STRATEGY

MANAGING PERFORMANCE

HEALTH INC.

Organisational health — the ability to align, execute and renew at the strategic, organisational and operational levels faster than the competition to sustain exceptional performance over time — is the holy grail of the corporate world. Research by McKinsey & Company has identified nine factors which determine organisational health. ***Alice Breeden, Helena Karlinder-Östlundh, Colin Price,*** *and* ***Sharon Toye*** *offer a health check.*

Companies typically view their performance in terms of financial returns; core systems and processes are assessed on their contribution to those returns. An assembly line, for example, is designed to produce so many widgets per week while meeting standards for cost and quality. The accounts receivable function is to process so many billings per month and remain below a limit set for number of days of receivables outstanding.

This means that "managing performance" first and foremost suggests the need to keep routine functions working within defined tolerances, to execute solidly, like a well-oiled machine. A bit of reflection, of course, quickly brings to mind the many ways in which performance can be affected by changes outside the limits. The assembly line must accommodate a new manufacturing technology. The accounts receivable function must meet new efficiency standards or be outsourced. The company as a whole must enter new geographic markets, must attract new kinds of customers, must provide new products and services, or must deal with a funding shock or supply chain disruption.

All of these challenges directly affect financial performance. It is highly unlikely that a company primarily focused on managing performance to meet a given set of standards will be able to redefine those standards quickly enough to avoid significant drops in performance. This has always been true, but in our current economy, with an ever-faster pace of change, it is even more urgent. Change moves into the foreground, and established routines into the background. So what does a company need to do to maintain performance over time?

Harnessing health

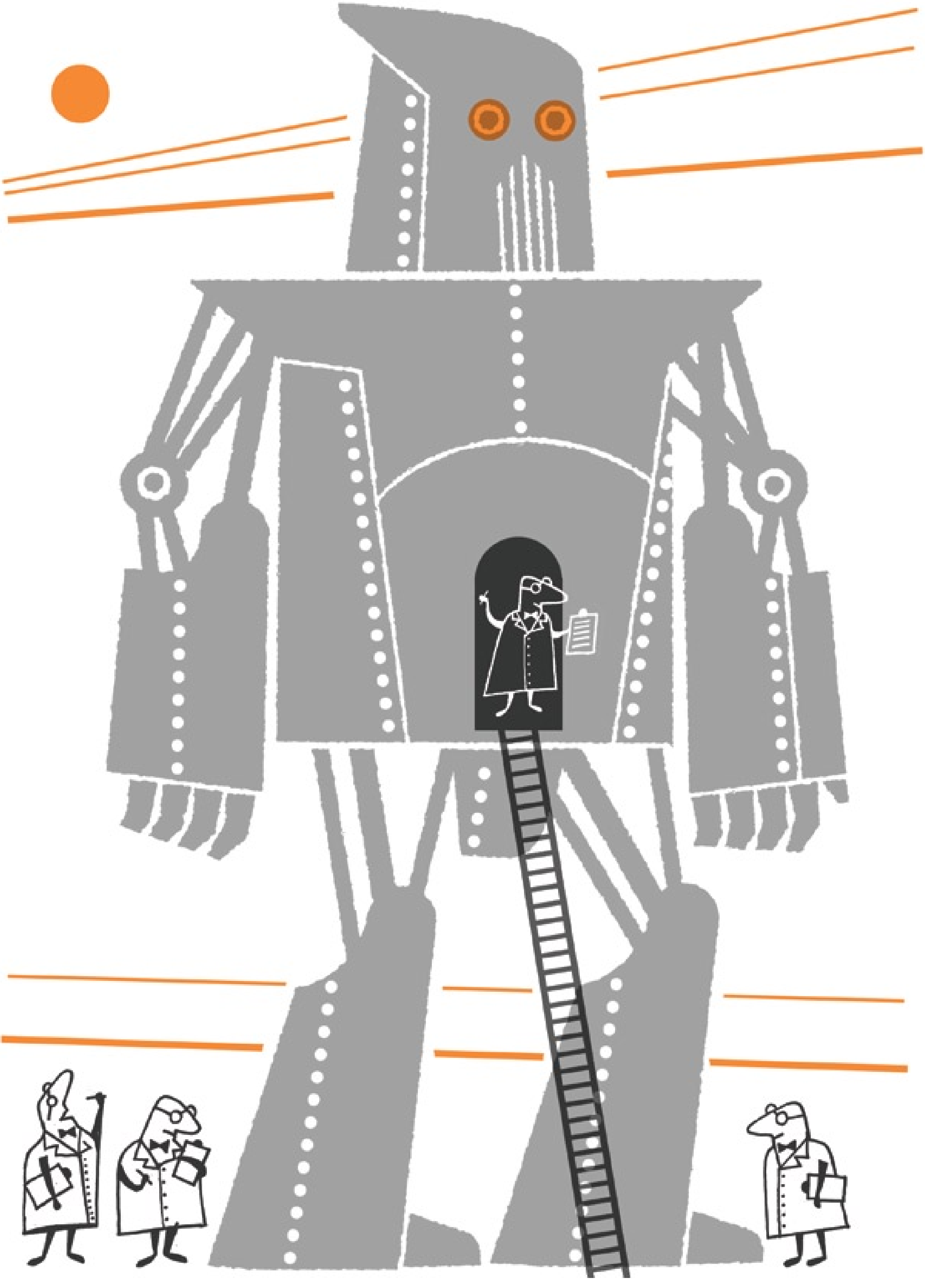
The organisation — with its complex patterns of behaviours and relationships, its intricate meshing of groups defined by hierarchical level, functional role, and professional affiliation, its embedded layers of culture, its mysterious energy dynamics, its meaning-making role for individuals, and its openness to leadership but resistance to manipulation — is the least machine-like entity in business. Yet all those parts must work together over the long term for the organisation to succeed.

A useful tool for understanding how they can do so is a simple metaphor: a person's health. A complete health examination provides both a snapshot of how well the body is performing today and a set of indicators about how well it will function in the future. With the right indicators, organisational health can be assessed in the same way.

Over the past ten years, McKinsey & Company has undertaken research to better understand what companies do to attain organisational health.

NEXT ISSUE
Ferran Adria of El Bulli on innovation and leadership in the kitchen.

STRATEGY ILLUSTRATIONS: JOE MCLAREN



Ideas about potential indicators of organisational health were distilled into a tool, the Organisational Health Index, which allows us to assess where companies stand on a range of critical markers and to link those scores to corporate financial performance in a way that identifies the key relationships. The Organisational Health Index survey has, over ten years, been completed by more than 600,000 employees at more than 500 companies. We have found nine organisational factors that are consistently, and statistically significantly, tied to strong financial performance:

01

DIRECTION

TALKING ABOUT PURPOSE, AS WELL AS PERFORMANCE

Communicating a clear sense of where the organisation is heading and how it will get there, that is meaningful to all employees.

The core business idea of a company can be captured in a phrase: for example, the company develops and markets drugs; it flies people from city to city; or it provides financial services to retail and business customers. While this is clear, it is not necessarily the kind of purpose that gives employees enough meaning or motivation to achieve extraordinary things. Yet our research shows that meaningful direction is closely tied to financial performance: the likelihood that a company with a top-quartile score on direction has above-median EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation) margin is 67 per cent.

So what does provide that kind of direction? We define it as a widely understood and truly engaging vision, a strategy that is aligned with that vision and guides the day-to-day behaviour of employees, and operational plans and targets that are directly derived from the strategy.

Other research has shown that what makes the most difference is meaning or engagement — the purpose beyond financial returns. The challenge for leaders, therefore, is to expend the extra effort it takes to provide an authentic purpose beyond making money. Some have an easier job than others: Daniel Vasella, chairman of Novartis, commented in 2009, "Last year we saved an additional two hundred thousand lives. Two hundred thousand lives! This resonates with everyone."

Once identified and articulated, an organisation's sense of purpose still needs to be embedded into internal structures, systems and processes. Academic literature, for example, shows how strong alignment between a company's mission and its performance management system has the power to shape individual employee behaviour and leads to higher return on assets. Tom Glocer, CEO of Thomson Reuters, explains: "What's going to be required for success? Obviously a much higher amount of emotional intelligence, because just designing the best incentive plan, and 'we'll do dry cleaning,' isn't going to be good enough. You need to be able to lay out an appealing vision that excites people, coupled with systems and processes which respond to different payoff matrices for people."

02

LEADERSHIP

INSPIRING ACTIONS BY OTHERS

Using effective leadership styles to shape the actions of people in the organisation to drive high performance.

The importance of leadership is a managerial truism for good reason. One seminal piece of research on 167 companies in 13 industries suggested that CEO and top-team leadership accounted for some 70 per cent of the variance in sales and some 30 per cent of the variance in profit margin, after taking into account such factors as economic climate, industry traits, organisation size and location. Our McKinsey data show the likelihood of a company with a top-quartile leadership score having above-median EBITDA margin to be 59 per cent, which is 1.8 times higher than for bottom-quartile peers.

But what kind of leadership works best, and in what context?

Our data consistently show that an empowering and challenging leadership style is more effective than a command-and-control approach: organisations scoring high on empowering leadership had a 55 to 58 per cent likelihood of achieving top-quartile EBITDA margin, compared with a likelihood of only 43 per cent for those following

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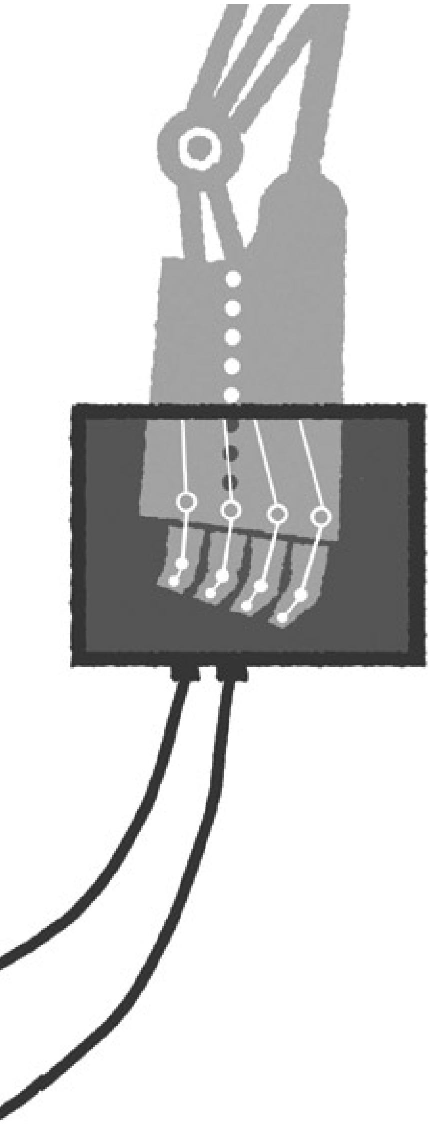


a command-and-control approach. Numerous academic studies have also linked empowering leadership with effective team performance outcomes such as team learning.

It is important to understand, however, that leadership is not the CEO's task alone; leadership quality — good and bad — has a ripple effect on many other elements of organisational health. In our work, we define it as the combination of a fully aligned and well-respected top team with managers (on all organisational levels) who make high-quality and timely business decisions, build good relationships with their teams and act as role models.

03

CULTURE AND CLIMATE

CULTIVATING SHARED BELIEFS AND QUALITY OF INTERACTIONS WITHIN AND ACROSS ORGANISATIONAL UNITS

Cultivating a clear, consistent set of values and working norms that foster effective workplace behaviour.

High-performing companies tend to be known for, among other things, their strong cultures. Our research shows that the likelihood of a company with a strong culture (scoring in the top quartile on culture and climate) having above-median EBITDA margin is 61 per cent, suggesting culture is a key contributor to financial performance.

Reuters' cultural adaptability is an interesting example. Over its long history, Reuters has been in many businesses, from its origins in news gathering, to oil and foreign-exchange dealing, and more recently information management through its merger with Thomson. Through these various incarnations, Reuters has maintained a consistent cultural backbone of integrity and fact-based analysis. It has also, however, deliberately nurtured the capability to adapt and to ensure its culture can shift to suit new value creation modes.

It is also clear that in order for culture to drive value, it needs to be created and made meaningful at the local level, whether that is a single plant, a functional department or another small organisation-within-an-organisation. Novartis, for example, has a distinct corporate culture characterised by an emphasis on corporate citizenship, which shapes the conduct of every one of its 100,000 employees across 140 countries. This corporate citizenship is built upon four core pillars: patients, business conduct, people and communities, and environmental care. However, the culture varies by division. Novartis has highly commercial, market-focused sales organisations, while its production and manufacturing divisions value quality and predictability, and its R&D divisions focus on harnessing creativity and innovation. These markedly different cultures allow Novartis to access the best talent in each relevant area and to build an organisation that can compete with the specialised players in each of its business segments.

04

ACCOUNTABILITY

ENABLING EVERYONE TO ACT LIKE AN OWNER

Ensuring individuals understand what is expected of them, have sufficient authority and take responsibility for delivering results.

Our research shows that high-performing companies do two things to ensure accountability. They put in place structural levers — key performance indicators, decision rights and reporting lines — to clarify exactly what each individual is responsible for and to ensure adequate performance management. They also invest in creating an owner mind-set at all levels of the organisation, meaning that each and every employee feels an individual responsibility for making decisions that are in the long-term interests of the company.

There is no doubt that the structural mechanisms are fundamental. Our research confirms that role structure, performance contracts, consequence systems and personal obligation practices drive accountability, which in turn drives superior performance. The likelihood of demonstrating above-median EBITDA margin for a company with an accountability score in the top quartile of the database is 65 per cent — 1.9 times higher than for a company with a bottom-quartile score. We also found that this relationship is linear, meaning that the stronger the accountability, the more beneficial it is to performance.

How can organisations create an owner mind-set? The research suggests that giving all employees visibility of and some kind of say in how the business is run, as well as a share in the rewards, drives the right behaviours and creates superior performance. Whole Foods is a case in point. There everyone is considered a key decision maker, so everyone has access to all key business data. Information is shared so widely that the Securities and Exchange Commission considers all 40,000-plus employees to be "insiders" for stock-trading purposes.

But ownership does not have to be literal. What matters is the sense of ownership — a deep level of engagement and an opportunity to make a valued contribution.

05

COORDINATION AND CONTROL

EVALUATING ORGANISATIONAL PERFORMANCE AND RISK AND ADDRESSING ISSUES AND OPPORTUNITIES WHEN THEY ARISE

Consistently measuring and managing the business and risk, and acting to address problems when they arise.

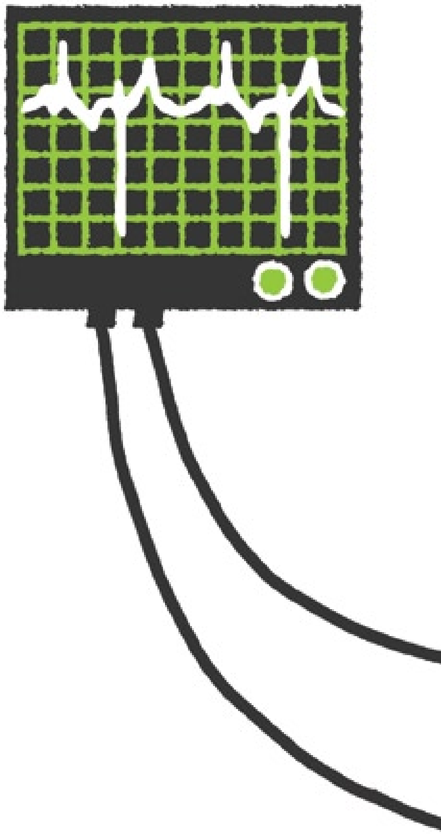
There are many examples of organisations making expensive mistakes due to simple breakdowns in coordination and control. NASA lost a $125 million Mars orbiter because a Lockheed Martin engineering team used the English imperial units of measurement while NASA's team used the metric system for a key spacecraft operation.

Here at ground level too, being able to measure and manage business performance and risk and to act accordingly makes a significant difference to performance. These actions are one of the most critical drivers of performance among the nine factors of organisational health. A high score on this outcome gives an organisation a 73 per cent chance of above-median EBITDA margin. Our own data also tell us something about how to do it right.

First, companies need to track and balance performance measures encompassing financial performance, operations, people and professional standards — commonly known as the balanced-scorecard approach — allowing a powerful cross-functional view. Although there are benefits to getting each performance measure right (showing a 49 to 53 per cent likelihood of achieving a top-quartile score for coordination and control), these are significantly outweighed by the benefit of getting all four right (a 59 per cent likelihood of a top-quartile score).

There is another key dimension to coordination and control beyond monitoring the right metrics. In working with our clients, we have consistently found that creating the right networks across divisions of the organisation, both formally and informally, is critical to success, and this is supported by academic research. Such networks differ from the vertical control systems represented by formal metrics. For example, a 2002 study by Brandeis University's Jody Gittell showed that organisations can build effective coordination through the design of high-performance work systems, including work routines, team meetings and effective communication. These in turn have a strong positive impact on quality of care and length of stay.

Health care provides particularly good examples because it is typically fragmented and complex. An individual with diabetes, for example, needs help from his or her primary-care practitioner. This person may also be referred to a hospital for some specific treatment for the diabetes itself or one of its consequences. He or she is also likely to require some help from community practitioners with regard to diet and exercise programmes. To coordinate all of this onto a single pathway that the patient can reasonably follow requires horizontal coordination at each step.



06

CAPABILITIES

NETWORKING YOUR TALENT — OR LOSING THE VALUE

Ensuring the institutional skills and talent are in place to execute the strategy and create competitive advantage.

There is no doubt that an organisation's ability to attract and retain top talent drives its performance. Richard Parsons of Citigroup, formerly of Time Warner, sums up the additional challenge of harnessing existing talent in an organisation: "There is talent everywhere. It's identifying it, putting it in the right places, motivating it and then giving it the right assignments — and that's the part that's often missing."

According to our data, the likelihood that a company with a top-quartile score in capabilities has an above-median EBITDA margin is 67 per

> "It's not that this generation is suddenly amazingly altruistic; it's just that the absence of war and absence of need has basically changed what they most value.... Now it is all about that feeling of inclusion."

cent, making it one of the strongest contributors to financial performance we have found. In a separate McKinsey survey of 850 executives worldwide, management capabilities were found to be a key factor in determining how much value companies with above-average complexity were able to create. Specifically, companies with managers who had top-quartile collaborative-management capabilities such as being cooperative, looking to build linkages and taking initiative beyond the confines of one's job were found to be 50 per cent more likely to have an above-average return on capital employed (ROCE).

It seems that once you have successfully attracted the right talent, building social capital is the key to retaining and getting the best out of it. In a study of 1,052 star stock analysts, the individual performance of many stars sharply declined as they were recruited into another financial company. For example, 46 per cent of the star analysts did poorly in the first year after they left one company for another: their performance plummeted by an average of about 20 per cent. The performance drop was most pronounced if the star analysts moved from a big company to a small one, presumably because fewer company-specific resources were available. Further, stars who brought with them teams of research analysts, salespeople and traders performed better than analysts who moved solo, suggesting their network was part of their strength.

Studies into the development of the personality and psyche of organisations may be able to explain why the sum of an organisation's talent is more than its parts. These studies argue that the individual and the organisation are indivisibly linked, just like a mother and child. The development of the individual and all his or her talents will depend on whether the organisational environment is "good enough". That is, the environment needs to provide basic trust, boundaries and networks where the individual feels "held". In this context, personalities and capabilities can progress. At the same time, individuals influence the parts of the organisation to which they are connected, increasing its overall effectiveness. Given this iterative ongoing mutual influence, it is no wonder that stars who took their own part of their old organisation to their new one fared better than those who did not. And as organisational consultant Lionel Stapley points out, "Reliable holding is as important to the self-esteem of the members of an organisation as it is to the infant." In particular, if the organisation is found to be socially "not good enough", there is likely to be an antitask culture in which employees essentially avoid doing the work they are there to do.

More broadly, we have come to understand that the strength of talent is amplified by the strength of the context in which it operates. Highly capable individuals placed in a negative corporate environment will underperform more modestly skilled individuals. Top talent will deliver top returns only if the talent is deployed in what Jack Welch, former CEO of GE, describes as "a positive social architecture".

Strong networks can also help avoid the risk of losing employees. Tom Glocer, CEO of Thomson Reuters, puts his finger on the importance of social networks: "It's not that this generation is suddenly amazingly altruistic; it's just that the absence of war and absence of need has basically changed what they most value.... Now it is all about that feeling of inclusion."

07

MOTIVATION

DEVELOPING THE ENTHUSIASM THAT DRIVES EMPLOYEES TO PUT IN EXTRAORDINARY EFFORT TO DELIVER RESULTS

Developing employee loyalty and enthusiasm, and inspiring people to exert extraordinary effort to perform at their very best.

How many of your employees are truly motivated? And how much is a lack of motivation costing your company? A Gallup survey found that 14 per cent of the US workforce is actively disengaged, costing the US economy around $300 billion per year in lost productivity driven by absence, illness and other problems. Our own data lend further support to the idea that being distinctive at motivating your workforce is important to performance: the likelihood of a company with a top-quartile motivation score also having above-median EBITDA margin was found to be 73 per cent — 1.8 times the likelihood for comparable bottom-quartile companies. Notably, the data also suggest there is limited benefit to achieving only average motivation: companies showed a roughly 42 per cent chance of beating the median regardless of whether they were bottom-quartile scorers

> "For an organisation to have any hope of staying ahead, it needs the ability to look beyond its own traditional boundaries to those of its partners and competitors."

or in the middle half, indicating that only truly distinctive motivation provides a real financial upside.

Perhaps unexpectedly, hiring the right people is, according to one study, a quarter of the battle in creating a motivated workforce. The study showed that differences in personality profiles explained 24 per cent of the variance in employees' performance motivation. Conscientiousness, openness to experience and extroversion were the key traits to look for, suggesting that motivation of employees begins much earlier than most leaders recognise.

Equally importantly, throwing money at a motivation problem will not solve it. Adequate and fair compensation is a prerequisite to organisational health, but as our own and other research shows, it will not motivate exceptional performance. In fact, our data show that financial incentives are likely to be the least effective lever to drive motivation in most contexts, compared with other levers such as meaningful values and stretching career opportunities.

A company in our database that made extensive use of financial incentives had only a 48 per cent chance of generating a top-quartile motivation score.

Compare that with the corresponding likelihood of achieving high motivation through other levers, including high-quality leadership, engaging values and stimulating opportunities, which averaged a 55 per cent chance. Another McKinsey survey, covering 1,100 executives from multiple industries, showed that the three highest-rated non-cash motivators (praise from an immediate manager, leadership time and attention, and opportunities to lead projects or task forces) were at least as effective as the three most impactful financial incentives (performance-based cash bonuses, increases in base pay and cash-based long-term incentives).

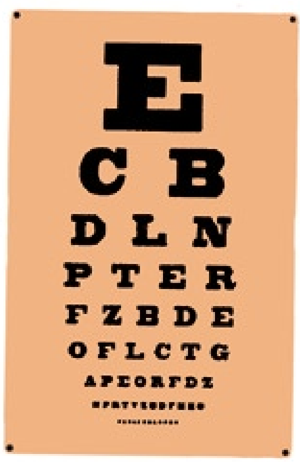
Complex incentive and reward systems may be less productive than social or nonfinancial rewards. Julio Linares, Executive Chairman of Telefónica de España, observes: "By involving people at different levels of the organisation, we are more likely to reach 100 per cent engagement, which is the objective we should have."

08

EXTERNAL ORIENTATION

ENGAGING WITH CUSTOMERS. SUPPLIERS, PARTNERS AND OTHER EXTERNAL STAKEHOLDERS TO DRIVE VALUE

Engaging with important external stakeholders (customers, suppliers, partners, and others) in order to more effectively create and deliver value currently and in the future.



Putting customers at the centre of an organisation's strategy, operations and culture is clearly a good idea, as it enables rapid product and service innovation in quick response to customer needs. Customers are the most critical external group to focus on to drive performance.

But putting customers at the heart of the business can be trickier than it sounds: customers do not always know what they are going to want. For an organisation to have any hope of staying ahead, it needs the ability to look beyond its own traditional boundaries to those of its partners and competitors. Microsoft CEO Steve Ballmer says he no longer thinks of his competition as individual companies. Instead, he says, "It's alternative business models that we'll have to compete with or embrace." His two biggest threats are "the open-source phenomenon and advertising-supported software".

Our research shows that for organisations to remain healthy, they need to think in terms of a broad external orientation. We see a clear link between an organisation's external orientation — defined as the quality of engagement with customers, suppliers, partners and other critical external stakeholders to drive value — and its financial performance. Top-quartile scorers on this element were 1.8 times more likely than bottom-quartile scorers to have an above-median EBITDA margin.

Other research suggests that the broader the view, the better; trade-offs traditionally thought to be inevitable (such as between customer groups and other external stakeholders) are not required. Management thinkers LE Preston and HJ Sapienza, for example, examined satisfaction ratings of stakeholder groups such as employees, customers, shareholders and non-profits across more than 100 large corporations to establish any potential relationships among levels of satisfaction of the various groups. Self-reported satisfaction among such groups was positively correlated, suggesting that management of the groups' respective needs was mutually beneficial rather than inherently at odds. This has been recognised by some forward-thinking leaders including John Mackey, CEO of Whole Foods, who sees his key task as "creating win-win-win scenarios".

09

INNOVATION AND LEARNING

ENSURING THE QUALITY AND FLOW OF NEW IDEAS AND THE ORGANISATION'S ABILITY TO ADAPT AND SHAPE ITSELF AS NEEDED

Encouraging and harnessing new ideas, including everything from radical innovation to incremental improvement, so the organisation can effectively evolve and grow over time.

Innovation is well known as a significant driver of financial performance. In our research, we were able to quantify how significant: the likelihood of a company with a top-quartile innovation score having above-median EBITDA margin was 66 per cent, which was 2.1 times greater than for comparable companies with a bottom-quartile innovation score.

But how do you make innovation happen? The key, according to 3M, is to "purposefully stumble". Richard Carlton, former CEO of 3M, says, "We've made a lot of mistakes. And we've been very lucky at times. Some of our products are things you might say we've just stumbled on. But, you can't stumble if you're not in motion." 3M works hard to ensure that this "stumbling" takes place. It has a 15 per cent rule stating that employees can spend 15 per cent of their time on new ideas they feel might benefit the company. 3M also encourages informal networking, providing formal leadership and small budgets to like-minded individuals who want to organise themselves into special-interest groups. This informal, horizontal structure around specific topics or technologies is driven by the grassroots. The Post-it Note, for example, was the result of years of development, often on employees' own time. Yet, in 1981, one year after its introduction, Post-it® Notes were named 3M's Outstanding New Product. Today this product line remains an office staple and generates over $100 million in sales for the company.

According to academic research, the key to fostering and enabling innovation in any organisation is putting the right conditions in place concerning leadership, external networks and striking the right balance between internal and external innovation. Leadership is central in terms of what the leader does and what the leader expects to happen. In one study, the effectiveness of the leader in ensuring clear objectives, balancing participation, building true commitment to excellence and supporting new ideas explained as much as 26 per cent of the variance in magnitude, impact and frequency of innovation. Other studies have found that the more a leader expected innovation to be demonstrated as part of someone's role, the more the person holding that role engaged in innovative behaviours such as actively searching for new ideas; generating, promoting and championing ideas; and securing funds and planning for implementation.

Striking the right balance between internal and external innovation is important because many ideas come from outside an organisation but need to be embedded into a particular context and culture to boost performance. One study found that increasing the amount and quality of knowledge transfer both within an organisation and between it and its external partners positively affected innovation and ultimately performance. The same research also suggested that organisations should develop trusting and strong networks and maintain a centralised "brokerage" position in external networks.

Mastering this critical balance between internal and external enables an organisation to be exposed to new thinking and practice as it happens elsewhere and to draw on many different parts of its own organisation in understanding how to make that thinking and practice most valuable to itself.

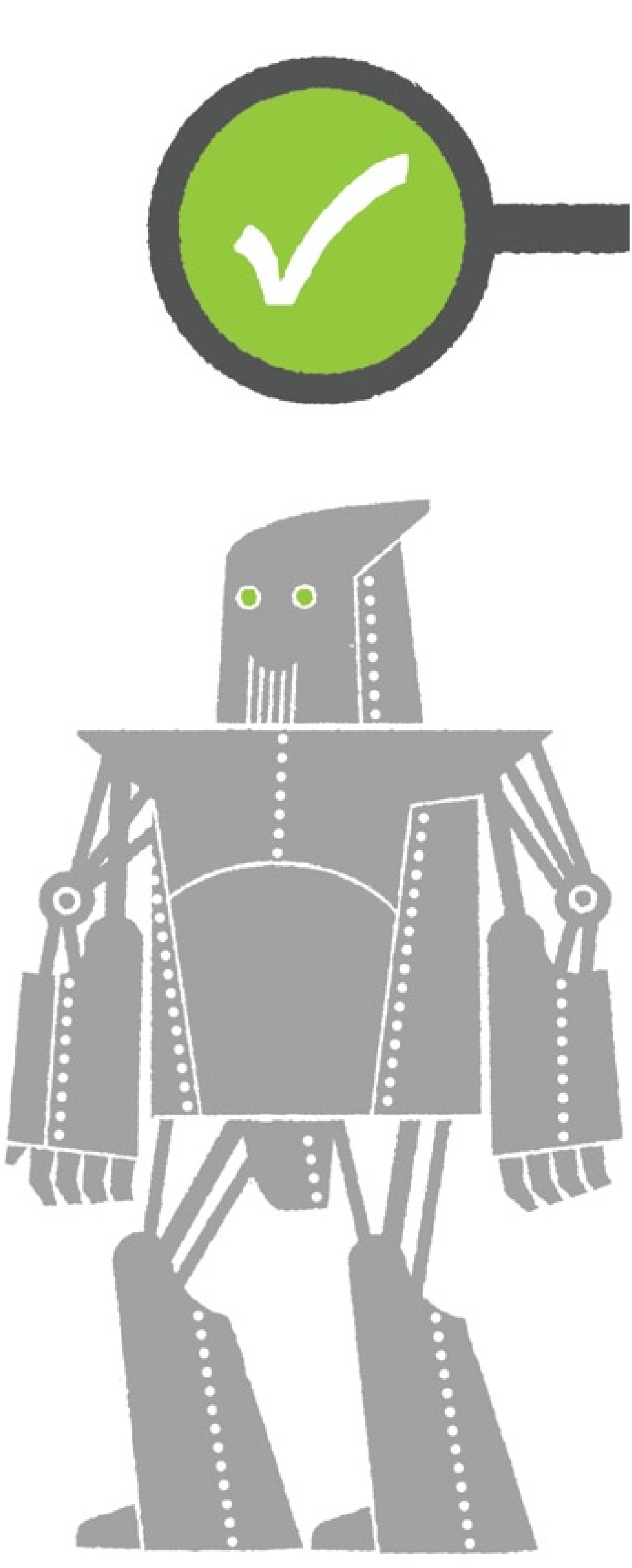
Healthy living

Health underlies performance. Of course, measures of performance differ by company type. A high-performing investment bank has very different characteristics from a high-performing oil company or a high-performing hospital. Similarly, indicators of health vary. In all of the work we have done with the model of organisational health we have described, we have never found a single organisation to be truly distinctive on more than five out of the nine elements. The trick appears to be to avoid ill health in any of the elements and to choose a critical few in which to become exceptional. The choice of the most critical elements is determined partly by the past, the organisation's heritage, and partly by the future, the organisation's competitive situation.

> "In all of the work we have done with the model of organisational health we have described, we have never found a single organisation to be truly distinctive on more than five out of the nine elements."

So is there such a thing as a fully healthy organisation and one that can remain so forever? Where are the cases that an organisation should emulate? There are certainly organisations that have been through extended periods of health. Southwest Airlines continues to outperform in a challenging and troubled sector. Its focus on a "triple bottom line — our Performance, our People, and our Planet — enables it to combine low fares with outstanding customer service. In pharmaceuticals, Johnson & Johnson has consistently outperformed its rivals. In automotive, Toyota has for many years been regarded as a paragon of health but at the time of writing is deeply mired in the customer recall process due to systemic faults in accelerators. Will this bring to an end the company's "health premium" over its competitors, or will it prove to be a serious but surmountable fitness challenge?

No individual on the planet is perfectly healthy and remains so forever. We are all becoming more or less healthy at any one time. So it is with organisations. Unlike individuals, though, organisations are not subject to the certainty of declining health as time goes by and aging sets in. It is in their own power to sustain their health and to regain it if they should lose it. This, we predict, will be the core challenge for the leaders of the future. ◻



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