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A **software** subcontinent

Software and information technology services are already a bright spot in India's economy, yet they could be a lot brighter. Employing 280,000 skilled and semiskilled workers, the industry does enjoy favorable tax treatment, but it is encumbered by government red tape and by a clunky telecommunications infrastructure. Overhauling both could help catapult the business to world-class status by 2008, McKinsey concluded in a study for India's National Association of Software and Service Companies (Exhibit 1). By that year, software and IT services could create 2.2 million jobs and attract up to $5 billion in foreign direct investment—more than the entire Indian economy attracted in 1998. Of the $87 billion in revenues the industry might generate by 2008 (up from $3.3 billion in 1998), $50 billion would come from exports. The industry's market capitalization could be expected to rise tenfold, to $225 billion.

Markets are opening up in four broad areas: software products, electronic business, IT-enabled services (for instance, remote processing), and basic IT services themselves, which is the source of almost all of India's current success. IT services are expected to remain the bulwark of the industry, thanks to the competitive advantage that India has in people and vendor skills (Exhibit 2). These opportunities are driven by fundamental discontinuities in the global technological environment (such as the increasing capacity of electronic devices), by market shifts (to embedded software, for example), and by economic changes (in particular, the emergence of the Internet).

EXHIBIT 1

A bright future

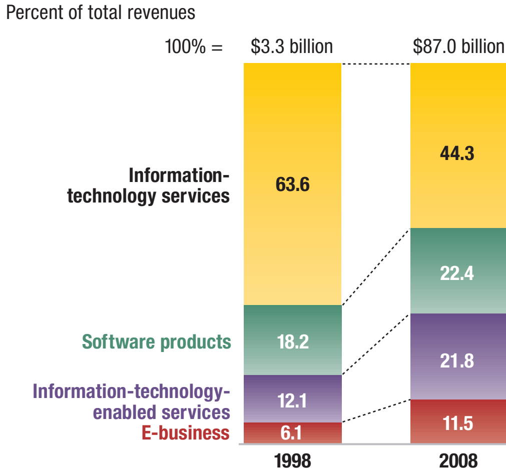
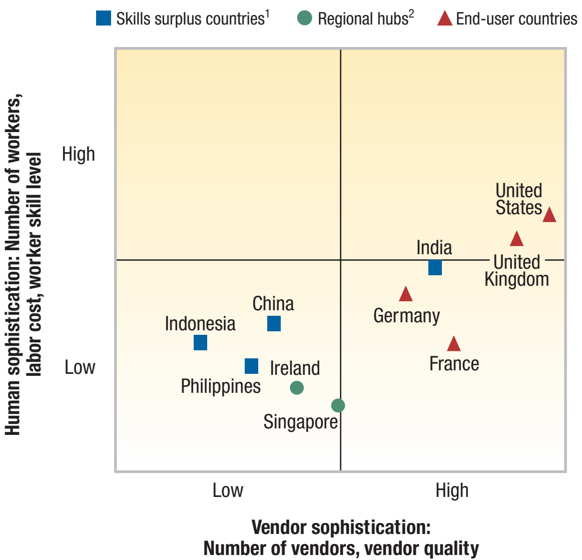


EXHIBIT 2

India's strong foundation: People and vendor skills



[1]Countries that have attractive human resources but neither the infrastructure nor the political resilience of hub locations.
[2]Countries that have superior infrastructure and low perceived political risk.

However, for India to build on its current success in the provision of cross-border IT services, the study found, it must transform itself into a country where the local technological infrastructure supports a profusion of software and IT specialists and where the level of political risk is perceived to be lower than it is in today's India.

The industry must also move up the value chain into enterprise resource-planning (ERP) services, applications maintenance, and Internet services.

Rane Computers, of Mumbai, for example, is building a complete World Wide Web sales system for a bookseller based in the United Kingdom.

Exports would have to account for a big chunk of the higher revenue. To increase them to the necessary level, the study asserts, India must tap markets outside the English-speaking world. (In 1997–98, as much as 63 percent of Indian software and IT service exports went to the United States or the United Kingdom, and those exports were also concentrated in the manufacturing sector and in financial services for the banking and insurance sectors.) To achieve the rapid growth the study envisions, the software and IT industry must break into retail and distribution, professional services, health care, communications, and utilities.

But unless the government of India reduces the volume and onerousness of its laws and regulations, makes them accessible and intelligible to businesspeople, and curtails the discretionary powers of the bureaucracy, the industry's potential will not be realized. The study results suggest that the government should act as an enabler and facilitator rather than as an investor and regulator.

In particular, the study calls for the enactment of "cyberlaws" governing e-business, for efforts to facilitate investment by multinational corporations and venture capitalists in Indian companies (including those building the private telecom infrastructure), and for a willingness to let them make large global acquisitions and create overseas development centers. Furthermore, the government should allow India's companies to offer stock options on global stock exchanges and make it possible for those companies to create an entertainment, telecommunications, and public-service infrastructure that would improve the lifestyle in the country's "IT hubs." The new Ministry of Information Technology should lobby for these changes, asserts the study.

—Pramath R. Sinha, Ramesh Srinivasan, and Ramesh Venkataraman

M&A in Asian insurance

Many Asian insurance companies—battered by losses in their real estate, stock, and bond portfolios—

have come to realize that they need Western investment. Most of them also understand that they need Western know-how. Yet the total transaction value of the mergers and acquisitions consummated in Hong Kong, South Korea, Taiwan, and Thailand came to only about $200 million in 1998 and to $700 million in 1999, just a fraction of the $2.3 billion and $5.6 billion value of the bank mergers consummated in those years.

Nonetheless, pressure is building rapidly because many Asian insurance regulators—urged on by Western governments and sobered by overall portfolio losses ranging from about 11 percent in Taiwan to nearly 21 percent in Korea—are relaxing restrictions on foreign ownership. As a result, we estimate, an additional $42 billion in life premiums is now available to foreign insurers (exhibit).

EXHIBIT

Asia opens up to the world

	Postcrisis market availability to foreign insurers, percent	Incremental increase, percent	Postcrisis premium availability to foreign insurers, $ billion	Incremental increase, $ billion
South Korea	93	91	43.1	39.2
Hong Kong	22	16	13.2	2.1
Taiwan	96	8	3.2	0.3
Thailand	60	4	1.9	0.1

Yet lax regulation of Asian insurance companies and their poor accounting practices make it difficult to assess their financial condition, and therefore their true value, and this has deterred potential investors and acquirers. Moreover, the Asian insurance players who are leaders in their markets have no interest in selling, although they are about to heat up the M&A game as acquirers. Meanwhile, even some companies that are technically insolvent have not yet come under pressure from their shareholders or regulators to sell, because they still enjoy positive cash flows. This, however, is likely to change quickly, for Hong Kong, Korea, Malaysia, Singapore, and other countries are instituting more transparent accounting and business conduct rules, and market saturation and more intense international competition are slowing the growth of premiums.

Two categories of insurance company are available now. The first consists of companies that not only are insolvent but also have short-term cash flow problems. Such companies face regulatory pressure to raise capital or sell, but nobody wants to buy them without government guarantees covering bad debt. The second category of available companies comprises low-skilled but viable businesses whose managers and shareholders recognize the competitive need to upgrade rapidly.

How can troubled companies that are under no immediate pressure to sell be induced to do so? First, it is necessary to understand the predicament of their owners, who are for the most part families. In Taiwan, for example, family-owned companies control 77 percent of property-and-casualty insurance premiums. Such a company typically constitutes the majority of the family's wealth and often represents years, or even generations, of dedication and toil. A seller wants to feel that the company will be in safe hands, maintain its ties to the community, protect the existing workforce as far as possible, and, perhaps, offer the family's next generation a role. M&A negotiations therefore involve efforts to ascertain the buyer's trustworthiness and take longer than those in the West. Western buyers, mostly interested in the financials, cut themselves out of this essential trust-building process by letting their bankers handle the negotiations.

Our preliminary analysis suggests that as a result of the Asian financial crisis, companies in the two most distressed, and thus most available, categories control around 30 percent of total life premiums, up from around 15 percent. In all, perhaps 18 to 20 companies in four markets—Korea, Hong Kong, Taiwan, and Thailand—are now in a must-sell position. In these four markets, the number of insurers that may be looking for minority partners has increased to about 22 companies, representing 39 percent of premiums.

Winning majority control of many of these companies is often very risky, very expensive, or simply impossible. Therefore, buyers must view the investment process as a gradual, long-term evolution toward majority control. Several leading acquirers—including AXA and GE Capital—have proceeded cleverly by obtaining parts rather than entire assets of insurance businesses and then gradually raising their stakes. GE Capital, for instance, formed a joint venture with Japan's Toho Life to manage the marketing and servicing of new policies. (Toho continued to service the old ones, guaranteed by Japan's government.) AIG raised its stake in Nanshan, a leading Taiwanese life insurer, over many years and is now making similar moves in Indonesia. Only companies with strong Asian management teams and a long-term commitment to the region are likely to succeed.

Whether Western companies acquire all or part of Asian insurers, the transfer of skills should be a well-thought-out aspect of any deal. Asians trail their Western counterparts in almost every area: product design and underwriting as well as agent, risk, and investment management. They will be needing these skills and exercising them far longer than they will be needing Western capital.

—Daniel Adamec, Gregory D. Gibb, and Raoul Oberman

Good news for **newspapers**

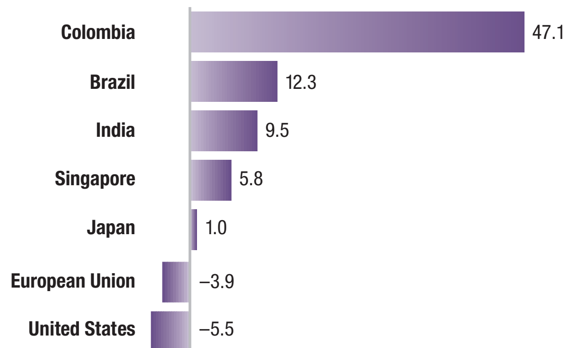
Many publishers and readers of newspapers think that the industry is declining. It is true that overall circulation is lower than it was before broadcast TV, cable TV, and the Internet made huge inroads. Yet by comparison with those mass media, the position of newspapers suddenly looks quite strong: the audiences for up-and-coming media remain terribly fragmented, so newspapers, though diminished, have once again become something like a broad-reach medium. In the United States, they reach 59 percent of the adult population daily, a penetration rate higher than that of prime-time TV, at 42 percent, or of radio, at 25 percent. Instead of substituting on-line publications for newspapers, readers commonly frequent the World Wide Web sites of their usual papers or use the Internet to complement the print media. In fact, many newspapers have succeeded in extending their readership bases by attracting new demographic groups to their Web sites.

Perhaps it should therefore be no surprise that newspapers around the world have been aggressively raising their prices. What is a surprise is the fact that, in seeming defiance of the standard inverse relationship between price and circulation, this development hasn't driven away readers. In an industry that has been shrinking for decades, such evidence of price elasticity is very good news.

EXHIBIT 1

Growth is strong in emerging markets

Circulation growth, 1993–97, millions

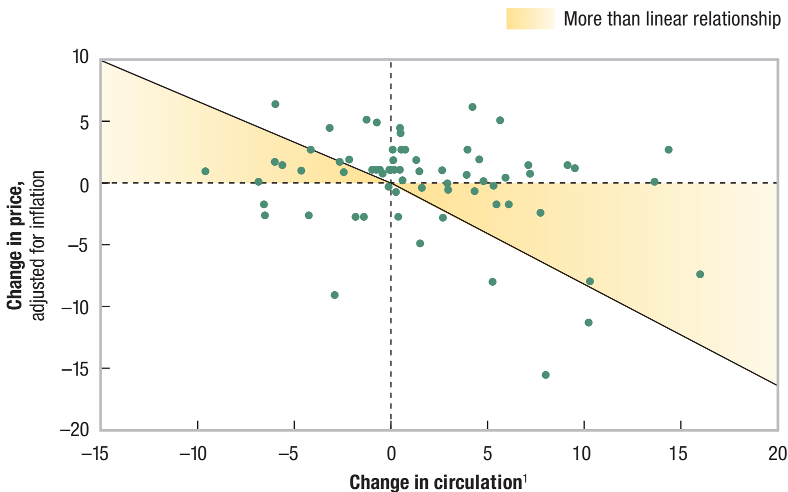


Indeed, even in mature markets, newspaper prices have increased much more than those of other daily goods. In emerging markets, as Exhibit 1 suggests, circulation growth is very strong, and individual newspapers, such as the *Times of India* and Brazil's *O Dia* and *O Estado de São Paolo*, have achieved growth rates of up to around 60 percent over the past five years.

EXHIBIT 2

Reexamining the relationship between price and circulation

Percent change, 1992–97



[1]Measured as compound annual growth rate.

EXHIBIT 3

Winning ways: Alternative pricing strategies

Percent change, 1993–98

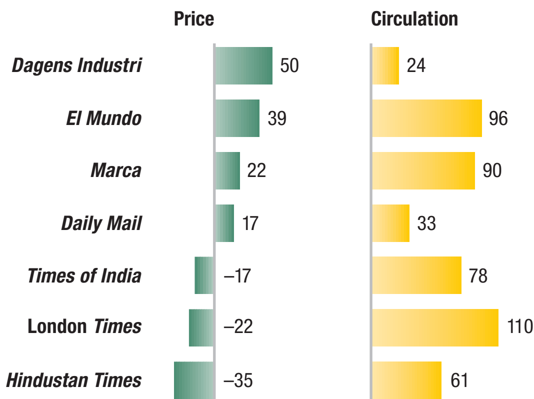


Exhibit 2 maps changes in circulation against changes in inflation-adjusted prices for top newspapers in each of nine markets around the globe during a period of six years. You would expect circulation to decrease as prices increased, putting most of the dots along the diagonal or into the shaded areas, but more than half of the newspapers actually fall outside them. Thirty-seven percent gather in the upper right-hand quadrant, indicating an increase in both their inflation-adjusted prices and their circulations.

When we looked at the relationship between a newspaper's circulation and its competitor's price movements in 11 markets where two or more newspapers compete head to head, we found another surprise. You

would expect a price increase by one newspaper to raise the circulation of its competitor, but in reality competing pairs of newspapers frequently deviated from the norm.

Of course, raising a newspaper's circulation requires the integrated use of all levers in the marketing toolbox. Price is among those levers, and since it is an expensive one it calls for careful planning and skillful execution. Moreover, it isn't easy to construct models of circulation that account for external factors such as the amount of compelling news in a given period, the existence of competing media, and the quantity of advertising that competitors run. Internal factors such as product development, branding, promotions, the process for selling subscriptions and papers, and distribution are also hard to model. But at a minimum, the relationship between price and circulation seems to be far from transparent. Price increases are more feasible than most players realize (Exhibit 3).

—Fredrik Gren, Luis A. Ubiñas, and Marie-Ann Wachtmeister

Black-Scholes
meets *Seinfeld*

Uncertainty defines the television business. Who really knows whether a show will be a hit or a dud, or at what time or on which day it must be broadcast to reach the biggest audience and thus capture the largest advertising premium? TV executives have been struggling with these questions since the industry's creation. Although TV programmers put their faith in pilots and market research, they also rely heavily on instinct. Much rides on their judgment, since programming accounts for 55 to 65 percent of a TV channel's expenses. Is there a way to improve the odds of success or at least to minimize the damage caused by disappointing shows?

McKinsey has found that applying options theory to TV programming decisions can improve returns from programming investments. The holder of a financial option has the right, but not the obligation, to buy or sell a stock at a fixed price within a fixed period. In recent years, many companies have begun to apply options theory and the Black-Scholes pricing formula to nonfinancial, or "real," investment decisions. Options used in this way—known

as real options—have found ready acceptance in the mining, petroleum, and pharmaceutical industries, where uncertainty is high and the need for flexibility at a premium.[1]

Nothing can ever replace human instinct in a business like television, in which creativity plays such a predominant role. But real options have a place in the tool kits of TV broadcasters because of the high uncertainty and costs of a program series. Indeed, TV executives informally exercise options whenever they yank underperforming shows or otherwise modify schedules. What they must now do is institutionalize the process of recognizing, evaluating, and exercising the options embedded in TV programs.

EXHIBIT 1

Real options in real life: Two case studies

	Market share, percent	**Program portfolio,**[1] number of local-content programs	**Average program duration,** years	**EBITDA**[2] **value linked to real options,** percent
Commercial Broadcaster A	40	100	2	6
Commercial Broadcaster B	25	140	2	4

[1]For Commercial Broadcaster A, 80% of programs are produced externally; for Commercial Broadcaster B, 70%.
[2]Earnings before interest, taxes, depreciation, and amortization.
Source: Client examples; McKinsey analysis

In the cases McKinsey has studied, the application of real options has led to an average increase of 25 to 50 percent of the original value to be captured in a program's life cycle. In other words, real options are every bit as valuable in TV as in industries such as mining. Of course, some programs don't embed large option values, because they are either very profitable or very poorly designed.[2] Nevertheless, for a majority of programs, whose returns are likely to be close to the minimum, options are very profitable; indeed, they can contribute an additional five to ten percentage points of EBITDA (earnings before interest, taxes, depreciation, and amortization) margin. Since the TV industry has generated total returns to shareholders of about 18 percent, exercising real options could increase shareholder value by more than one-third (Exhibit 1).

Using options means coming to grips with risk. The risk of a program series lies in its uncertain ability to generate high ratings and therefore high advertising revenue. Fortunately for broadcasters, enough information is available to provide at least clues to the likelihood that a series might succeed. In the

[1]*See* Thomas E. Copeland and Philip T. Keenan, "How much is flexibility worth?" *The McKinsey Quarterly*, 1998 Number 2, pp. 38–49; Thomas E. Copeland and Philip T. Keenan, "Making real options real," *The McKinsey Quarterly*, 1998 Number 3, pp. 128–41; and Keith J. Leslie and Max P. Michaels, "The real power of real options," *The McKinsey Quarterly*, 1997 Number 3, pp. 4–22.

[2]*See* Jacques Bughin and Wilfred Griekspoor, "A new era for European TV," *The McKinsey Quarterly*, 1997 Number 3, pp. 90–102.

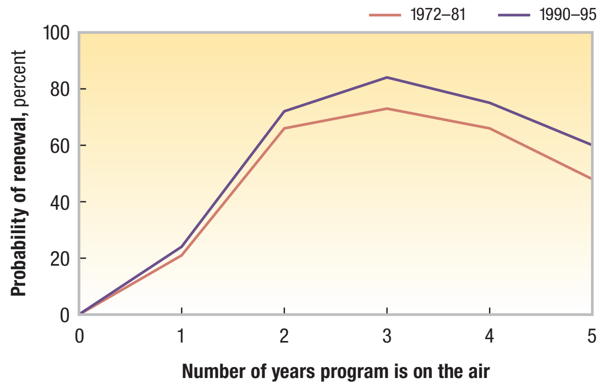
United States, for example, a series that has already been granted a second season is up to three times as likely to be renewed as one that has yet to be granted a second season (Exhibit 2). Moreover, content tends to cluster in genres, each with its own characteristic range of performance: national-team soccer in Europe, for example, does very well, with market shares of 45 to 55 percent. An option for a show can thus be valued by referring to the performance of other shows in its genre.

Television programming involves several kinds of options, such as "scale," "temporary," "kill," and "switch." The range of options for a TV series depends on its genre, and the same program can embody more than one option. A scale option projects the life (including reruns and sequels) of a high-performing show. A temporary option might make a channel refrain from scheduling a high-cost series during typically low-ratings months such as July and August. A kill option identifies struggling programs with no future. And a switch option might suggest changing the time slot of a program to improve its ratings or demographics.

EXHIBIT 2

Weighing the risks of renewal

Prime-time television series in the United States



Source: *Video Economics*; Paul Kagan Associates; McKinsey analysis

In the United States, the NBC television network exercised a switch option when it moved *Seinfeld* to Thursday night. Most people forget that this enormously popular series performed poorly during its first two seasons, ranking in the bottom quartile. By shaping stronger characters and moving the show—thus exercising an option embedded in it—NBC eventually created a sensational program. The option to shift *Seinfeld* to another time slot could be valued as a call option, which gives the network the right (but not the obligation) to adapt its schedule after experimenting with a program's performance in various time slots. That flexibility has a monetary value.

Real options in TV will probably become even more relevant in the years to come. Digitization and the Internet are heightening uncertainty in the broadcast industry by creating more competition and further fragmenting audiences. But even with the help of options, TV programmers will have to rely

on their sixth sense and on luck. Who would have guessed that *Hogan's Heroes*, a 1960s US situation comedy about World War II prisoners of war, would spend years in production and many more in syndication?

—Jacques Bughin

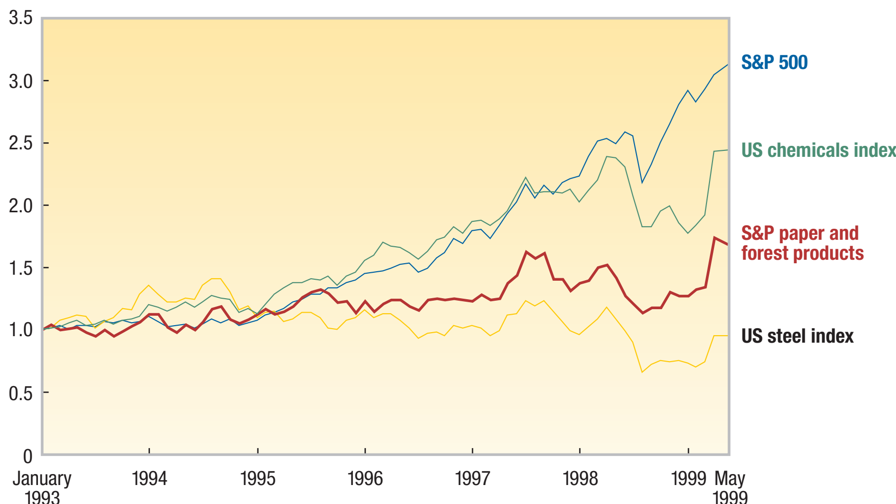
Pulp fact

The past decade has been a punishing one for shareholders of pulp-and-paper companies, and the current low level of returns is expected to continue. Notwithstanding a series of acquisitions in early 2000, the industry remains fairly fragmented, and legal constraints generally limit concentration. Even in segments that are fairly concentrated, independents are numerous enough to make competition fierce. Meanwhile, international players apply pressure wherever regional price umbrellas appear. Thus the pulp-and-paper industry, despite a certain amount of consolidation, has created less long-term value than have other asset-intensive basic-materials industries (Exhibit 1).

EXHIBIT **1**

Capital market performance, January 1993 to May 1999

Index: January 1993 = 1.0



As if the structure of the industry wasn't difficult enough, almost no pulp-and-paper companies have managed to develop significant intangible or privileged assets (such as proprietary technology or patents) or superior operational practices. Both of these failures exert intense commoditization pressures. Management's propensity to spend capital in good times and to cut back in bad amplifies the industry's cyclical nature and compounds all of these problems.

Depending on where companies stand between the trough and the peak of the business cycle, their valuations range from one to two times book value. No surprise, then, that the industry is losing the war for talent, and doubly so in the face of all the exciting new opportunities—not least, the stock options awarded to executives—emerging in electronic commerce.

Pulp-and-paper companies fall into three broad categories. Despite the gloom, the companies belonging to each have a winning, or at least a remedial, strategy (Exhibit 2).

"Underperforming" companies ought to be treated as corporate raiders would treat them in the first 90 days after a takeover. In other words, parts of these companies should be liquidated or placed elsewhere if that would enhance their value, and their executives should be retained, reassigned, or dismissed on the basis of competencies and track records. In addition, financial leverage should be used to extract cash from mature assets. By the end of the process, profitable businesses will have a new focus. Most of these steps were taken during the 1997–98 turnaround at Canada's MacMillan Bloedel.

EXHIBIT 2

Winning, losing, and getting by: Strategies for creating value

	Annual real productivity gains, percent	**Do they earn cost of capital over the cycle?**	**Cyclical market-to-book value,** ratio	**Does market expect long-term growth?**	**Strategy**
Under-performing companies	Less than 2%	No	Consistently less than 1.5	No	Divest, liquidate, refocus
In-the-pack companies	Approximately 2%	Yes, but just	Between 1.0 and 2.0	No	Focus on productivity
Shaping companies	Consistently above 2%	Yes, and more	Above 2.0	Yes	Accelerated growth agenda

"In-the-pack" companies need to focus on the three pillars of productivity: operating costs, revenue, and capital investment. Research suggests that taking a rigorous approach to capital productivity and establishing cycle management, risk management, and customer productivity programs can help the industry's commodity businesses achieve operating margins that are 5 to 10 percent higher than those of their average competitors. Of the three strategies, this one is the most demanding.

"Shaping" companies inspire or force other players to emulate their strategies or tactics. Their superior productivity allows them to develop intangible assets and skills. There are few such companies in the pulp-and-paper industry, and they commonly adopt niche strategies. Kimberly-Clark has perhaps been its most important shaper during the past 15 years. By shedding unproductive assets, focusing on profitable segments, and leveraging brands, the company moved its market-to-book ratio up to 7:1, the top of the shaping range. Few people remember that Kimberly-Clark too was once in the pack.

By definition, most companies find themselves in the pack. They must begin the hard work of improving their operating and capital productivity. In view of the history of most pulp-and-paper companies, making this happen may require an energetic board and chief executive officer to lead a cultural revolution.

—Thomas G. Horton and Patrick Pichette

Stop wasting promotional money

When consumer goods manufacturers set out to improve their efficiency, they usually start with marketing and production. Trade spending—the payments they make to retailers in hopes of encouraging promotion—is almost always overlooked. Yet for improving the profitability of a consumer goods manufacturer, this is among the most important levers, up there with pricing, media spending, production costs, and distribution. Indeed, McKinsey has found that proper management of trade spending can increase a company's return on sales by two percentage points.

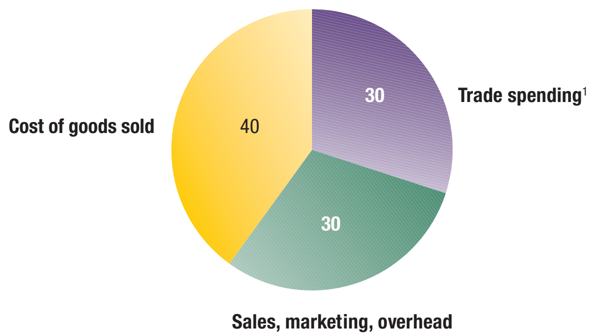
In consumer goods, “trade spending” means all of a manufacturer’s cash payments to grocery retailers beyond “terms and conditions,” such as bonuses, discounts, and advertising allowances. One example of trade spending is the central-warehouse discount; another is the second-placement fee. In all, these payments account for up to 30 percent of the costs of a typical consumer goods manufacturer (Exhibit 1).

Such is the power of retailers that an absolute reduction in trade spending is hardly realistic. Competition for limited shelf space is intensifying, particularly in center-city grocery outlets with 600 to 800 square meters of selling space. More intense pressure from private labels is also weakening the position of manufacturers. In addition, more and more of them are turning away from media spending for product launches and toward trade-related activities (such as free sampling) that often raise trade spending.

EXHIBIT 1

Trade spending: A cost of doing business

Share of total costs for a typical consumer goods manufacturer, percent



[1]Includes listing fees, which are paid to a retailer in return for shelf space.
Source: Annual reports; McKinsey analysis

These higher levels of trade spending have shifted profits from manufacturers to retailers: in 1992, consumer goods producers in the United Kingdom collected about 48 percent of the total industry profit pool; by 1997, their share had fallen to 44 percent. During that period, the retailers’ share grew to 49 percent, from 42 percent. The same trend can be observed in the rest of Europe.

In many cases, only about half of the total payment a manufacturer makes to grocery retailers earns something definite, such as shelf space, in return. The rest of these payments are hidden price concessions. Although most manufacturers know this, the retailers’ power compels them to pay up. But the high degree of variation among individual accounts in the structure of trade spending shows that manufacturers can at least increase the part of it that adds value for them (Exhibit 2, on the next page).

To do so, however, a manufacturer must ascertain the profitability of each account by instituting a system of account-specific profit-and-loss

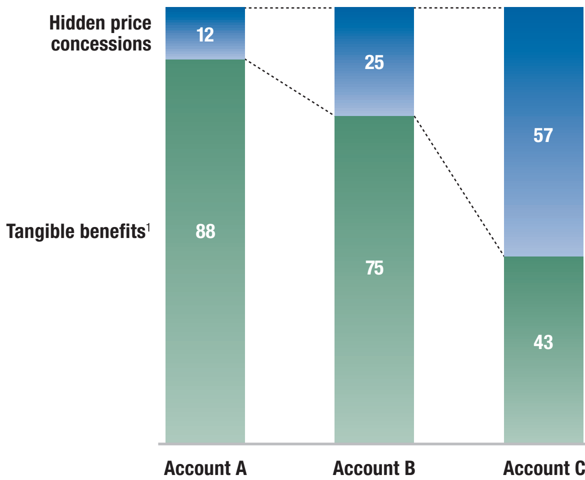
statements. Many consumer goods manufacturers don’t use them at all; others don’t use them sufficiently; and still others don’t perform complete calculations for them. Yet the detailed knowledge of accounts they can provide reveals the effectiveness of individual profit levers (for instance, the promotion mix) and indicates which are most likely to increase the part of trade spending that adds value for manufacturers instead of serving as a disguised price concession.

In fact, price concessions don’t always suit the best interests of either manufacturers or retailers. The additional sales volume that a whisky manufacturer, for example, generated by increasing the level of the price concessions it gave retailers to 30 percent, from 10 percent, was minimal. Both sides would have benefited more from a different use of those funds.

EXHIBIT 2

Getting nothing for something

A typical manufacturer’s trade spending, by account, percent



[1]Includes benefits such as promotional activities and campaigns, second-placement fees, and listing fees.

Agreements on prices and promotional spending are worthwhile alternatives. Manufacturers entering into the former should insist that price concessions benefit consumers instead of vanishing into the retailer’s coffers. As for promotion, the impact of different measures on sales volumes varies considerably, so a separate P&L statement is needed to verify that the terms of such agreements are being honored.

Price agreements and promotional spending tend to be more effective when they are tailored to an account’s specifics. Moreover, it is possible to achieve higher profits in the short term, but they are not likely to be sustained without long-term investments to build skills in sales and key-account management.

—Konrad Gerszke, Udo Kopka, and Thomas C. A. Tochtermann

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