

4.1 percent, while the stock market declined by 18 percent. It doesn't seem logical to attribute the decline in the stock market during 2022 to the increase in interest rates; other factors must have been driving up the market from 2019 to 2021, because interest rates at the beginning and end of the period were flat.

It turns out that while textbook answers may be fine for classrooms, classrooms are not real life. Consider price-to-earnings (P/E) ratios. In practice, the cost of equity is a major driver of P/Es; if the cost of equity really varies significantly, we would expect P/E ratios to move substantially as well. Yet over the course of about 15 years, as government yields were reduced to unprecedented lows and then increased to much higher levels, median P/E ratios have remained remarkably constant—and firmly within historical bounds.

The consistency of median P/E ratios is yet another indication that markets no longer apply government bond yields as a proxy for the risk-free rate. Valuing a company by using a 6.6 percent cost of equity implies that even modestly growing companies would have P/E multiples of 25-fold or higher. Mathemati-

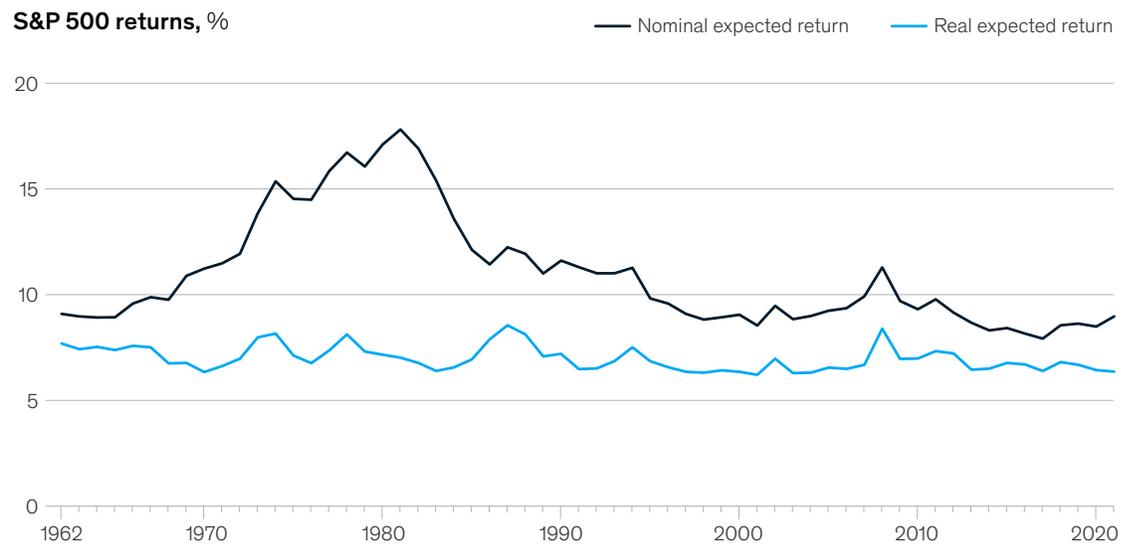
cally, every 1 percent decrease in the cost of equity for the S&P 500 index should increase the P/E of the index by roughly 20 to 25 percent. Given the low interest rates over the past 15 years, the typical large company should have traded in the well-above 20-fold P/E range since the Great Recession. But that hasn't been the case. Median large companies have consistently traded in the 15-fold to 17-fold P/E range since the financial crisis—despite low interest rates during the entire period.

### An evidence-based approach to the cost of equity

One helpful way to explore further is to infer an actual cost of equity from market valuations. We conducted an analysis to reverse engineer P/E multiples, applying time-tested assumptions about profit growth and ROIC, and derived a narrow band of costs of equity that markets have been applying for years. Under this approach, we observe that the real cost of equity has remained stable over the past six decades—in the 6.5–7.0 percent range. The only meaningful changes in expected returns over time have been on a nominal basis (Exhibit 1).

Exhibit 1

### The only meaningful changes in expected returns over time have been on a nominal basis.



Source: Corporate Performance Analytics by McKinsey; McKinsey analysis

The results of this analysis are consistent with a long-term view of median P/Es of large companies, which has also been stable—in the 15-fold to 17-fold range—for decades (Exhibit 2).

Facts being stubborn things, it's fair to dig more deeply into 2022 market dynamics. If the cost of equity didn't rise in lockstep with interest rates and therefore push stock prices down, what actually was the reason for lower returns? While a portion of the decline has been due to economic concerns, the largest contributor, by our analysis, has been the reversal of massive valuation increases that a handful of companies (mostly in the technology sector) enjoyed in 2020 and 2021. We draw this conclusion by examining the gap between the "official" P/E ratio of large stocks (a weighted average that was heavily weighted by the Big Tech companies in 2020 and 2021) and the P/E of the median company. Large, outperforming companies carried so much weight in the index and had such high multiples that the weighted average P/E rose significantly in 2020 and 2021. Yet throughout 2020

to 2022, the median P/E multiple remained constant. More recently, we've seen that the weighted average P/E is reverting to the median.

### Today's cost of equity

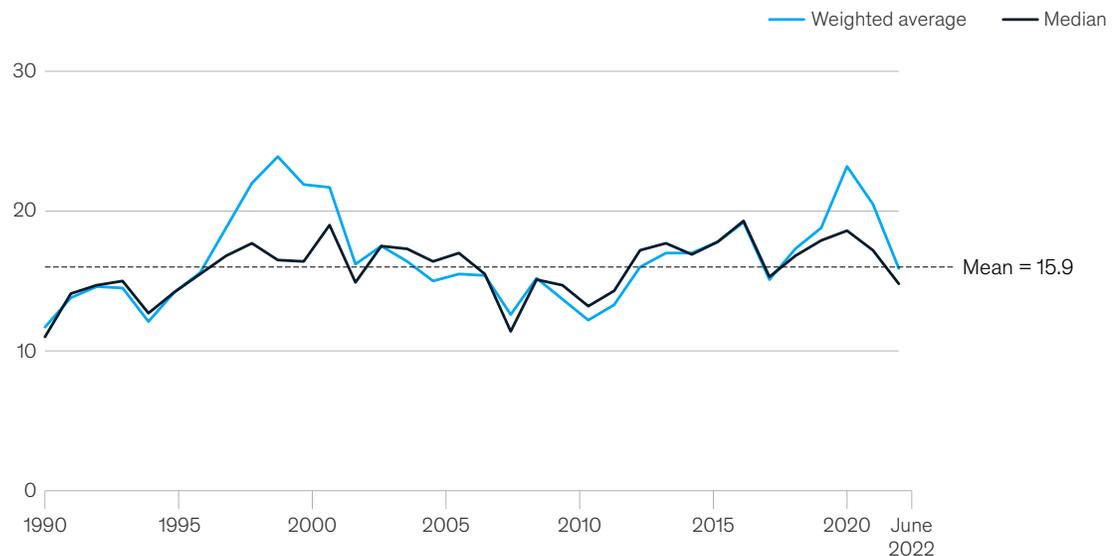
To estimate the current cost of equity, we convert the real expected return into a nominal return, by adding an estimate of inflation that is consistent with reasonable cash flow projections. This can be done by using the spread between the yield on inflation-protected bonds (TIPS) and standard, non-inflation-protected government bonds. As of today, this approach brings the nominal cost of equity to approximately 9.5 percent (7.0 percent real return plus 2.5 percent expected inflation, based on the TIPS spread). That's only about 0.2 percent higher than at the start of 2022.

This approach has proved effective throughout the period of low interest rates that started with the Great Recession. Valuation models based on low interest rates over the past 15 years, on the other

Exhibit 2

## Median P/E ratios are remarkably consistent.

Stock price multiples (consensus 12-month forward earnings), Jan 1990–June 2022



Source: Corporate Performance Analytics by McKinsey; McKinsey analysis

McKinsey & Company

hand, have not led to sensible results. If the cost of equity had truly declined along with falling interest rates in the past decade and a half, we should have seen a dramatic increase in P/E multiples. For example, a 3 percent drop in the cost of equity should have increased the P/E ratio from a typical trading range of 15–16 times to over 25 times. However, no such increase occurred. As government-pronounced rates declined from 4–5 percent in 2006 to 1–2 percent in 2012, P/E ratios remained within their consistent band.

We can also triangulate this approach by using a synthetic estimate for the risk-free rate rather than government bond yields. To build a synthetic risk-free rate, add the expected inflation rate (about

2.5 percent) to a long-term average real interest rate (2 percent); this results in a synthetic risk-free rate of about 4.5 percent. Adding a 5 percent market-risk premium leads to an expected market return of approximately 9.5 percent, which is entirely consistent with an expected cash-flow-based approach.

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Calculating today's cost of equity is not a rote exercise, and the most fundamental assumption of all—that markets use government bond yields as a proxy for the risk-free rate—does not withstand closer scrutiny. But then, why should it? Complicated challenges are seldom settled by fiat.

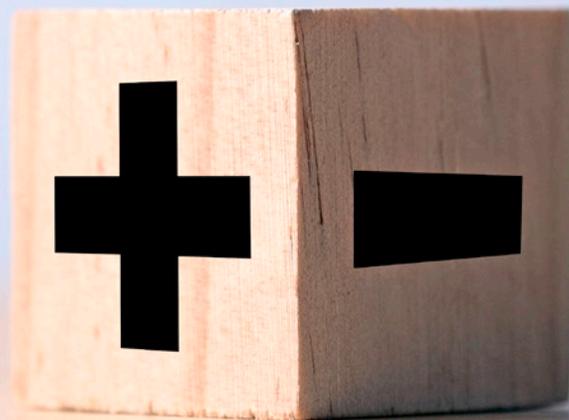
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# Communicating headwinds and tailwinds

Investor relations should always address business-critical headwinds and tailwinds. But which do companies refer to more—and how does that choice affect market performance?

*by Ryan Davies, Raghav Dubey, David Kennedy, and Radhika Ray*



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**The old, apocryphal curse** about “living in interesting times” seems more pertinent now than ever. Over the past several years, companies have had to confront seismic developments—including the COVID-19 pandemic, geopolitical tensions, supply chain stresses, social protests, accelerating climate change, and inflation at its highest in decades. It’s no wonder that investor relations would address the effects of external events on business performance. Even during the *relatively* tranquil years before COVID-19, investors wanted (and regulators required) executives to explain how broader material forces affect company performance. When global events dominate headlines, it’s almost impossible not to highlight them in investor communications.

One might, however, expect more balance in discussing positive and negative forces. After all, depending on particular conditions, the performance of some companies may actually receive a boost during challenging times. For example, large discount retailers outperformed

during the Great Recession of 2008–09. More recently, stock prices of energy companies rose after Russia invaded Ukraine.

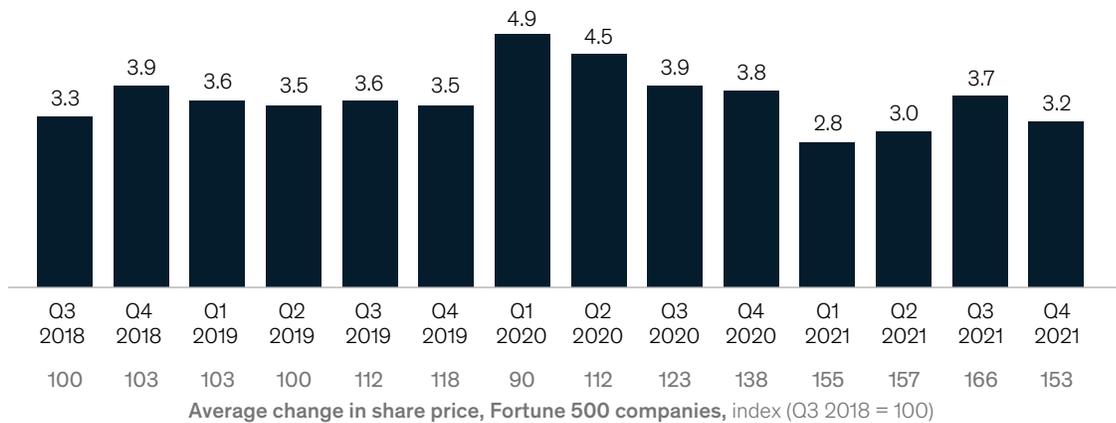
Yet remarkably, in good times and terrible ones, companies across industries tend to talk a lot more about headwinds than tailwinds. Most recently, we studied 14 consecutive quarters of public-company reporting, from third quarter 2018 to fourth quarter 2021. We analyzed not just investor relations messaging but also company performance and market responses.<sup>1</sup> What did we find? Management teams blamed external events for poor performance roughly *three times* more often than they credited external events for helping them. They did so even when total shareholder returns (TSR) trended higher during the period studied (Exhibit 1) and the wind, as the Irish blessing wishes, was at their backs.

We found, too, that almost every company resorts to finger-pointing. The highest and lowest performers in the Fortune 500 were equally likely to blame a

Exhibit 1

## Companies mention headwinds far more than tailwinds during earnings calls.

**Mentions of headwinds vs tailwinds in company earnings transcripts, Fortune 500 companies,<sup>1</sup> ratio**



Note: Headwinds includes mentions of “headwinds,” “challenges,” or “unfavorability”; tailwinds includes mentions of “tailwinds,” “uplift,” or “favorability.”  
<sup>1</sup>Includes all Fortune 500 companies reporting public quarterly earnings; does not include businesses identified as privately held.  
 Source: S&P Global, earnings call transcripts, Q3 2018–Q4 2021; McKinsey analysis

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<sup>1</sup> We purposefully selected a time frame that included prepandemic reporting (as a guide to “normal” conditions) as well as pandemic-period reporting (to understand COVID-19’s impact on markets and sectors).

specific negative outcome on exogenous occurrences such as changes in regulations, political developments (international and domestic), and the COVID-19 pandemic. The phenomenon of using events outside of company control more to explain why something goes wrong, and less to credit them when results go right, applies within industries and across them.

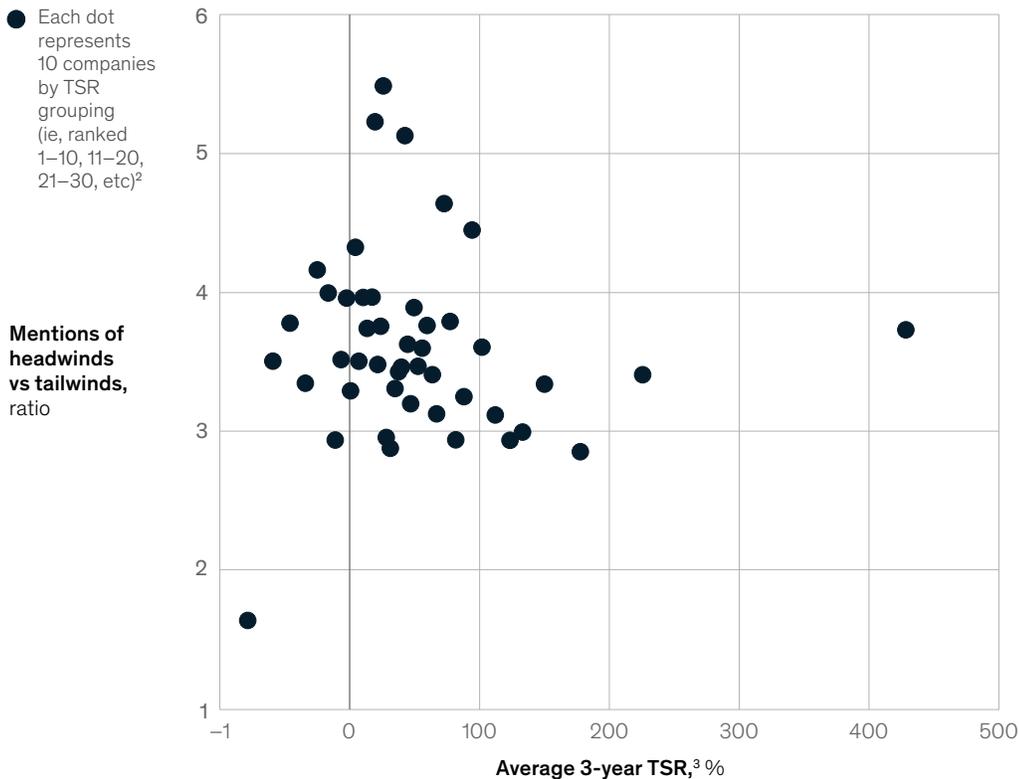
It's possible that business leaders may choose to talk about headwinds to mitigate negative responses from the market. If a company misses its targets,

there can be good reasons for explaining—*this time*—how exogenous factors affected planned improvements. Sometimes, the dog really does eat the homework. But on the aggregate, highlighting headwinds more than tailwinds (even given changes between 2019 and 2021) neither helps nor hurts stock performance. Our research finds little to no correlation between how frequently, in investor communications, company leaders attributed business outcomes to headwinds or tailwinds, and how well, as measured by TSR, their companies actually performed (Exhibit 2).

Exhibit 2

**There is little correlation between company performance and headwind versus tailwind communications.**

**Mentions of headwinds vs tailwinds in company earnings transcripts, compared with total shareholder returns (TSR), Fortune 500 companies<sup>1</sup>**



Note: Headwinds includes mentions of “headwinds,” “challenges,” or “unfavorability”; tailwinds includes mentions of “tailwinds,” “uplift,” or “favorability.”  
<sup>1</sup>Includes all Fortune 500 companies reporting public quarterly earnings; does not include companies identified as privately held.  
<sup>2</sup>Companies are grouped by rank in sets of 10: 1–10 for those with the highest returns; 441–450 for those with the lowest returns.  
<sup>3</sup>Average TSR increase/decrease across Fortune 500 companies, indexed to Q3 2018.  
 Source: S&P Global, earnings call transcripts, Q3 2018–Q4 2021; McKinsey analysis

From our experience, it's often the case that investors simply don't see the links of external events to internal operations as clearly as management does. Investors therefore appreciate companies that can clearly and consistently explain the companies' value proposition and the external and competitive forces that its businesses face.<sup>2</sup> McKinsey research shows that consistent, clear, and transparent messaging is essential for companies to maintain and enhance credibility with shareholders.<sup>3</sup>

No less important, senior managers should themselves understand the relationship between headwinds, tailwinds, and the company's unique value drivers. Ensuring that capability, in fact, is an essential element of performance management—and long-term value creation.

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<sup>2</sup> Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, seventh edition, Hoboken, NJ, John Wiley & Sons, 2020.

<sup>3</sup> See Tim Koller, Rishi Raj, and Abhishek Saxena, "Avoiding the consensus-earnings trap," McKinsey, January 1, 2013; and Tom Kolaja and Tim Koller, "When investors call: How your business should talk about coronavirus," McKinsey, March 30, 2020.

# ESG scores: Does change matter?

Changes to ESG scores seem to be correlated to total shareholder returns, but the result is not conclusive.

*by Lucy Pérez, Vivian Hunt, Hamid Samandari, Robin Nuttall, and Krysta Biniek*

This article is adapted from “Does ESG really matter—and why?,” *McKinsey Quarterly*, August 10, 2022.



Illustration by Graham Hutchings

**Among the most** sharply debated questions about environmental, social, and governance (ESG) is the extent to which ESG, as measured by ratings, can offer meaningful insights about future financial or total shareholder returns (TSR) performance—particularly when ratings and scores providers use different, and sometimes mutually inconsistent, methodologies. A number of studies find a positive relationship between ESG ratings and financial performance.<sup>1</sup> Other research suggests that while scoring well in ESG does not destroy financial value, the relationship between ESG ratings at any given time, and value creation at the identical time, can be tenuous or nonexistent.<sup>2</sup> Because of the short time frame over which the topic has been studied, and the resulting lack of robust analyses, conclusions from the analyses should be tempered.<sup>3</sup>

In exploring the connection between ESG ratings and financial performance, another approach is to look at the effect of a *change* in ESG ratings. This approach mitigates issues deriving from differences among various ESG rating methodologies (assuming the methodologies are relatively consistent over time). It stands to reason that demonstrating real improvement—if reflected in the scores—could, in turn, drive TSR outperformance for multiple reasons, including those we explore in this article. Our initial research indicates, however, that it is too soon to tell. We found that on average companies that show an improvement in ESG ratings over multiyear time periods may exhibit higher shareholder returns compared with industry peers in the period after the improvement in ESG scores. We found, too, that the effect of this result has increased in recent years

## A number of studies find a positive relationship between ESG ratings and financial performance. Other research suggests that the relationship can be tenuous or nonexistent.

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<sup>1</sup> Florian Berg, Julian Kölbl, and Roberto Rigobon, “Aggregate confusion: The divergence of ESG ratings,” *Review of Finance*, forthcoming, updated April 2022; Ulrich Atz, Casey Clark, and Tensie Whelan, *ESG and financial performance: Uncovering the relationship by aggregating evidence from 1,000 plus studies published between 2015–2020*, NYU Stern Center for Sustainable Business, 2021.

<sup>2</sup> See *Chart of the Week*, “Does ESG outperform? It’s a challenging question to answer,” blog post by Raymond Fu, Penn Mutual, September 23, 2021; Giovanni Bruno, Mikheil Esakia, and Felix Goltz, “‘Honey, I shrunk the ESG alpha’: Risk-adjusting ESG portfolio returns,” *Journal of Investing*, April 2022.

<sup>3</sup> When the ESG characteristic of a company changes, based on MSCI ESG data, it may be a useful financial indicator for generating alpha. Guido Giese et al., “Foundations of ESG investing: How ESG affects equity valuation, risk, and performance,” *Journal of Portfolio Management*, July 2019, Volume 45, Number 5.

Exhibit

**Changes to ESG scores seem to be correlated to TSR, but given the underlying measurement challenges the result is not conclusive.**

**Total shareholder returns (TSR), by change in ESG score<sup>1</sup>**

	Median of annualized, excess TSR <sup>2</sup> from 2017–21, %	Companies <sup>3</sup> with positive excess in TSR, % <sup>4</sup>	Number of companies
Deteriorators	-2.8	39	221
Slight deteriorators	-1.5	45	220
Slight improvers	-0.2	49	1,097
Improvers	1.5	54	1,097

<sup>1</sup> Based on ESG scores of S&P Global for fiscal years 2017–21. 2021 data is updated through Jan 18, 2022.

<sup>2</sup> Annualized TSR is defined as the CAGR of the dividend-adjusted share price between 2017 and 2021 in companies' local currency.

<sup>3</sup> Companies decreasing in S&P Global ESG score are categorized as deteriorators and slight deteriorators. Companies increasing in S&P Global ESG score are categorized as improvers and slight improvers.

<sup>4</sup> Results statistically significant (p-value <0.01) with Mann-Whitney U test between improvers and deteriorators, but not (p-value ~0.2) between slight deteriorators and deteriorators.

Source: S&P Global; McKinsey ESG Insights

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(exhibit). This initial finding is in line with some of the recent academic research and was also generally consistent across data from multiple ratings and scores providers.

Still, the findings are not yet conclusive. For example, only 54 percent of the companies we categorize as “improvers” and less than one-half of those categorized as “slight improvers” demonstrated a positive excess TSR. The research also does not prove causation. It is important to bear in mind that ESG scores are still evolving, observations in the aggregate may be less applicable to companies considered individually, and exogenous factors such as headwinds and tailwinds in industries and individual companies cannot be fully controlled for.

Most important, this research does not explain the mechanism of TSR outperformance and whether the outperformance is sustainable. We know from

decades of research that companies with a higher expected return on capital and growth are ultimately TSR outperformers and that there is clear, statistically significant correlation. Are ESG ratings a sign of greater expected resilience of margins in the transition, an indication of higher growth through green portfolios—or do they suggest something else? Will these increased expectations relative to peers ultimately materialize, or will they revert to the mean? ESG ratings are very new compared with financial ratings, and therefore, it will take time for them to evolve. We will continue to research these questions as data sets increase and refinements to ESG scores continue to be refined.

Regardless of current ratings scores, many companies are already advancing in ESG to improve their long-term financial performance. High performers consider and seek to learn from ESG ratings, but they do not get unduly distracted or

make superficial changes merely to score higher. Companies should focus on ESG improvements that matter most to their business models, even if the improvements do not directly translate to higher ratings.

Since conclusions about the relationship between ESG ratings and financial performance are not yet certain, they might not be compelling enough,

on their own, to persuade executives to invest significant resources in ESG. But there is a tangible cost to waiting. In fact, companies should adopt a bias toward focusing on ESG *today*; if companies, particularly those with significant externalities (such as high-emitting industries), hold out for perfect data and a “flawless” rating process, they may not have a business in 20 to 30 years.

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# Five insights for public company CFOs from private equity

CFOs of public companies can draw enormous insight from PE's focused, proactive approach to value creation—but they have to take the initiative themselves. Here are five lessons to get started.

*by Ankur Agrawal, Kevin Carmody, Matthew Maloney, and Ishaan Seth*



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**Inflation, low or negative growth, geopolitical tensions**—what’s next? As the Cheshire cat in Lewis Carroll’s *Alice in Wonderland* answered: “That depends a good deal on where you want to get to.”

For years, our colleagues have explored lessons from private equity (PE)–held companies, particularly the clear direction that these companies take toward value creation.<sup>1</sup> The lessons are evergreen. In fact, for public company CFOs confronting today’s raft of uncertainty, a proactive approach to value creation is essential. PE-backed companies don’t play wait and see. They have a clear investment thesis, with hard milestones and accelerated timetables (that are not geared to quarterly earnings), and are actively engaged in realizing value-creating opportunities. Their CFOs are indispensable leaders, called on to understand the business in granular detail, lift performance management to a much higher level, and build a talent factory. The actions are bold precisely because the stakes are enormous.

As the CFO of a public company, you operate under unique pressure. You may feel that a call for bold action bears little resemblance to what you are practically called upon to do: meeting financial reporting requirements, maintaining a modern finance function, and stewarding your immediate and larger teams. There is a lot to manage, even when economic and other exogenous conditions are (relatively) calm. Is this really the time to ramp up expectations?

Yes—and now more than ever. In good times and challenging ones, CFOs must take a decisive, proactive approach. PE-backed companies offer invaluable insights that CFOs can draw from to raise their game. Here are five of the most important lessons.

## **Focus relentlessly on value creation**

From the moment a PE fund acquires a company, that company is on the clock. It’s not the same clock that public company CFOs come to know (and often dread)—the quarterly cadence of earnings reports culminating in an annual report. It is, instead, a typically five-year, “here to there” sprint *and* marathon, during which the senior leaders forge a lean, value-creating, and value-sustaining operation.

To jump-start the process, PE-backed companies typically develop a 100-day plan that outlines the key drivers to achieve the investment thesis and provides a road map to ensure the alignment of priorities and resources in the short term. It also sets the pace (or metabolic rate) for the organization. Their CFO typically develops and implements the 100-day plan—an undertaking that is both supremely strategic and rigorously tactical. The notion that a PE-backed CFO would be cast as a mere accountant, or reporter of results for the organization, would be absurd. It’s an unfortunate contrast to the lack of direction that some CFOs endure at public companies, where, in the most egregious cases, they may not even be invited to strategy planning. Too often, public company CFOs pull back and see their primary job as risk avoidance.

Yet “risk” is broader than it may appear. In the PE context, CFOs live daily with the risk of falling short on achieving double-digit returns. That perspective compels CFOs to scrupulously mind ROIs and understand that the resource spigot should be zealously monitored for every function. One PE-acquired company, for example, had historically set marketing budgets using prior year amounts *plus* some assigned, additional amount. As a consequence, marketing’s spending as a proportion of revenues stayed relatively constant—and unnoticed. But the new CFO dug in on the

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<sup>1</sup> See Andreas Beroutsos, Andrew Freeman, and Conor F. Kehoe, “What public companies can learn from private equity,” McKinsey, January 1, 2007; Viral Acharya, Conor Kehoe, and Michael Reyner, “The voice of experience: Public versus private equity,” McKinsey, December 1, 2008; Conor Kehoe and Tim Koller, “Climbing the private-equity learning curve,” McKinsey, May 26, 2021; and Matt Fitzpatrick, Karl Kellner, and Ron Williams, “What private-equity strategy planners can teach public companies,” McKinsey, October 4, 2016.

details and noticed a significant funding shift over the years from working categories (what customers see and experience) to nonworking categories (for example, campaign development, creative, and strategy). In addition, the marketing function had planned on expanding its in-house capabilities, but it continued to rely on third-party support even after the in-house group was up and running. What appeared, from a superficial review, to be a case of “nothing to see here” was actually, on closer analysis, a troubling trend of less money being put to work.

Proceeding from an informed perspective, the CFO and chief marketing officer codified and prioritized various marketing projects based on effectiveness. They shifted more funds to working categories, sought to “sweat the marketing assets,” and built more modular marketing campaigns to minimize the need for a complete redesign. Ultimately, the CFO reallocated more than 40 percent of the marketing budget, increased ROI, developed a common language (using financial metrics) for operational decisions, and instilled an investor’s mindset, breathing life back to the marketing group.

This approach can certainly apply to public companies. Effective CFOs are instrumental in developing a value creation strategy tied to the most impactful levers—growth, margin expansion, and capital structure. In fact, other than the CEO, it’s frequently the case that no one is better suited to build consensus with the organization’s senior leaders and to bring competitive advantages into long-term strategy and annual operating plans. They’re also prepared to radically reallocate resources and keep their portfolio on the move.

### **Define and incent ambitious but achievable targets**

About a decade ago, the new coach of a losing American football team was asked how he planned to create a winner. His response? “Just get better.” Not surprisingly, the team then proceeded to lose more than 75 percent of its games, with a losing record in every season. Four years later—following its worst season of all—the coach was fired.

“Just get better” wouldn’t last a day in a PE-backed company. Instead, senior leaders, including the board and the CFO, invest enormous time and effort in establishing real, achievable targets that stretch performance targets but never bend credulity. The idea is to shake the organization out of its business-as-usual approach and to make dramatic, step-change improvements. These targets typically cover top-line revenues, margin expansion, and inorganic growth. Setting the right balance between ambitious but achievable targets is case-specific: go too aggressive and employees won’t believe the targets are achievable; err too much toward achievable and organizations will foreclose upside. But while the process involves a mix of art and science, the targets themselves are absolutely concrete and clearly defined.

For example, at one PE-backed company, the CFO recognized that revenues were growing as profits declined. The analysis revealed that sales had shifted significantly from high-margin branded products to lower-margin items. Meanwhile, private-label business had expanded substantially—primarily to the detriment of the company’s branded business. In meeting with the sales leads, the CFO recognized the function was gauging progress based on sales growth rather than considering gross margin or other measures of profitability. Moreover, the incentives for sales reps were tied to revenue alone rather than margins as well.

Among other actions, the CFO led an all-day workshop with the head of sales to drive the imperative for change. The CFO also partnered with the head of sales and the chief human resources officer (CHRO) to redesign targets and incentives for the sales teams, in hard numbers, and provide training to ensure all the sales reps understood not only the new metrics but also how revenues and margins contribute to value. This transparency helped enable the company to achieve the right mix of revenue and margin and maximize value creation over a multiyear horizon.

The process can work just as well in a public company. Once public company CFOs set the right stretch targets, they can help link performance to

# By clearly defining targets and meaningfully incenting distinctive performance, CFOs can break out of a vague or incremental ‘just get better’ default.

incentives and clearly communicate the milestones. It's frequently the case that targets should be accompanied by incentives that align the managers' rewards with their teams' success. In other words, everyone wins or loses. Performance means achieving actual results. As in PE, incentives should be disproportionately weighted toward tangible, demonstrated outperformance.

By clearly defining targets and meaningfully incenting distinctive performance, CFOs can break out of a vague or incremental “just get better” default. Average value creation may be cause for celebration at some public companies, but the reality is that in many cases, these companies could be achieving much more—and in every case they should be aspiring to do so. The CHRO can be a valuable partner, collaborating to review targets, incentives, and payouts. But the CFO should fully share leadership. The goal is value creation, which is directly in the CFO's purview.

## **Become an authority on every facet of the business**

In PE-backed companies, the CFO is expected to have a granular understanding of all elements of the business. Which customers are the most profitable? Which product lines or markets generate the highest growth rates? What potential risks

or disruptions could occur? What are competitors doing better or different? This knowledge is crucial to making informed decisions on strategy and resource allocation. It also makes the CFO an invaluable team member—the key person with informed, bottom-up insight about business performance.<sup>2</sup> Being a font of knowledge helps ensure that other senior leaders will *want* the CFO to be involved in mission-critical decisions.

For example, during a time of a near liquidity crisis, the CFO of one PE-backed company recognized that too much money was allocated to processes that were not leading to strategic insights. He undertook a radical redesign of the monthly business review and forecasting process, tasking the head of financial planning and analysis (FP&A) to build a bottom-up model for the key drivers for each line in the P&L, company-wide and by business unit. The analyses and conclusions were then spelled out in a clear, actionable report for leadership, which described how each KPI was measured and simplified access to the data. The result: forecasting was slashed from one and a half to two weeks each month to one to two days.

It's tempting for CFOs at public companies to question whether they can achieve that level of mastery, and change, in large, multibusiness, multinational corporations. But they can—and being

<sup>2</sup> See Mike Emsley, Matthew Maloney, Michael Parrott, and Abhishek Shirali, “Do you know where your budget is?,” McKinsey, June 30, 2019.

value-focused is the key to that success. Optimizing capital allocation for long-term value creation necessarily forces CFOs to understand critical value drivers, key business levers, and consolidating details. CFOs understand the company as no one else can. The CEO of one multinational consumer company goes so far as to call his CFO a “walking encyclopedia.” That’s a tribute to the CFO, of course, but also a tell that the CFO is paying attention to the right things.

Solving for value creation forces CFOs to not play favorites among the businesses. They follow the data. With an informed view, CFOs are well positioned to advise on where and to what extent businesses may be affected by broader competitive dynamics. Public company CFOs, if they take a proactive approach, can be a natural thought partner for business leaders—playing devil’s advocate, asking probing “what if?” questions, and exploring a broad range of scenarios.

Another fundamental part of the CFO’s role is to standardize data so that executives and managers speak the same language. Clear numbers cut through bureaucratic fuzziness, accelerate the pace of decisions and actions, and empower others to manage and deliver results. CFOs are uniquely positioned to identify and elevate the KPIs that matter most and bring consistency and discipline to capital allocation.

### **Embrace an investor mindset**

One reason that CFOs at PE-backed companies are so proactive is that they often have a once-in-a-lifetime opportunity for financial reward—if they can deliver on the investment thesis. They feel with immediacy what pension funds and long-horizon investors understand viscerally: long-term value maximization matters, a lot. This stark realization jolts CFOs from a mentality of passively minding year-over-year performance to a much more engaged approach. PE-backed CFOs consciously

adopt an investor’s mindset. They are more vigilant in asking hard questions, shaping strategy, and redeploying resources.<sup>3</sup> They also look across all functions to ensure that the entire organization is hitting its targets with a mix of short-, medium-, and long-term initiatives.

To borrow from an old quip, everyone talks about value creation, but no one does anything about it. But PE-backed CFOs actually *can* do something about it. That starts with asking, “If the company makes *no* changes, what would financial results likely be?” For example, one CFO identified unprofitable businesses that had been overlooked due to opaque and complex intercompany cost accounting. The CFO also discovered that no one person was responsible for profitability across the product portfolio. When accounting for marketing spending, sales discounts during parts of the year, and the cost of shipping from operations (often not considered part of profitability), some SKUs were actually contributing to negative margins on a large portion of the business. The CFO partnered with both the product and sales groups to rationalize the portfolio and redirect sales from low-profit products to similar ones with higher margins.

Taking ownership of the outcomes helps CFOs become more proactive and engaged. The role cannot be passive, whether the company is private or public. Effective public company CFOs are always prepared to be challengers—asking the tough questions, assessing end-to-end profitability (rather than looking only at functions or business units), championing bold capital reallocation, and fulfilling their duties to the company and its shareholders—which includes, as a necessary element of achieving long-term value, considering the effects that decisions have on a wide range of stakeholders. Although this proactive approach can feel uncomfortable, at least initially, it’s impossible to be an effective CFO by simply keeping one’s head down.

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<sup>3</sup> See Ronald Falcon, Kyle Hawke, Matthew Maloney, and Mita Sen, “How absolute zero (-based budgeting) can heat up growth,” McKinsey, January 11, 2018.

## Establish finance as a talent factory

Because CFOs at PE-backed companies take a company-wide perspective, they seek out talent with world-class potential, people who want to gain a bird's-eye view of overall strategy, hone their expertise in data analytics, and build tactical expertise in performance management. These individuals are “all-around athletes.” By being in the finance function—the center of the action—they become immensely valuable to an organization, with a fast-track to senior roles across other parts of the company, including those with P&L responsibility and major initiatives across a variety of functions.

CFOs at PE-backed companies are uniquely positioned to build a talent factory. Their role has such a high profile that they are magnets for the most motivated and skilled candidates. But their remit is broad enough to allow flexibility in choosing people whose experience does not yet match their potential. For example, while the CFO of one PE-owned company recognized the need to bring in more new talent, other functions traditionally required candidates to have deep tactical knowledge, built over years in the business. To broaden the pool of talent, the CFO partnered with the CHRO and went against the grain, hiring generalists to work with the FP&A team and to bring a fresh set of eyes to identify new opportunities, collaborate with leaders across business lines to solve high-priority problems, set priorities for value capture, and mobilize cross-functional teams to pursue substantial opportunities.

Over time, these employees were able to rotate to different functions and business units—cross-pollinating finance and strategy throughout the enterprise while teaching the language of finance and strategy through the lens of an investor. These all-around athletes were uniquely well equipped for success in other business areas. And, on a personal level, they could recognize career advancement paths not just within a department but across the organization.

Today, as broader perspectives are increasingly needed to respond to a crosscurrent of major (and sometimes existential) challenges, public company CFOs can also adopt this approach. Of course, doing so requires collaboration with the CHRO. But the CFO must lean in; the value proposition is too great to ignore. The finance function can be an ideal launching pad for promising employees who want to apply their foundational knowledge in other roles and get on the fast track to leadership. A high-performing CFO makes that happen.

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Private equity offers important lessons for public company CFOs: extraordinary challenges require focus, initiative—and leadership. Now more than ever, CFOs can take a proactive approach to value creation.

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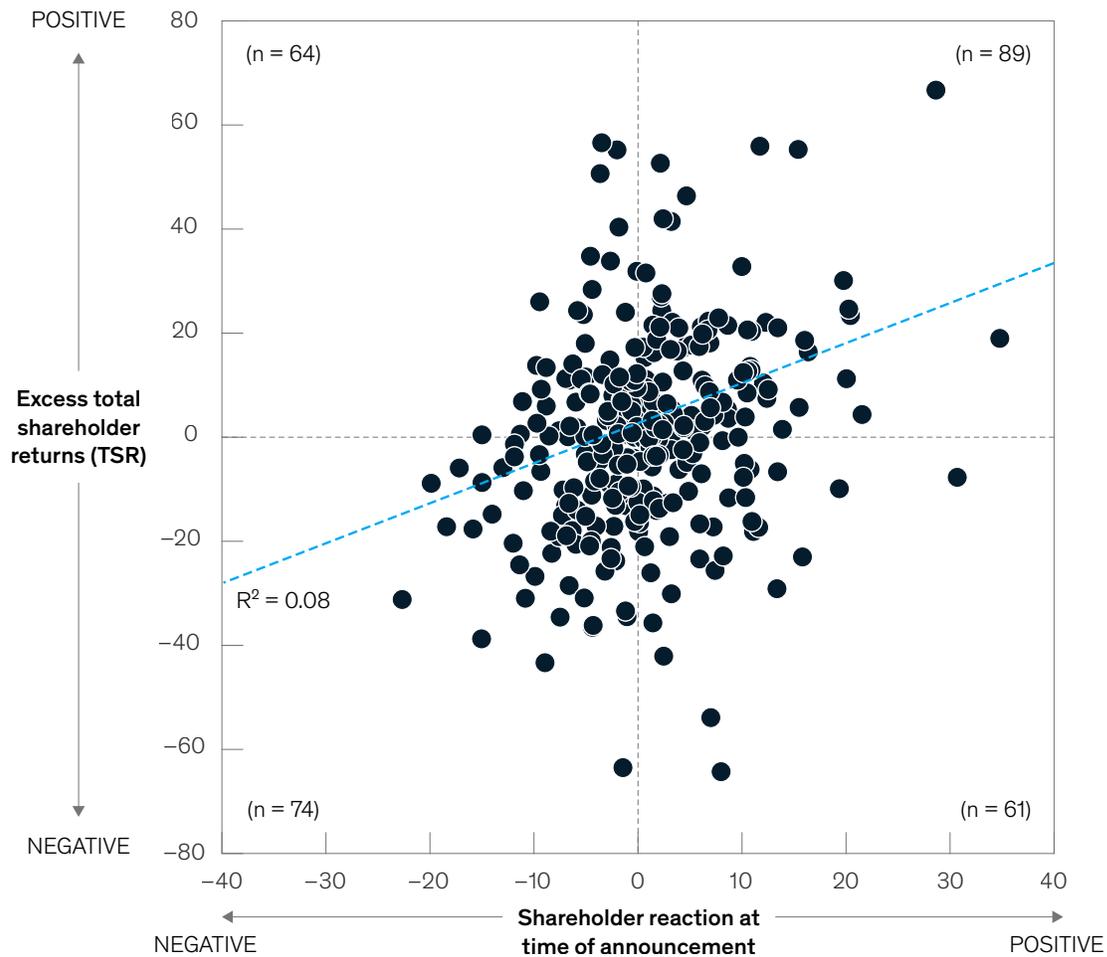
# Looking back

## Initial reactions to M&A announcements

Exhibit

**Initial reactions to M&A deal announcements can be unreliable indicators of potential long-term value.**

**Shareholder reactions to announcement of M&A deal vs returns 2 years after, % (n = 288)<sup>1</sup>**



<sup>1</sup> Out of 138 companies that received negative initial response, 64 (46%) earned positive TSR. Out of 150 companies that received positive initial response, 61 (41%) had negative TSR.

Source: Deal Patterns 2019; S&P Global; Corporate Performance Analytics by McKinsey

**When a company announces** a merger or acquisition, executives hold their breath and hope for a favorable reaction from the market. In general, the market tends to be pessimistic about such deals. So a positive reaction must mean that the deal team struck the right terms, told the right story to investors, and has the right strategies in place to appease regulators and create value from the deal long term—right? Maybe not.

Our research shows that the market's immediate reaction to M&A announcements isn't correlated with long-term value creation. In fact, of the large M&A deals<sup>1</sup> we studied, just under half of the announcements that got a negative reaction from the market initially went on to earn positive total shareholder returns (TSR) two years later. By contrast, slightly more than 40 percent of the announcements that got a positive reaction initially had negative TSR two years later (exhibit).

Rather than hold out for the hosannas, executives should take the market's reaction for what it is—a reflection of investors' current best understanding of the deal given the information they have in the moment. If the market *doesn't* respond enthusiastically, there are steps that executives can take to counter the skepticism. They could increase communications with investors, for instance, and be more transparent about their integration plans and performance objectives. Whatever the initial reaction to a merger or acquisition, executives should remember that there are always opportunities to validate or change the narrative on a large deal so that their messages about value creation come across more clearly.

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*For a full discussion of market dynamics, see Valuation: Measuring and Managing the Value of Companies, seventh edition (John Wiley & Sons, 2020), by Marc Goedhart, Tim Koller, and David Wessels.*

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<sup>1</sup> "Large M&A deals" defined as M&A deals worth 30 percent or more of the acquirer's market capitalization.

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