Performance and Health

In Search of Sustainable Excellence

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Introduction

Ask almost any business leader about a company's goals and you are likely to hear some variation of the performance mantra – "we want to outperform our peers," say, or "we aspire to market-leading performance." Rapt attention to performance – simply, to doing better according to the most obvious metrics, such as profits and share price – pervades modern business, and even modern life. A football coach, when asked if he was building his team for the future, famously replied that "the future is now." Many CEOs take the same view, wagering all their chips on bets with immediate payoffs.

What exactly is wrong with performance, or profits, or a rising share price? Nothing. But we believe that the current fixation on short-term performance can debilitate a company or organization over the long term, leaving it incapable of achieving more than a brief moment of deadline-driven glory.

Many companies would dispute this, countering that they have taken steps to build a durable organization. But often, these fail to yield the intended result. Consider stock option grants. Thousands of companies award them to executives, attempting to align leaders' interests with those of shareholders. Yet the prevailing research concludes that the practice of granting options is at best ineffective – and sometimes harmful.

Take another example: Many companies are justifiably proud when they eliminate costs from their supply chain. In a world where one industry after another is succumbing to low-cost, no-frills champions, cost cutting is a necessary step. But some companies take it too far, eliminating needed redundancies, jeopardizing relationships with longtime partners and suppliers, and leaving themselves exposed to a variety of external shocks.

In these and many other ways, companies that think they are prepared for the marathon are fit only for a sprint. To be ready for both, companies must be in good health, which we define as the prevalent qualities and practices of an organization today that help sustain performance tomorrow.

So how can an executive determine the health of her company? To answer this question, we have conducted surveys with more than 115,000 business leaders, assessed more than 800 recent articles from the business and academic press, and conducted more than 100 workshops with senior leaders at some of the world's largest companies.[1]

The result: We have determined that good health has five characteristics. First, a healthy organization is *resilient,* possessed of a sound strategy and able to combat risk and weather shocks to its systems. It *executes* its core activities well and *aligns* its people and resources so that every team member is running in the same direction. The healthy company *renews* itself through investment in growth, innovation, and adaptation. Finally, it enjoys *complementarity,* the ability to add one and one and make three – that is, the ability to derive benefits from a system of mutually reinforcing elements, such as management practices, intellectual capital, and brands.

Looked at this way, many companies, even strong performers, find themselves in fragile health. If high fliers want to continue to thrive, they too must pay attention to the underlying health of their enterprise. All companies, the sick and the strong, should embed the ideals of health into their management and planning processes to ensure that they count profits both today and tomorrow.

1 McKinsey's organizational performance profile surveys of more than 115,000 executives at 230 companies, conducted over five years (2002 to 2006).

The perils of performance

In 1980, Atari was on top of the world. The company was founded in 1972 to exploit what was then only a figment of a designer's imagination – the electronic game. In 1973, Atari sold $40 million worth of these games (remember Pong?) and earned $3 million in profits. In the next few years, it was bought by some deep-pocketed owners and invested heavily in R&D. In 1980, it posted record revenues ($415 million) and was the fastest-growing company in U.S. history. Two years later, it was saluted by Waterman and Peters in their book *In Search of Excellence*.[2]

Even as the book's readers were learning how Atari excelled, the company was crumbling. Spending and investment, especially in R&D, were cut. Creativity and product quality were sacrificed in the name of faster time-to-market. The result was some of the biggest duds in video gaming history: The shoddy visuals and poor playing characteristics of "Pac-Man" and "ET" alienated the company's devout customers. Fed-up engineers left in droves, many to join or form rival companies whose innovative products captured Atari's former customers. By 1983, the rot was exposed: The company lost $536 million and resorted to massive layoffs. Atari never again came remotely close to its brief heyday. The shell of the company, which by then consisted mainly of a brand name, was sold in 1998 for a mere $5 million. Today, Atari is mainly a memory – but the video game market is worth $25 billion and is still growing at a tremendous rate.

Two questions arise from this tale: What did Atari do wrong? And how did Waterman and Peters miss it? A single answer will suffice: Both the company and its chroniclers were intensely focused on performance and indifferent to the indicators of deteriorating health. In this regard, they are not alone. Many companies, executives, and analysts are consumed with boosting this quarter's profits, hoping for a knock-on effect on the share price.

Many executives will protest, claiming that they invest in the future, are committed to enduring performance, and have engaged in building a company for the long haul. But as we will show, many ostensibly performance-enhancing measures can ultimately prove detrimental to companies' health. These measures include not only stock options and lean-to-a-fault supply chains but a variety of other "clearly" beneficial practices, such as consequence management for increased accountability and investing in the best talent money can buy.

Exhibit 1

Five common misconceptions about compensation

Myth	Reality
1. Financial incentives drive retention and performance	Total compensation drives retention but does not always drive performance Incentives help drive perfermormance, but only if used properly
2. Stock-based incentives encourage executives to focus on improving company performance	Research covering five decades, 229 studies, and nearly 1,000,000 equity/performance relationships, reveals no systematic relationship between executive equity ownership and company performance
3. Repricing options that are "underwater" maintains their incentive effects	Repricing defeats the supposed purpose of stock-based incentives
4. Stock-based incentives reward value creation	Stock-based incentives can inadvertantly reward behaviors that undermine long-term value creation
5. CEO performance should be measured and rewarded according to stock price	CEO performance should be measured using considered oversight and good judgment, with stock price being one of many data points in the evaluation

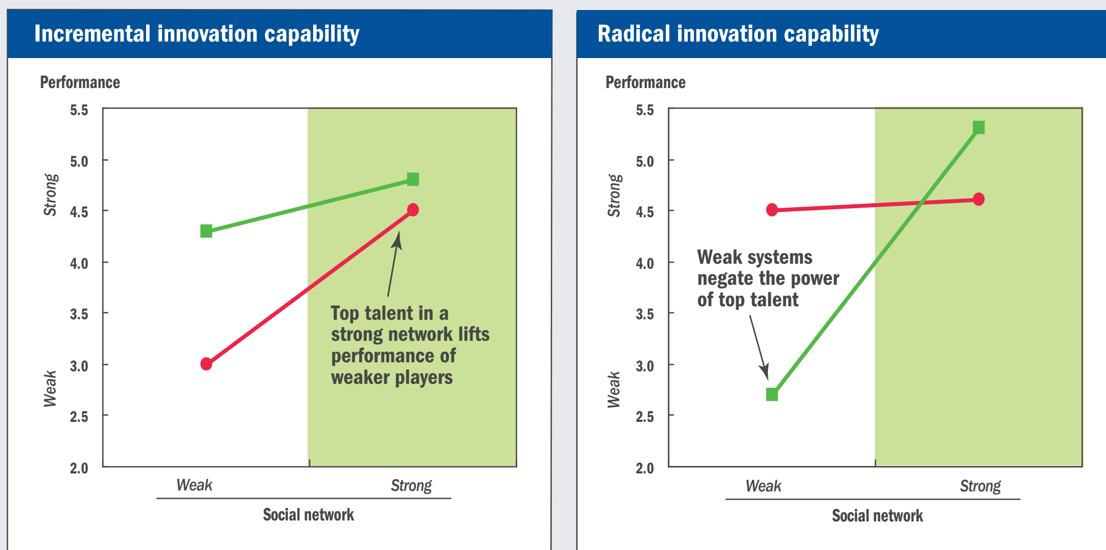
Sources: McKinsey OPP survey; Catherine M. Daily and Dan R. Dalton, "The Problem with Equity Compensation," *Journal of Business Strategy,* July-August 2002, vol. 23, pt. 4, pp. 28-30.

2 Tom Peters and Robert H. Waterman, *In Search of Excellence,* New York: Harper & Row, 1982.

Most companies, especially those in high-growth industries, grant options to their senior leaders. Companies are currently reviewing this custom as a result of changes to the accounting rules, but they should be doing so for another reason. Significant research – spanning more than five decades and including 229 studies investigating nearly a million cases – yields compelling results: There is no evidence that executive stock options help increase a company's performance, but plenty of evidence that other kinds of incentives do *(Exhibit 1, see p. 4)*.

What about those companies that have cut their supply chains to the bone? Many companies believe, following successful examples such as Wal-Mart, that they must remove costs from their system. Land Rover, for example, pressured its suppliers relentlessly, always pushing for further reductions in its price.[3] But as it planned for the manufacturing and rollout of a new model, the Discovery, it suddenly found itself exposed: The sole supplier of chassis for the new vehicle, facing imminent bankruptcy, threatened to stop shipments. Redesigning the car would have taken nine months, cost the company tens of millions of dollars, and thrown an estimated 11,500 workers out of work. Fortunately for Land Rover, it was able to invest in the near-bankrupt chassis maker and turn the situation around. Less fortunate companies are unable to cope with the fallout from an attenuated supply chain.

Many executives point to their investment in talent as proof of their commitment to the health of the company. But few realize that new and expensive talent cannot simply be dropped into the organization and expected to prosper *(Exhibit 2)*. In fact, when high-quality talent is added to companies with weak social networks – i.e., companies where workers are not meaningfully engaged with one another, where they fail to create strong personal



Source: Mohan Subramaniam and Mark Youndt, "The Influence of Intellectual Capital on the Types of Innovative Capabilities," *Academy of Management Journal,* 2005, vol. 48, pp. 450-463.

3 Yossi Sheffi and James B. Rice, Jr., "A Supply Chain View of the Resilient Enterprise," *MIT Sloan Management Review,* Fall 2005, vol. 47, no. 1, pp. 41-48.

and professional connections, where it is difficult to find expertise and information, and where the sharing of knowledge and expertise is not valued – then the net effect is typically muted or even negative, as new workers' contributions are undervalued or ignored.

The healthy company

High performance is clearly a requirement for success. No business can thrive without profits, and a stalled share price can constrain a company unduly. But without robust enterprise health, no business can thrive year after year for 10, 20, or 50 years. It is the combination of performance and health that engenders long-term success. Broadly speaking, the qualities and practices that underlie an organization's health fall into five main categories *(Exhibit 3)*.

The first category is *resilience*. We know that markets are unkind, customers are fickle, and competitors are relentless. But beyond these everyday problems, managers must also contend with unpredictable, often life-threatening disruptions – financial market meltdowns, extreme weather, power failures, even terrorism.

Healthy companies engage in four kinds of practices that enhance their resilience. First, they build a sturdy foundation: a robust corporate strategy *(Exhibit 4, overleaf)*. They place themselves in the right competitive environment and offer customers an enduring value proposition. Next, they are practiced at spotting risks of all kinds – including low-probability but high-impact catastrophic risks – and they act to manage and mitigate them. They have sufficient resources – including cash reserves, some slack in resources, and backup IT systems – to weather difficult periods. Finally, they work to build strong networks, including logistical chains to ensure adequate supply and unencumbered distribution, and networks of relationships with customers, suppliers, distributors, regulators, and others critical to their operation.

Consider Wal-Mart, which had 125 stores in the path of Hurricane Katrina. The hurricane devastated the Gulf Coast, paralyzing the highway system – yet the company opened almost all of its stores within a few days. How? Wal-Mart had planned for catastrophe and developed an alternative distribution system that relied heavily on railroads. When forecasts indicated that a catastrophic storm was on the way, Wal-Mart was already staging its equipment and stocking inventories. When highways closed, Wal-Mart activated its plan and was able to restock stores and supply its customers with essentials. The company demonstrated extraordinary resilience at a time of crisis.

Exhibit 3

The five characteristics of healthy companies

Source: McKinsey team analysis

By *execution,* we mean the set of attributes that allows a company to operate effectively and efficiently *(Exhibit 5, overleaf)*. These include a clear and well-designed management structure, which makes explicit the company's expectations of performance, the reporting structure, and decision rights to allow the company to act swiftly and definitively. The company must also have at least one core competence – a collective ability to do some value-creating activity well. This competence must be central to the company's strategy, of course; further, it must be distinctive, difficult for competitors to copy, and continually refreshed. The company should also have a deep "bench" of talent, and a leadership "engine" to provide a steady stream of high-quality leaders at all levels of the organization. It must have a planning process that actively generates feedback and uses that feedback to make course corrections – an element noticeably missing in many of the big corporate disasters of recent years. And it must possess sound judgment and a capacity for critical thinking – qualities that are especially important among top leaders but also throughout the enterprise.

Alignment is needed to make sure that all the company's activities serve a common purpose. Alignment is achieved through the company's mission and direction, a focus on its stakeholders, its degree of shared identity, and its formal reinforcing mechanisms. A company's mission probably needs no explanation. Even so, many companies can improve their mission by avoiding generic platitudes such as excellence, customer satisfaction, and innovation, and by articulating a specific or even unique value proposition and

Exhibit 4

A robust corporate strategy

	THE HEALTHY COMPANY:
SECTOR ATTRACTIVENESS	◆ Expands into industry sectors and subsectors with high growth potential for the foreseeable future ◆ Anticipates market changes and reallocates resources to business areas likely to be attractive ◆ Maintains an objective understanding of which businesses are becoming less attractive and exits early
STRATEGIC CHOICE	◆ Makes sound strategic decisions about which businesses, products, and markets to invest in ◆ Implements major initiatives to ensure competitive advantage in key businesses, keeping overall portfolio of initiatives well-balanced across multiple time horizons, risk levels, and markets ◆ Takes calculated risks and makes "bets" to develop strategic options likely to be crucial for future success
ACQUISITION AND DIVESTITURE	◆ Identifies, develops, and screens many acquisition and divestiture options, and conducts rigorous assessments and due dilligence on the most attractive ◆ Makes well-informed and unbiased decisions, bearing in mind both the short- and long-term interests of the company and its shareholders ◆ Negotiates and closes deals that maximize both value capture and feasibility of implementation ◆ Executes completed transactions quickly and efficiently, including effective integration (spin-off) of acquired (divested) companies

Source: McKinsey team analysis

Exhibit 5

Assessing a company's capabilities

Definition The internal skills and talent to support strategy, execute core competencies, and create competitive advantage

Weak ← HEALTH → Strong

1 2 3 4 5

	1–2	3	4–5
Competition	The company lacks one or more of the core competencies it needs to be competitive	The company has the basic capabilities it needs to deliver its current strategy and compete effectively	The company's strategic capabilities/core competencies are distinctive, difficult to imitate, and consistently renewed over time
Leadership	The company lacks sufficient quality and/or quantity of leaders	The company has sufficient leadership to execute effectivelyand remain competitive	The company has a deep "bench" and a robust pipeline of high-quality leaders at a levels to deliver excellence into the future
People	Good people are hoarded by their "owners" (e.g., business unit heads)	The most appropriate people are allocated to the right projects across the firm	The most appropriate people can be allocated to the right projects easily, regardless of their function or unit
Talent	The company faces a constant shortage of talent because of poor recruiting yields, poor development, or high turnover	The company has the people it needs to get today's work done	A constant flow of talented people are attracted, hired, developed, motivated, and retained by the company

Source: McKinsey team analysis

business strategy that energize and guide employees in their day-to-day work.

Just as important is a sense that the company's values and practices genuinely address the concerns of important stakeholders, notably employees, customers, shareholders, and business partners. A company should aspire to a shared identity – one with common values and beliefs that helps employees feel connected, as though they are part of something bigger than themselves. Finally, alignment must be stitched into the fabric of the workplace through formal reinforcing mechanisms, including financial and other incentives that go beyond simple reward systems. The criteria on which people are evaluated, role modeling by leaders, verbal recognition, supporting tools and training – all are needed to reinforce the expected behaviors, and not mere outcomes. It's not simply what you do; it's also how you do it.

Execution and alignment are critical to today's work. To position a company for continued success tomorrow, its leaders must also invest in *renewal*. One important practice here is thoughtful expansion into markets where the probability of success is high and where current assets and competencies can provide leverage. Another is innovation – the creation of an environment where idea generation is encouraged and acted on. Finally, the company must be adaptive, responding with speed and agility to fundamental shifts in the market, remaking its strategy and culture in anticipation of such changes, and quickly reallocating resources to new

activities and business areas when necessary – even when, as is almost always the case, it has only imperfect information.

The kind of corporate failure that Atari experienced comes from a lack of renewal capability. McKinsey research has documented the results of this kind of failure, and a way to overcome it, called "creative destruction."[4] An exhaustive analysis of decades of history of public companies reveals that over the long term, almost no companies survive in any form, let alone as industry leaders. Markets and industries move quickly; companies do not. Thus, according to the proponents of creative destruction, companies must continually re-invent themselves, buying promising new businesses and shedding old and fading ones.

For many companies, this kind of readiness to trade is indeed one answer to the renewal challenge. But healthy companies can build for the future in a number of other ways, through innovation, say, or targeted expansion. Nike has done this repeatedly, and has established a pattern in which it establishes a leading position in footware in a new market (golf, for example), then follows with clothing lines endorsed by top athletes, and then higher-margin equipment (irons and drivers). At the same time it builds its supply chain for all the new products, and then expands from U.S. to global distribution. This strategy of building in a deliberate way for the future has helped Nike to dominance in its industry.

Finally, a company enjoys *complementarity* when its assets, processes, relationships, and management practices act in concert, creating more value collectively than they would individually. This is the essence of synergy and requires that the various elements be consistent and mutually reinforcing.

Complementarity, a concept explored in some detail by John Roberts in his book *The Modern Firm,*[5] can be seen in organizational practices, such as hiring policies, training programs, and behavioral incentives that are consistent and mutually reinforcing in attracting, developing, retaining, and motivating the right kinds of employees to perform in the desired fashion. Product categories should likewise be consistent and mutually reinforcing; this is the premise of value creation that underpins many of today's big "content" companies. And activities across the business system – from product development through manufacturing to sales and distribution – should also be complementary, ensuring that a company makes products that consumers want and that operations can deliver.

While many rightly point to Toyota as the exemplar of lean manufacturing, few realize that the Toyota Production System embeds the ideal of complementarity into the company. Famously, parts arrive at the assembly line "just in time." But why? Because procurement and purchasing have absorbed the high-level goals of the company and changed their procedures in ways that benefit others, in this case the manufacturing division. And manufacturing's practices, such as their "pull" system of inventory management, are a good fit with procurement's just-in-time delivery. Manufacturing's way of assembling cars using less inventory and fewer people in turn allows HO to switch its capability-building effort to vendor management and away from manual labor. And so it goes, in a virtuous cycle.

Complementary relationships among individuals and teams can also produce value. Organizations achieve this when its people are sufficiently – but not overly – connected with one another, making it is easy to find and collaborate with others. In large organizations, it is cumbersome – often even impossible – for everyone to have direct ties with everyone else. A more efficient model is for people to know someone who knows someone. When tightly interconnected teams are knitted into the organization (through mechanisms such as informal liaisons or more formal "brokers," whose job it is to bridge gaps between divisions), a company can maximize the cohesiveness of its networks

4 Richard Foster and Sarah Kaplan, *Creative Destruction: Why Companies that are Built to Last Underperform the Market,* New York: Random House, 2001.

5 John Roberts, *The Modern Firm: Organizational Design for Performance and Growth,* New York: Oxford University Press, 2004.

without overwhelming the organization with too many relationships to nurture, meetings to attend, phone calls to return, and e-mails to send. Organizations get a big boost in performance when a large and diverse population is sufficiently networked that it feels like a "small world," supported by a culture of collaboration, knowledge sharing, and efficient and egoless transfers of resources (information, people, money) to where they are most needed.

Getting healthy

When assessed against these five characteristics, most companies will come up short in one or two areas. Some will be weak across the board, and a few will find that their organizations are, in fact, robust and healthy. For those with gaps to close, highly tailored initiatives can be designed. But all companies, the sick and the strong, should think about inculcating health into their management. Again, we see five ways to make this happen.

First, companies should embed health-derived metrics in their management systems *(Exhibit 6)*. Many businesses make a religion out of counting the number of new customers and the growth of revenues. Banks love to look at the cost/income ratio; insurers, the combined ratio. But these measure performance, not health.

Instead, companies should keep track of cross-BU revenues, say, or the share of cross-BU promotions. Doing so will give them a better handle on their

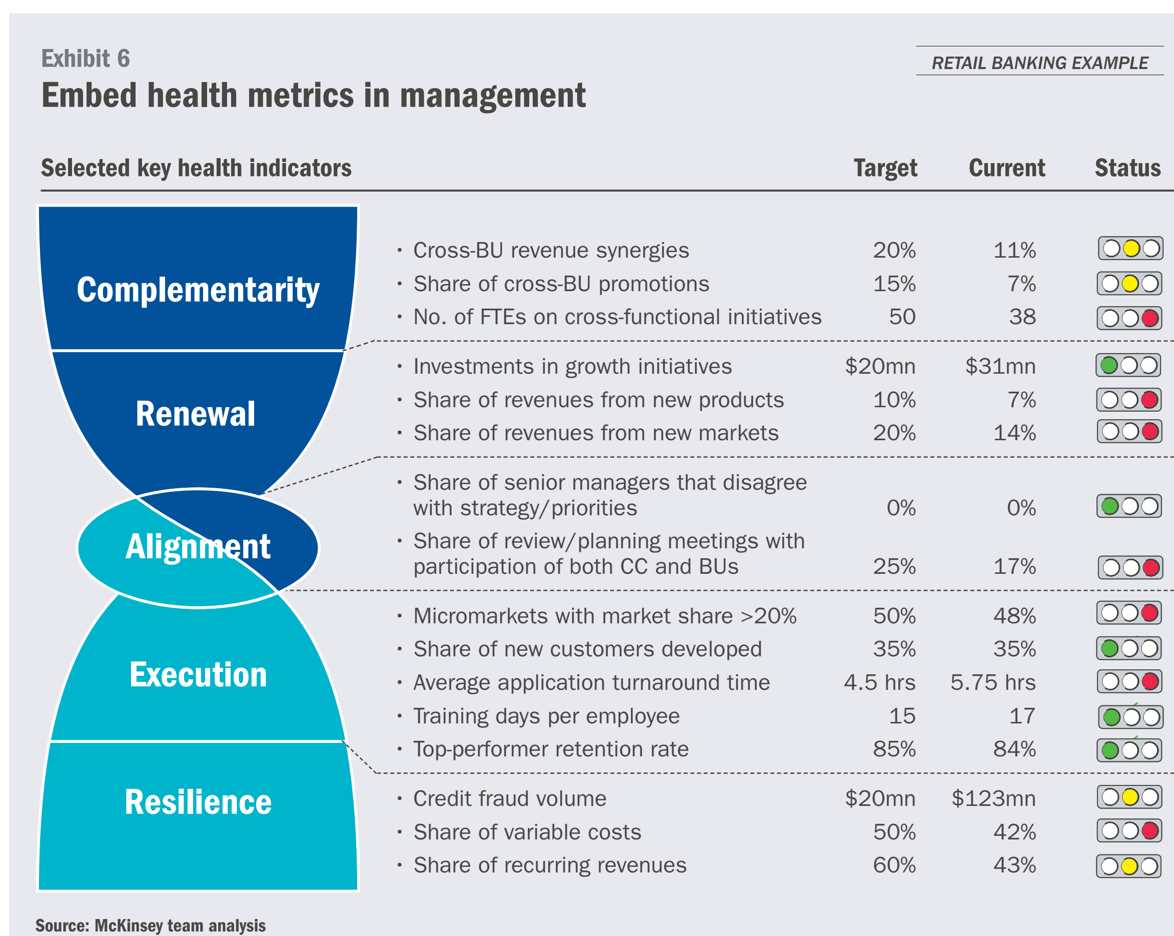


Exhibit 6

Embed health metrics in management

RETAIL BANKING EXAMPLE

Selected key health indicators		Target	Current	Status
Complementarity	Cross-BU revenue synergies	20%	11%	yellow
	Share of cross-BU promotions	15%	7%	yellow
	No. of FTEs on cross-functional initiatives	50	38	red
Renewal	Investments in growth initiatives	$20mn	$31mn	green
	Share of revenues from new products	10%	7%	red
	Share of revenues from new markets	20%	14%	red
Alignment	Share of senior managers that disagree with strategy/priorities	0%	0%	green
	Share of review/planning meetings with participation of both CC and BUs	25%	17%	red
Execution	Micromarkets with market share >20%	50%	48%	red
	Share of new customers developed	35%	35%	green
	Average application turnaround time	4.5 hrs	5.75 hrs	red
	Training days per employee	15	17	green
	Top-performer retention rate	85%	84%	green
Resilience	Credit fraud volume	$20mn	$123mn	yellow
	Share of variable costs	50%	42%	red
	Share of recurring revenues	60%	43%	yellow

Source: McKinsey team analysis

complementarity. Likewise, they should monitor the share of variable costs among all costs, and the share of recurring revenues among all revenues. A rising proportion of variable costs and recurring revenues is indicative of growing resilience.

Second, companies should break out their resource allocations in terms of performance and health. It's not enough to know what total labor costs are. Instead, companies should know how much of their workforce is working on the here and now – and how much on the hereafter.

Third, companies should assess all their businesses, business ideas, and new initiatives using two criteria: the time at which they are likely to create greatest value and the company's degree of familiarity with the work, which is an indicator of the probability of success and the need for resources. This portfolio of initiatives should then be evaluated for its contribution to performance and health, and companies should redress the imbalance they are likely to find. They should continue to monitor and assess their progress in this area over time.

Next, companies should extend this kind of health-oriented strategic planning into their other planning and budgeting processes. For instance, they should modify traditional budget reviews to determine whether cash flows are healthy *(Exhibit 7)*. In this example, a company should take all the money going out in the current quarter and split it into two piles: payments for current operations (i.e., the expenses necessary to generate this quarter's revenue), and everything else. The first stack is purely performance-related. The second represents longer-term investments. From the latter stack, the company should strip out in-kind capital replacements as performance-maintaining expenditures. What remains is real investment in health. This process will help a company see how much of its IT spend, say, goes toward innovation and R&D (health) vs. toward productivity (perfor-

Exhibit 7

A healthy balance sheet

BANKING EXAMPLE

Traditional income statement

	$ mn	%
Total income	41,235	100
Personnel expenses	18,132	44
Product advertising	932	2
Corporate advertising	376	1
General and administrative expenses	7,103	17
Management training and development	1,263	3
Depreciation of property and equipment	1,034	3
Amortization of goodwill and other intangible assets	673	2
Goods and materials purchased	2,678	6
Total expenditure	32,191	78

Restructured expense overview

	Expenses	$ mn	%
Performance oriented	Personnel expenses	15,676	38
	General and administrative expenses	7,103	17
	Deprecation of property and equipment	1,034	3
	Amortization of goodwill and other intangible assets	673	2
	Goods and materials purchased	2,678	6
	Total	27,164	66
Health oriented	Complementarity	403	1
	Renewal	1,206	3
	Alignment	754	2
	Execution	1,508	4
	Resilience	1,156	3
	Total	5,027	12

Source: McKinsey team analysis

mance). And it will let a company compare how much it invests in brand building, lobbying, community outreach, and the employee value proposition (all health-related areas) with how much it spends outsourcing operations to boost profitability (performance). Most companies will find that they overinvest in performance and underinvest in health.

Companies can conduct similar reviews in areas such as allocation of human resources. A simple test can involve reviewing how executives spend their time. Jack Welch said he spent "at least 50% percent of my time" on people issues and talent development when he ran GE.[6] Most CEOs spend far less.

Finally, companies should embed health in the formal mechanisms they use to manage people, such as performance contracts, incentives, career path planning, and staffing decisions. Managers at all levels should know their performance and health expectations. Reflecting back to the change in metrics discussed above, companies should use these to structure evaluations that ensure employees are rewarded as much for health-building work as for performance.

* * *

People obsess over performance in part because doing so is comfortable: They can obtain instant and reliable feedback (such as that provided by prominently displayed stock tickers) that tells them how they are doing. Investing time and resources into fostering long-term health is less comfortable. Without prompt feedback, executives worry that despite their best efforts, they might be managing health poorly but that they won't discover this until years later. Companies must make health tangible and observable by embedding it into their activities and culture. They must make it measurable by establishing specific targets and keeping track of when those targets are hit and missed. And they must make sure that they pin their aspirations on those factors that really make a difference.

6 The Wall Street Journal, *Boss Talk: Top CEOs Share the Ideas that Drive the World's Most Successful Companies,* New York: Random House, 2002

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