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2015 Number 2

# Thriving at scale

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## This Quarter

When companies grow, they enjoy advantages such as economies of scale, global reach, interconnected capabilities, brand recognition, and a deeper bench of talent. But scale also creates challenges. Corporate leaders frequently struggle to replicate the actions of fleet-footed entrepreneurs, to cut through corporate bureaucracy, to stay customer-centric, and to marshal the skills and talent of far-flung operations effectively.

This issue of the *Quarterly* offers fresh ideas for confronting scale-based obstacles to innovation, organizational effectiveness, and talent development. It's conventional wisdom, for example, that large companies are better at execution than at innovation. But in "The eight essentials of innovation," Marc de Jong, Nathan Marston, and Erik Roth demonstrate that this does not have to be true. Drawing on an exhaustive analysis of 2,500 executives in more than 300 companies, the authors present a comprehensive operating system for innovation—practices that can help companies both set the ground rules for innovation and deliver results.

One impediment to innovation at many large companies is the opacity of R&D's performance, which creates friction between R&D managers trying to articulate their case for funding and other executives, frustrated by the rising cost of product development. In a separate article, "Brightening the black box of R&D," our colleagues Eric Hannon, Sander Smits, and Florian Weig propose a simple formula for lifting the veil by quantifying R&D's productivity.

A quite different challenge facing large organizations is what we called (in our 2011 *Quarterly* article) "the globalization penalty": the tendency in many global companies for cost structures to soar, for local operations to buckle under organizational clutter, and for responsiveness to customers to decline. In "The globally effective enterprise," Pascal Visée, a former senior executive at Unilever, revisits this problem through a case study of that company's effort to create a new architecture for global services. A key theme is the potential of new technology solutions, though he also recognizes their limitations.

Leading-edge digital platforms similarly take center stage in Arne Gast and Raul Lansink's "Digital hives: Creating a surge around change." Based on four case studies, the article illustrates how executives can harness the power of social media to engage large and widely dispersed groups of employees by encouraging new ideas and ways of working, driving organizational change, and even helping to formulate better strategy.

A common feature of many large organizations is a well-developed human-resources function. As McKinsey's Neel Gandhi and Bryan Hancock say in "Getting beyond bureaucracy in human resources," HR organizations, at their best, help drive talent strategy while establishing useful guardrails for management. There's also a danger, though, of paper-pushing sluggishness that handcuffs instead of helps. McKinsey alumnus Peter L. Allen, who leads human resources at a fast-growing Asia-based online travel company, describes an alternative vision, for an HR function that helps managers focus on managing their business and developing their people. Combining scale and agility, in this area as in others, isn't easy, but it's a critical need for organizations in today's fast-moving business environment. We hope this issue of the *Quarterly* provides you with inspiration as you embrace that imperative.


**Martin Dewhurst**
Director, London Office

**Suzanne Heywood**
Director, London Office

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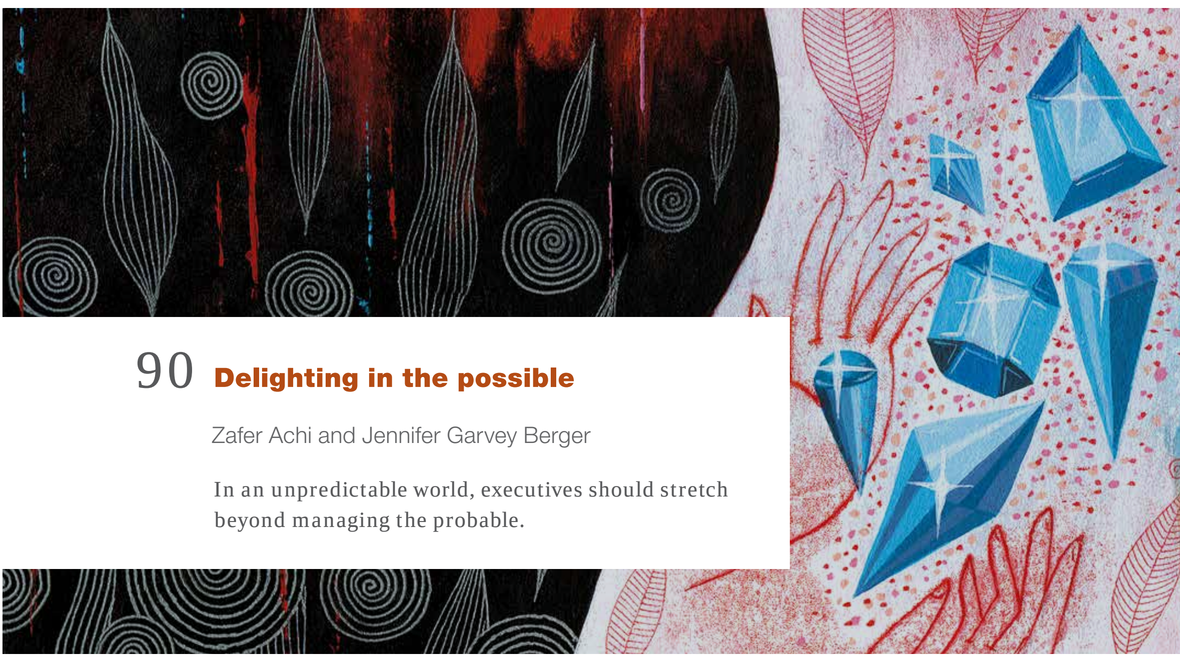

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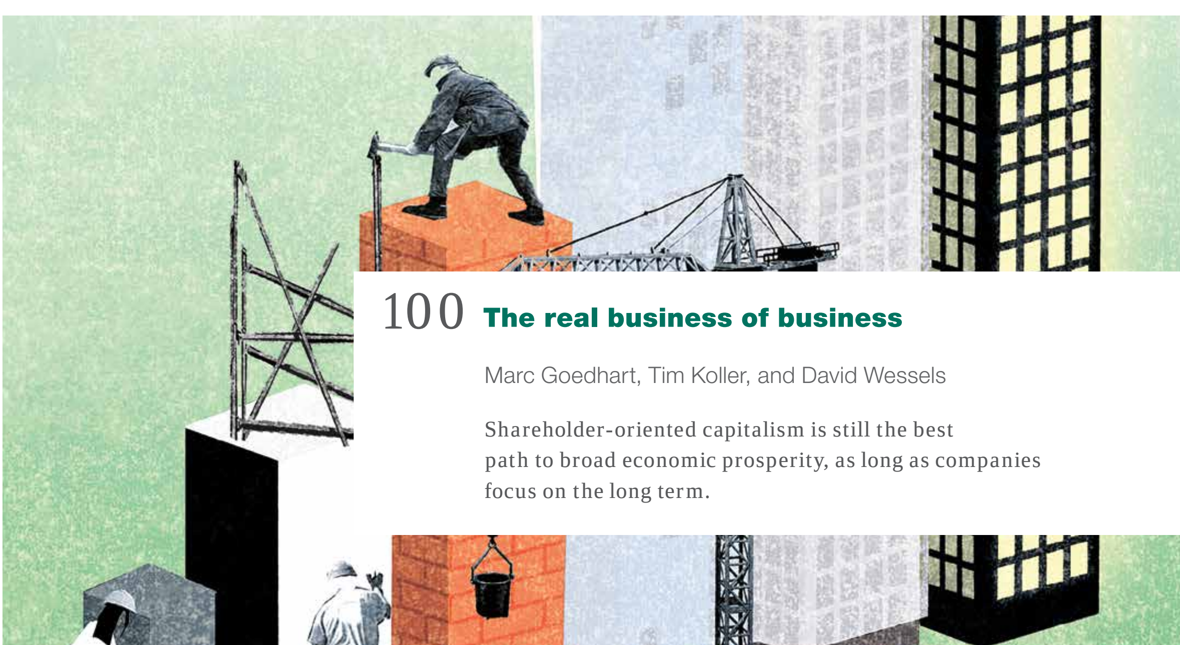

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# Japan: Lessons from a hyperaging society

**Misato Adachi, Ryo Ishida, and Genki Oka**

The country's population, already the world's oldest, is aging quickly. Companies in Europe, North America, and Asia can learn from its experience.

Japan is the world's oldest country—25 percent of its people are aged 65 or over. By 2040, that ratio is estimated to rise to the historically unprecedented level of 36 percent. The population of Japan nearly tripled in the 20th century, peaking at 128 million in 2010. But with a falling birth rate, one of the world's longest life expectancies, and close to zero net immigration, the country is headed for not only a uniquely high ratio of seniors but also a sharp downturn in its total population (Exhibit 1). All that will put increasing strains on Japan's ability to manage its rising debt and social-security obligations and will create growing shortages of skills.

How the island nation responds to this unprecedented economic and social challenge will help guide government and corporate leaders in other hyperaging societies, including Germany, Italy, and Sweden (Exhibit 2).[1] These are important public-policy choices, to be sure. But Japan's companies too can play an important role, by creating environments where seniors continue to work and developing more products and services that increase the quality of their lives and engagement with the world.

## The labor-market gap

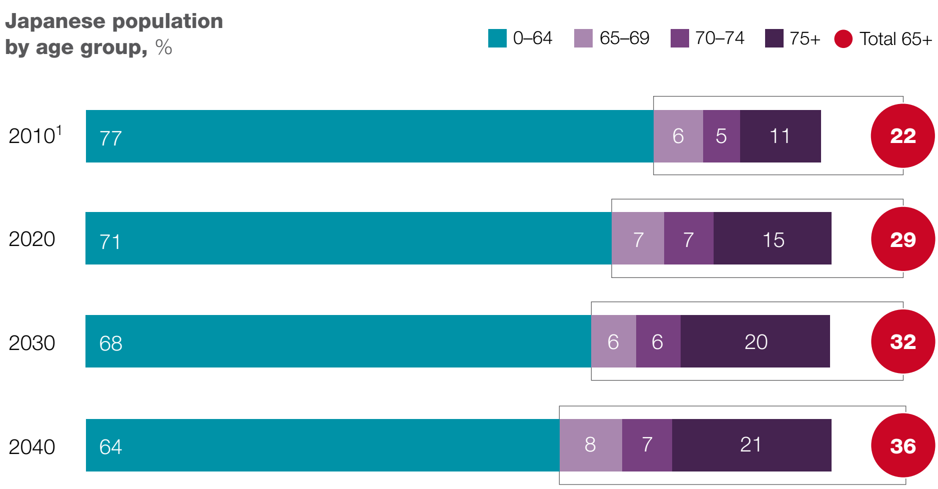
Most forecasts suggest that Japan's economy will continue to grow at roughly

1 percent a year, and the Organisation for Economic Co-operation and Development (OECD) estimates that this rate of growth will extend until 2040. Without dramatic change, primarily in service-sector productivity, this seems quite optimistic to us. If labor productivity (measured as GDP per capita) continues to increase at only 1.2 percent a year, that sort of economic expansion will require a working population of 62 million in 2040. We, on the other hand, estimate that if labor-market dynamics remain unchanged, in that year the working population will have shrunk to 49 million—21 percent lower than what's needed.

Japan could fill the gap by increasing the overall working population, accelerating the improvement in labor productivity, or a combination of the two. One path would be to raise female labor-force participation in the 25–44 age range to about 80 percent by 2040, from 71 percent now—narrowing the gap with the United States and Germany and bringing two million additional women into the workforce. As our colleagues at the McKinsey Global Institute point out, further increases in productivity across sectors would still be needed to meet Japan's overall GDP-growth expectations.[2]

Exhibit 1

**By 2040, estimates suggest, more than a third of Japan's population will be 65 or over.**




[1] Figures do not sum to 100%, because of rounding.

Source: e-Stat (Japan's portal for government statistics); IHS Global Insight World Market Monitor

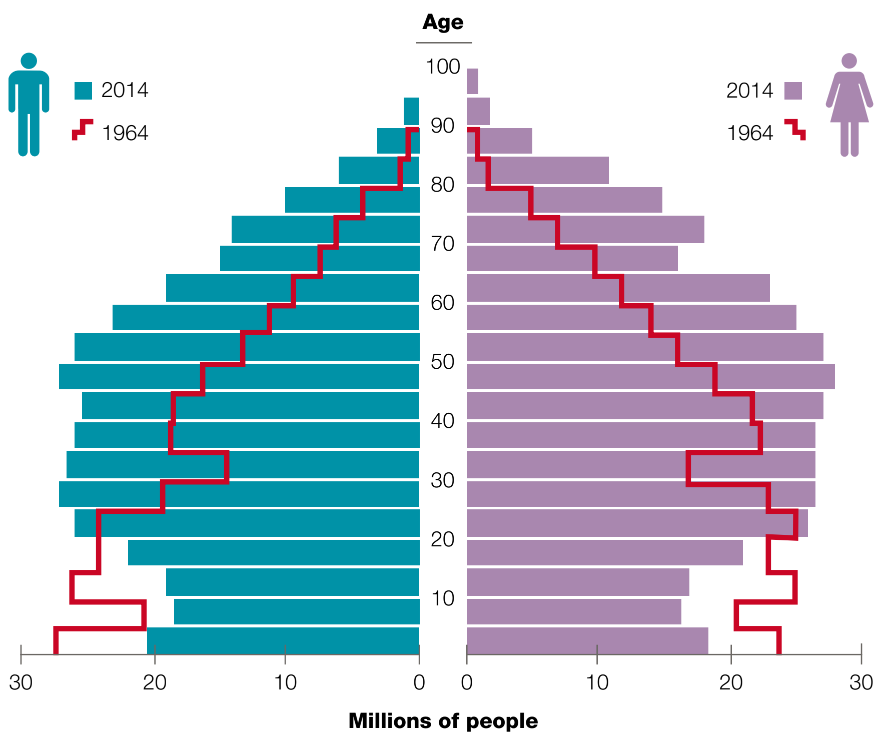
**Helping seniors to go on working**

Raising workforce participation by seniors would also help close the gap. In Japan, nearly 6.1 million people 65 and over work—about 20 percent of the total population in that age group. But in a survey by the Japanese Ministry of Internal Affairs and Communications, 66 percent of the respondents over 60 expressed an interest in continuing to work beyond the age of 65. Two things can restrict employment for seniors. One is the general resistance of companies, which want to control payroll costs, lack systems to manage older employees, and see lower physical strength and

Exhibit 2

**The aging of society will present a human-resource challenge for corporations.**

**Example:** Population of Western Europe




Source: Eurostat; IHS Global Insight World Market Monitor; Observatory for Sociopolitical Developments in Europe; United Nations population forecasts; McKinsey analysis motivation as problems (especially as workers become eligible for pensions). The second is the lack of a large market to outplace seniors; many people who want new careers retire because they can't find new opportunities to keep going. To make it easier for seniors to continue in jobs beyond the age of 65, companies could adopt three approaches.

**Encourage a range of work formats.** Food producer Kagome and department-store operator Takashimaya both let employees aged between 60 and 62 go on working either full time (at the same or reduced pay) or part time, depending on their performance. Both continue to evaluate such employees, so they can switch positions at a later stage. Because these companies link work levels and pay for seniors to their performance, both now employ them without increasing payroll costs.

**Address labor shortages with seniors.** Japan's Ministry of Health, Labour, and Welfare finds that the biggest labor shortage lies in the welfare sector, which currently has 170,000 openings (20 percent of the total labor shortfall). It says that 2.5 million caregivers will be needed by 2025, up from nearly 1.8 million employed now, as the number of seniors with nursing-care needs reaches 7.0 million by 2025, against more than 5.5 million today. Technology will help meet the demand but will not completely fill the gap.

The idea of able-bodied seniors providing nursing care for more dependent ones is appealing. Eleven percent of seniors who want to continue working said they would be willing to do this kind of job, according to a 2013 survey by the Japanese government. Most caregiving involves talking with residents and performing tasks such as cleaning and laundry, which don't require special skills or physical strength. If, say, 10 percent of currently unemployed seniors in the 65–74 age range worked several days a week as nursing-care staff, Japan could have 700,000 additional caregivers by 2025. One incentive might be to give them priority in admissions to nursing facilities once their turn comes.

**Create knowledge and skill networks.** Companies could generate value by encouraging seniors to share their knowledge and experience of tackling problems (especially in management, marketing and sales, development, or production) with younger workers. Former Mitsui employees, for example, use their experience in a range of industries and roles to provide consulting services to more than 650 small and midsize enterprises, handling projects involving sales worth hundreds of millions of yen. The Japanese staffing agency Mystar 60 specializes in placement services for people over 60, and its own employees are at least that age. These include technicians who show younger colleagues at the corporate parent, Mystar Engineering, how to develop new customers, among other things.

**Developing products and services**

Active seniors without major health problems have interests and needs different from those of seniors whose health is deteriorating or who want to lead lives as normal as possible with family support. Rather than customizing existing products and services, many companies can thrive in hyperaging societies by identifying new customer segments among seniors and developing novel products and services to help them.

Coping with frailty. One way companies can profit from hyperaging is to develop products that help seniors cope with infirmity. Tokutake's line of Ayumi shoes, for instance, are designed not only to combat knee and hip pain but also to help prevent users from slipping and falling. Unlike conventional shoe retailers, the company allows customers to order right and left shoes separately.

Playing in this market segment also demands a new approach to distribution. Companies that want to help seniors whose physical functions are deteriorating, for example, should consider delivering products and services to the customer's doorstep. Benry Corporation provides dozens of services in seniors' homes, from cleaning air conditioners to weeding. 7-Eleven Japan offers meal-delivery services catering to seniors, and restaurant company Watami not only delivers handmade bento meals to the elderly but also operates nursing homes.

Remaining youthful. Serving the active elderly requires a different mind-set—a costly lesson learned by some companies. When Bridgestone launched its line of PHYZ golf clubs, it made the mistake of calling them golfing gear for seniors. A rival brand, acting on its research showing that seniors like being reminded of how youthful they are, positioned its offering on the promise that the ball would travel farther.

The US fitness chain Curves International, which entered Japan ten years ago to target the female market, seems to understand the "youthful" niche. With nearly 1,400 branches in the country and more than 580,000 members—70 percent of them over 50—the company offers basic services at low rates in convenient locations near residential areas. By emphasizing ease of access, and without overtly appealing to the elderly, it has generated demand among an age group that conventional fitness gyms find hard to attract.

Easing isolation. Companies can also assist older people by giving them ways to remain connected. Kozocom, for instance, developed Kozo SNS Village, a social-networking site for people 50 and over who want to share and talk about their hobbies. Kozocom has overcome seniors' inhibitions about social networking by creating a service that helps them feel part of a community. Club Tourism offers trips with special themes, such as photography or history, specifically for seniors. And some medical-checkup and rehabilitation companies combine day-care services, culture classes, and fitness clubs to help older people build new relationships.

• • •

Getting more seniors into the workplace and serving their burgeoning ranks will help Japan—and other countries—bolster their GDP growth in coming decades. Seniors are not only the fastest-growing consumer segment in Japan but can also become a highly profitable one if approached appropriately. Companies in almost all industries should take note.

[1] Looking further ahead, the McKinsey Global Institute forecasts that by 2064, 15 countries in the G19 will have higher proportions of the elderly in their populations than Japan has today. For more, see the full report, *Global growth: Can productivity save the day in an aging world?*, January 2015, on mckinsey.com.

[2] For more, see the full McKinsey Global Institute report, *The future of Japan: Reigniting productivity and growth*, March 2015, on mckinsey.com.

*The authors wish to thank McKinsey's Ryoichi Kusama and Yasuaki Sakurai for their contributions to this article.*

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# How agile is your supply chain?

**Raoul Dubeauclard, Kerstin Kubik, and Venu Nagali**

Our research shows that ten operating practices are tied to higher service levels and lower inventory costs.

What would it take for manufacturing businesses to operate like the best online retailers? How can such companies turn orders around in a day, deliver them with greater customization, and replenish stocks seamlessly? These aren't idle questions for the top teams of manufacturers, because customers, across both B2C and B2B markets, are more fickle now; service demands are steadily notching upward; and economic volatility shows no sign of abating. Supply operations often struggle to keep pace, as many aren't sufficiently agile to capture fleeting upside opportunities or to mitigate fast-moving risks.

To shed light on the enablers and enemies of agility, we examined the supply-chain performance of companies in five industries, as well as a range of practices that influence it. We analyzed proprietary data from interviews with operations executives at more than 250 global companies. The interviews assessed ten supply-chain capabilities, including portfolio and complexity, order and demand, forecasting, and risk.[1] Responses were plotted on a scale of one to five and the overall agility scores organized into quartiles. We then compared those scores with two widely employed measures of supply-chain performance: service levels, as measured by the proportion of orders delivered on time and as promised, and days of inventory held.[2] Companies with more agile supply-chain practices (as described by executive-survey respondents) had service levels that were seven percentage points higher and inventory levels that were 23 days lower than their less agile peers did (Exhibit 1).[3]

We also looked at specific agile practices and how consistently top-quartile companies adopted them. Most, we found, do well in areas such as demand forecasting, labor flexibility, and the optimal placement of inventory across distribution networks (Exhibit 2). Fewer had mastered capabilities such as modularization and postponement, which require standardized manufacturing and process inputs so that companies can respond more fluidly to fluctuations in demand and to lower stock levels. Most struggled to shape demand, a practice that relies on variable pricing—increasingly grounded in advanced analytics—to regulate the flow of products through supply networks and to optimize margins. One example of a company that uses these techniques is Amazon, which adjusts prices and inventory levels in real time in response to competitors' moves, among other things.

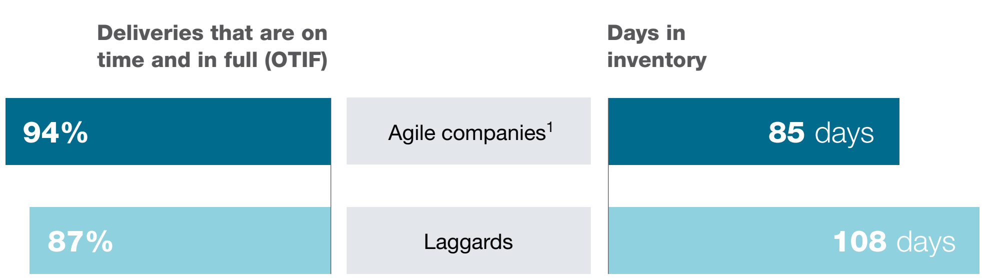
Experience in two industries demonstrates how supply-chain agility accounts for divergent levels of performance among companies.

Chemicals. One top-quartile company is an industry leader producing a full range of chemicals used in agriculture and food processing. After regularly missing shipments as a result of raw-material shortages, executives shook up their operations and now tightly integrate planning efforts with those of suppliers: the company shares data on forward orders with them and solicits their insights into the availability of materials and capacity constraints.

The company has also invested in redesigning processes (the modularization and postponement previously mentioned) so that end products can be made more efficiently and quickly from standard inputs that are always in the production stream. Thus, when demand increases for an individual product, a plant manager can access the modular base and rapidly create the final formulation with only a few more steps than would be necessary with nonstandard inputs. That capability has not only sharply reduced the number of end products the company needs to stock but simplified SKU management as well. This company has also negotiated greater labor flexibility across its plant network, easing contractual constraints on hours worked. In addition, it has trained employees in

Exhibit 1

**Agile companies offer higher service levels even though their inventories are lower.**




[1] Defined as those in top quartile in aggregated agility score; all others are laggards.

Source: McKinsey analysis

Exhibit 2

**Agile companies perform well in a number of areas.**

% of agile companies[1] in top quartile for given area


[1] Defined as those in top quartile in aggregated agility score.

Source: McKinsey analysis

multiple areas of process knowledge, so teams can quickly shift from one site to another to meet demand peaks. Factories now run at nearly full capacity, with lower logistics costs and far fewer expensive express shipments.

An industrial-chemical company with a broad product portfolio ranks two quartiles lower. Its service levels have slipped, because chronic shortages of materials, resulting from inconsistent coordination with suppliers, often delay shipments. Meanwhile, the company carries high levels of inventory because of its difficulties adjusting work schedules when demand increases.

Consumer products. A large consumer-goods company had trouble meeting demand for its fast-moving food and beverage categories. On closer inspection, it found that a lack of transparency across its supply chain was the culprit. To remedy the problem, the company charged a senior supply-chain executive with managing sales and operations planning end to end—something consumer-products companies often strive to do but rarely get right. After a successful pilot, the company extended the program to most of its suppliers, retail stores, and distributors. Inventory data became more reliable, collaboration improved, and on-time order fulfillment rose significantly.

Operations executives also sought ways to lower the risks when gyrating geographic and seasonal demand patterns put pressure on the supply chain. After a review of the company's distribution network, these executives found they could mitigate customer stockouts by outsourcing a significant portion of their warehouse operations. When regional demand for a line of new products surged, the business could easily add low-cost warehouse capacity.

By contrast, service and inventory performance were less strong at one home-products manufacturer, which like the consumer-products company above boasted a diverse product line but had lower agility scores for operations planning and risk management. Its logistics costs are 25 percent higher than those of the consumer company, and it has been hit by persistent transport problems that require it to carry twice as much inventory.

• • •

Agile practices can help companies navigate an increasingly volatile and unforgiving global economic environment. Only a few companies, however, are adopting these approaches broadly enough to improve their supply-chain performance significantly.

[1] The survey solicited self-reported answers to more than 60 questions on the following topics: forecasting, the ability to shape demand, risk management, modularization and postponement, integrated planning, labor and asset flexibility, network agility, lean fulfillment, inventory placement, and disruption-response planning.

[2] Inventory days average raw materials, work in progress, and finished goods across the supply chain. For this analysis, we examined more than 70 companies distributed across five industry groups. Industries such as chemicals and pharmaceuticals had higher average inventory levels than consumer products and automotive did.

[3] We found statistically significant correlations between reported OTIF service levels and agility scores across quartiles. Regression analysis also revealed a statistically significant relationship between reported inventory days and agility quartiles.

*The authors wish to thank McKinsey's Klaudia Sidor for her contributions to this article.*

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# Are you ready to decide?

**Philip Meissner, Olivier Sibony, and Torsten Wulf**

Before doing so, executives should ask themselves two sets of questions.

Good managers—even great ones—can make spectacularly bad choices. Some of them result from bad luck or poor timing, but a large body of research suggests that many are caused by cognitive and behavioral biases. While techniques to "debias" decision making do exist, it's often difficult for executives, whose own biases may be part of the problem, to know when they are worth applying. In this article, we propose a simple, checklist-based approach that can help flag times when the decision-making process may have gone awry and interventions are necessary. Our early research, which we explain later, suggests that is the case roughly 75 percent of the time.

## Biases in action

In our experience, two particular types of bias weigh heavily on the decisions of large corporations—confirmation bias and overconfidence bias. The former describes our unconscious tendency to attach more weight than we should to information that is consistent with our beliefs, hypotheses, and recent experiences and to discount information that contradicts them. Overconfidence bias frequently makes executives misjudge their own abilities, as well as the competencies of the business. It leads them to take risks they should not take, in the mistaken belief that they will be able to control outcomes.

The combination of misreading the environment and overestimating skill and control can lead to dire consequences. Consider, for instance, a decision made by Blockbuster, the video-rental giant, in the spring of 2000. A promising start-up approached Blockbuster's management with an offer to sell itself for $50 million and join forces to create a "click-and-mortar" video-rental model. Its name? Netflix. As a former Netflix executive recalled, Blockbuster "just about laughed [us] out of their office."[1] Netflix is now worth over $25 billion. Blockbuster filed for bankruptcy in 2010 and has since been liquidated.

In retrospect, it is easy to ascribe this decision to a lack of vision by Blockbuster's leadership. But at the time, things must have looked very different. Netflix was not, then, the video-on-demand business it has since become: there were nearly no high-speed broadband connections of the kind we now take for granted, and widespread use of video streaming would have seemed like a futuristic idea. In Blockbuster's eyes, Netflix, with its trademark red envelope, was merely one of several players occupying a small (and thus far unprofitable) mail-order niche in the video business.

Furthermore, this was the very time when the dot-com bubble had burst. As the Nasdaq Composite Index quickly collapsed from its March 2000 high, many managers of traditional companies felt vindicated in their belief that investors had grossly overestimated the potential of Internet-based models. Through the lens of the confirmation bias, Blockbuster's executives likely concluded that the approach Netflix had made to them was evidence of its desperation. And it did not take a lot of overconfidence for them to assume that they could replicate Netflix's mail-order model themselves, should they ever decide to do so.

The overconfidence and confirmation biases weren't the only ones at work at Blockbuster, of course, just as in most organizations.[2] But they are important enough to warrant special attention.

## An intractable problem?

Fortunately, debiasing techniques can help organizations overcome such biases. These techniques aim to limit the effects of overconfidence by forcing the decision maker to consider downside risks that may have been overlooked or underestimated. And they can mitigate the dangers of confirmation bias by encouraging executives to consider different points of view.

Examples of such techniques include either the systematic use of a devil's advocate or a "premortem" (individuals project themselves into a future where the decision has failed and imagine, in "prospective hindsight," what failed and why).[3] Another technique is to organize a formal scenario-planning exercise—expanding the range of assumptions underpinning a plan—or even a war game, in which executives put themselves in their competitors' shoes. One study of investment decisions[4] showed that when a company uses a range of debiasing techniques, its return on investment rises considerably. For high-impact, repetitive decisions, such as large investments, it is sensible to embed debiasing techniques in a company's formal decision-making processes.[5]

But this doesn't solve things for the myriad daily decisions that are the bread and butter of executives. A war game or a scenario-planning exercise entails a significant investment of time; how are senior leaders to know when that is worthwhile? Furthermore, the very nature of biases means that the person driving the decision process generally cannot judge whether further debiasing is needed. Indeed, that executive may be experiencing the confirmation bias and overconfidence at the crucial time. When managers make an ordinary mistake, such as a calculation error, they can learn from their experience and avoid repeating it. But when biases lead them astray, they are not aware of what's happening, so experience does not help them become better at debiasing themselves, and they cannot "just watch out" to keep their biases in check.

## Two tests of decision readiness

Since executives won't get very far by focusing directly on biases, they should consider instead whether safeguards against them have been used. In other

Exhibit 1

# Decision-making checklist

## Consideration of different points of view

| | YES or NO |
|---|---|
| **Have the recommenders checked their assumptions?** | |
| In their analysis, have they considered factors that would make the project exceed its initial goal? | |
| Have they compared their assumptions with those made for a comparable external project? | |
| Have they compared their assumptions with those made for a comparable internal project? | |
| **Have the recommenders integrated a diverse set of opinions?** | |
| Have they assembled a diverse team for the decision-making process? | |
| Have they discussed their proposal with someone who would most certainly disagree with it? | |
| Have they considered at least one plausible alternative to the course of action being recommended? | |

**Total "YES" answers:**

## Consideration of downside risk

| | YES or NO |
|---|---|
| **Inside the organization, what are this decision's two most important side effects that might negatively affect its outcome? Have the recommenders considered these side effects?** | |
| Side effect A | |
| Side effect B | |
| **In the company's industry, what are the two most important potential changes that might negatively affect the outcome of this decision? Have the recommenders considered these changes?** | |
| Potential industry change A | |
| Potential industry change B | |
| **In the macro environment, what are the two most important potential changes that might negatively affect the outcome of this decision? Have the recommenders considered these changes?** | |
| Potential macro-environment change A | |
| Potential macro-environment change B | |

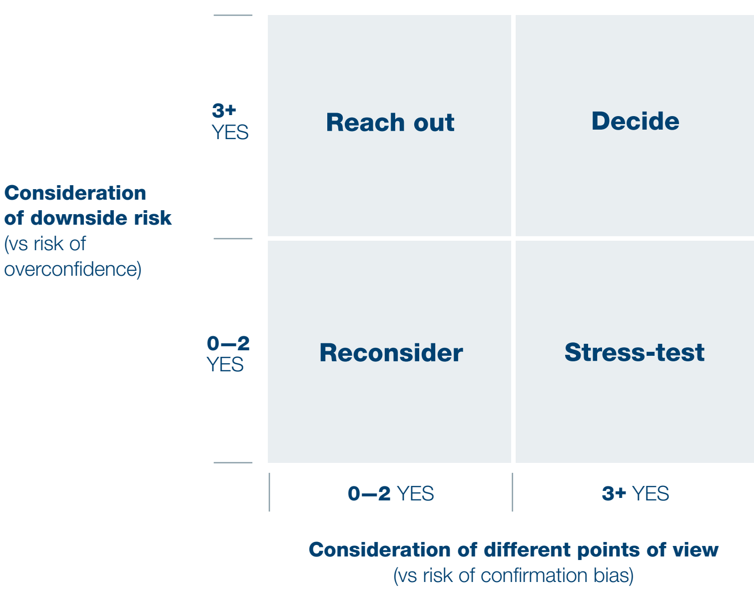
**Total "YES" answers:**

Source: Philip Meissner, Olivier Sibony, and Torsten Wulf

Exhibit 2

## Screening matrix

Map total number of "YES" answers here




Source: Philip Meissner, Olivier Sibony, and Torsten Wulf

words, leaders should ask about the *process* used to develop the proposal, not about the proposal itself or the degree of confidence it inspires. Exhibit 1 suggests questions for evaluating the process in the context of the two main categories of biases described earlier:

- The first set of questions ("Consideration of different points of view") aims to determine whether the confirmation bias has been kept in check. These questions focus on the sources of assumptions and the diversity of opinions expressed. A broad set of sources (including outside views) or a diverse set of opinions is a good indicator that the initial assumptions of the decision process have not gone unchallenged.[6]
- A second set of questions ("Consideration of downside risk") asks whether the possibility of negative outcomes—including downsides on a company, industry, and macro level—has been thoroughly evaluated. Such an evaluation can act as a safe-guard against overconfidence.

On each dimension, the questions are designed to be flexible, so that the circumstances of the decision at hand can be taken into account. Once the questions have been answered (with a simple yes or no), the responses can be transcribed on a matrix (Exhibit 2). This scoring will place the proposed decision in one of four quadrants, leading to different courses of action:

- Decide. This quadrant represents the most favorable outcome: the process that led to such a decision appears to have included safeguards against both confirmation bias and overconfidence.

- Reach out. Proposals that fall in this quadrant have been tested for their resilience to downside risks but may still be based on overly narrow assumptions. Decision makers should consider techniques that broaden their perspectives and help them generate meaningful alternatives. One such technique is the vanishing-options test: executives force themselves to generate new ideas by imagining that none of the proposals on the table are available.[7]

- Stress-test. Decisions in this quadrant reflect a variety of viewpoints but, nevertheless, may not have been sufficiently challenged and could therefore be tainted by overoptimism. Executives should consider a thorough outside review of the possible risks—for instance, by conducting a premortem or asking an outside challenger to play the role of devil's advocate.

- Reconsider. When a decision appears in the bottom-left quadrant, the process has probably not been comprehensive. Decision makers should therefore follow a dual strategy that generates both new perspectives and new reviews of risks.

By using this decision-screening tool, a company can learn if it needs to expand its focus and options in the strategy process. We recently applied a version of the tool together with 26 senior executives of European corporations from a variety of industries, ranging from construction to manufacturing, services, and retail. We asked these executives to analyze a strategic-decision proposal that a project team within their own organization (but not the participants) had recently made.

Only just over a quarter of the proposals, it emerged, were truly decision ready. The bar for readiness on each dimension (three positive answers out of six questions) was relatively low. Yet a striking 73 percent of the respondents judged that the decisions they were reviewing did not pass these tests. They then used the prescriptions of the matrix to revisit the decisions.

## How to use the decision-screening tool

A key question is *who* answers the questions in the tool. Since individuals developing a recommendation will not be aware of their biases, they cannot be expected to assess their own decision readiness. The answers must therefore come from the outside: not the executive who has driven the decision process, but others who have a more neutral view.

In practice, decision makers will be in one of two situations. In the first, and easiest, they reviewed recommendations prepared by others but had minimal involvement in developing them. In that case, decision makers are well placed to address the screening-tool questions themselves.

But in the second and more frequent case, the decision makers were actively involved in studying decisions that have now reached the final stage. In this case, they no longer have an outside view of the process and will need to seek out answers from informed observers: staff members, such as the CFO; colleagues from other parts of the organization; or outside advisers. Some companies will wish to define this role in advance and make it a formal part of their decision-making process, to avoid having a respondent who shares the decision maker's point of view.

• • •

In an environment of change and disruption, many leaders fear—rightly—that their companies do not take enough risks or will fall prey to "analysis paralysis" and let opportunities slip away. Hence the popularity of start-ups as role models of fast, iterative decision making. As Reid Hoffmann's often retweeted quote goes, "If you are not embarrassed by the first version of your product, you've launched too late."

While this "better sorry than safe" mind-set characterizes many successful start-ups, it may not be the best inspiration for the strategic decisions of mature companies. Some risks are worth taking: those taken knowingly, in pursuit of commensurate rewards. But some risks are taken recklessly because the risk takers are blind to their own overconfidence or have failed to consider alternative viewpoints.

The disciplined use of decision aids such as this screening tool offers a way to spot bad decisions before they happen, without significantly slowing down the decision process. Executives who adopt this approach will free up resources for value-creating projects—and improve their chances of keeping the names of their companies off the roll call of organizations that made notorious blunders. ○

[1] See Marc Graser, "Epic fail: How Blockbuster could have owned Netflix," *Variety*, November 12, 2013, variety.com.

[2] See Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 2010, mckinsey.com.

[3] See Daniel Kahneman and Gary Klein, "Strategic decisions: When can you trust your gut?," *McKinsey Quarterly*, March 2010, mckinsey.com.

[4] See Massimo Garbuio, Dan Lovallo, and Olivier Sibony, "Evidence doesn't argue for itself: The value of disinterested dialogue in strategic decision making," forthcoming in *Long Range Planning*.

[5] See Michael Birshan, Ishaan Nangia, and Felix Wenger, "Preparing to make big-ticket investment decisions, " July 2014, mckinsey.com.

[6] See Daniel Kahneman, "Daniel Kahneman: Beware the 'inside view,'" *McKinsey Quarterly*, November 2011, mckinsey.com.

[7] See Chip Heath and Dan Heath, *Decisive: How to Make Better Choices in Life and Work*, New York: Crown Business, 2013.

*The authors wish to thank McKinsey's Tim Koller for his contributions to this article.*

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Short takes

# What the airlines can teach bankers

In the interview excerpts that follow, Richard K. Davis, chairman, CEO, and president of U.S. Bancorp, explores two areas of airline practice that could serve banks well.

### Self-guided experiences

Transformation to the digital world and higher technology competence is completely about enabling employees to be better service providers. Think of how air travel now operates. When people walk into the airport, they print their own tickets. Customers able to handle their own transactions rate the experience positively because they are satisfied by being able to serve themselves and not having to wait for someone else. Yet there are still people there, if you really need to speak to them or if you need to check luggage weight, for example. Customers place a higher value on this because it is something they can't do for themselves. Technology allows us to help customers to be self-directed but to use a bank employee when needed. When that happens, the experience has got to be remarkable.

### Zero tolerance for errors

Credit risk is still there and always will be because banks are in the business of making loans. But in the last few years, the focus has shifted to doing things more competently. Now the bar is much higher,

# Using design thinking to delight your 'internal customers'

In this interview excerpt, Catherine Courage, senior vice president of customer experience at Citrix Systems, explains how a design mind-set can make corporate IT more intuitive and rewarding for employees.

Consumerization has raised the expectations of all users. They want to be delighted with the applications, tools, and devices they use, which need to be simple and should not require a lot of training—just like the technology experiences in their personal lives. The good news for CIOs is that the design-thinking principles product organizations have adopted can also be used by IT organizations. IT should think of its users not as stakeholders but as customers, and the department needs to move from building applications that meet functionality requirements to designing intuitive user experiences that empower customers.

Agile development is a parallel evolution in IT that is reinforcing many design principles. IT organizations apply agile and we need to be compliance perfect. Take air travel again. Baggage handlers look to get things done right, but if something goes wrong, a bag might be put on another plane and get delivered the next day. Nobody gets hurt too badly by the outcome. But an airline also has pilots, and they must have zero tolerance for errors—zero tolerance for planes that fall out of the sky.

In the last few years, bankers have had to adjust from being more like baggage handlers to becoming more like pilots. We're now moving to the same expectation of compliance, where it's no longer OK to make a handful of mistakes even if no one really gets hurt. Every transaction needs to be done perfectly, and your support capabilities must be as competent and as good as your origination.

That's caused us and a lot of other banks to really rethink compliance. One silver lining of this transition into a compliance-focused industry is that in the aftermath of the credit crunch, there weren't a lot of bad loans made. So we are spending our energy improving compliance risk. As the market recovers, banks will emerge with a compliance and credit culture that is better and more capable than the previous one.

This piece is adapted from an interview conducted by **Toos Daruvala,** a director in McKinsey's New York office.

For the full interview, see *Voices on bank transformation: Insights on creating lasting change*, March 2015, on mckinsey.com.

work through sprints and rapid iterations. Design thinking is similar: you rapidly iterate with customers to get a better product or application. The focus is on the user experience and on building deep empathy for customers about what makes these experiences delightful.

Change is always hard. The teams that found it easier to embrace change received explicit support and encouragement from their executive managers. It didn't require much to make a difference—just that an executive on the team would come in and say, "Guys, fantastic ideas. This is the behavior I want to see. Keep pushing forward!"

This piece is adapted from an interview conducted by **Hugo Sarrazin,** a director in McKinsey's Silicon Valley office and leader of McKinsey Digital Labs, and **Hyo Yeon,** a principal in the New Jersey office.

For more, see "Applying digital insights across the business: An interview with Citrix's Catherine Courage," *McKinsey on Business Technology*, February 2015, on mckinsey.com.

Banking

# Decoding financial-technology innovation

**Gergely Bacso, Miklos Dietz, and Miklos Radnai**

Start-ups are eyeing a wider revenue pool across a growing and broader range of products and services.

The next wave of the financial-technology revolution that started only a few years ago has arrived, and this time the impact will be broader. The earlier wave mostly hit payment transactions, which was an easy area to disrupt but represents only 6 percent of global banking-revenue pools.

We mapped those pools, across various products and business lines, against our database of over 1,200 financial-technology innovations. By conducting a deeper analysis of more than 350 of them, we found that start-ups are targeting the more lucrative retail-banking segment, which accounts for 52 percent of total industry revenues. The exhibit shows that the two biggest priorities outside payment transactions are retail lending (which has revenues twice as large as payment transactions does across all segments) and retail savings and investments (with 15 percent of global revenues). Start-ups in these areas are using peer-to-peer solutions, social technologies, and advanced data analytics to develop products, manage risk, and improve service. These firms are also beginning to target small to midsize enterprises—mostly in payment transactions, with some advances in credit and risk scoring as well. They are mostly staying away from large corporations and institutions for the time being.

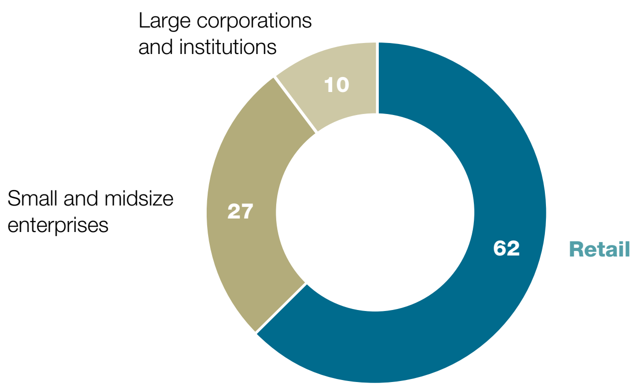
Banks should be monitoring innovations from five types of players: business-model disruptors, process innovators, technology start-ups outside the financial sector, digital banks, and platform attackers from other industries, such as e-tailing. Some of these innovations might radically reinvent banking; many can improve how banks currently do business. Decoding this landscape will be essential for them. o

*The authors wish to thank McKinsey's 'Tunde Olanrewaju for his contributions to this article.*

**Gergely Bacso** is an associate principal in McKinsey's Budapest office, where **Miklos Dietz** is a director. **Miklos Radnai** is an expert in the London office.

**Start-ups are targeting the more lucrative retail-banking segment, which accounts for 52 percent of total industry revenues.**

**Start-ups and innovations as % of total,**[1] by customer segment[2] (n = >350)




**Retail breakout**
Start-ups and innovations as % of total[1]

| | Start-ups and innovations as % of total | Estimated share of global banking revenues, % |
|---|---|---|
| Lending and financing | 14 | 24 |
| Savings and investments | 13 | 15 |
| Checking and debit accounts | 10 | 7 |
| Payment transactions | 25 | 6 |
| | | 52% |

[1] Analysis based on commercially well-known cases registered in the database; might not be fully representative.
[2] Figures do not sum to 100%, because of rounding.

Source: Analysis of data provided by McKinsey Panorama (a McKinsey Solution)

Consumer products

# Cohabiting with your e-commerce partners

**Kari Alldredge and Kelly Ungerman**

Top-performing consumer-product companies are aiming to strengthen their digital-channel strategies by locating teams at Amazon and other key players.

In the 1990s, consumer-goods companies began moving product specialists to Bentonville, Arkansas, to learn the "Walmart Way" and benefit from the retailer's expanding footprint. In the age of e-commerce, Amazon's Seattle headquarters has become a favored destination. We looked at the channel strategies of more than 45 leading US consumer-packaged-goods companies,[1] identifying the top 25 percent by online sales growth.[2] We found that 20 percent of the high performers are locating teams of digital and functional specialists at Amazon, while an additional 60 percent plan to do so within two years. Lower-tier performers have yet to make such moves, though a small percentage say they will (exhibit).

The on-site teams include category and distribution specialists who are learning to speed up decisions on product assortments and home deliveries to match Amazon's pace. They are also gaining real-time access to Amazon's tools for marketing and consumer analytics. Leading consumer companies are dedicating teams to work with other online partners as well, but the Amazon trend is more pronounced. Most consumer companies we surveyed are also investing in co-marketing with Amazon (exhibit). But while digital opportunities continue to swell, all players are maintaining their investments in traditional channel strategies, which remain vital to success.

[1] In conjunction with Nielsen and the Grocery Manufacturers Association, we interviewed approximately 150 executives at more than 45 leading US companies.

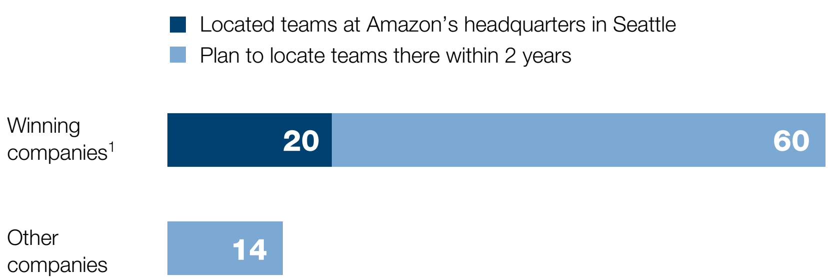
[2] High-performing companies—those in the top quartile—grew their online sales 1.3 to 7.5 times faster than other companies from 2012 to 2013, depending on the product category.

**Kari Alldredge** is a master expert in McKinsey's Minneapolis office, and **Kelly Ungerman** is a principal in the Dallas office.

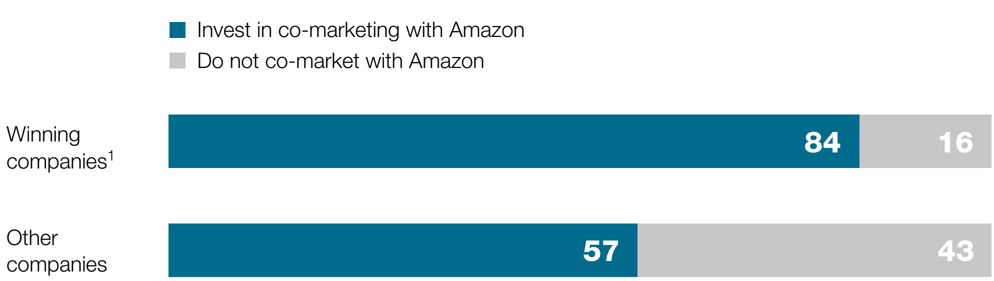
To download the full 2014 survey report, see "Adapting with speed: How agile selling orgs win," on mckinseyonmarketingandsales.com.

## High performers are increasingly locating—or planning to locate—digital and functional support teams at Amazon's headquarters . . .

**US consumer-packaged-goods companies,** % of respondents, n = >45 companies




## . . . and most consumer companies invest in co-marketing with Amazon for broader digital reach.




[1] Defined as top-quartile companies that outperform their peers in the categories in which they compete.

Source: 2014 McKinsey customer and channel-management survey, in partnership with the Grocery Manufacturers Association and Nielsen

Semiconductors

# Getting the most from R&D teams

**Aaron Aboagye, Dorian Pyle, and Alexander Silbey**

The size of these teams and the number of sites where they work have a big impact on semiconductor research productivity.

Companies struggle with decisions about the composition of teams of knowledge workers and how to deploy those teams productively. The experience of the semiconductor industry, which has trouble getting most new products to market on time, is instructive: our research on more than 2,000 R&D projects at more than 75 companies finds that leaders underestimate how the dynamics of teams affect the output of R&D.

Using a proprietary database that measures semiconductor-development efforts in a consistent fashion,[1] we examined productivity across a number of company sites. Increasing the size of R&D teams, we found, actually diminishes productivity. So does expanding the number of development sites. In the auto and wireless markets, for instance, R&D output decreased significantly as the size of project teams rose. Output also falls when companies try to manage design teams across multiple work sites, a path R&D managers often choose when they can't achieve critical mass at a single location.

Expanding from one site to three can lead to up to a 20 percent drop in productivity (exhibit). R&D efforts—and perhaps, by extension, other knowledge-work clusters—seem to have natural limits. Adding people beyond those limits diminishes returns. Organizations that manage complexity in an effective way at a single site may lose their grasp when far-flung teams take on complex tasks. ○

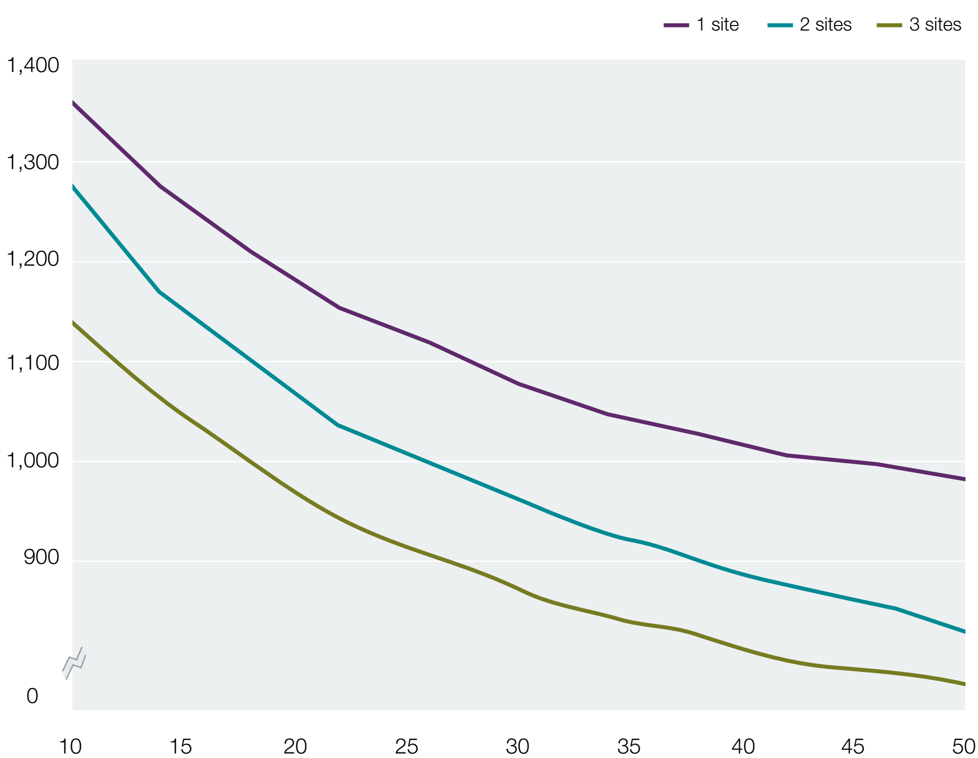
[1] Semiconductor output can vary tremendously within R&D organizations, depending on the complexity of individual products. Using proprietary data, we measure a project's technical characteristics, technical difficulty, and total development effort and normalize the variation among projects.

**Aaron Aboagye** is a principal in McKinsey's New Jersey office, **Dorian Pyle** is a consultant in the Silicon Valley office, and **Alexander Silbey** is a consultant in the Chicago office.

For more, see "By the numbers: R&D productivity in the semiconductor industry," *McKinsey on Semiconductors*, Number 4, Autumn 2014, on mckinsey.com.

**Development teams that span multiple sites can be up to 20 percent less productive than teams at a single site.**

**Productivity,** complexity units per person-week




**Team size,** number of full-time-equivalent employees in peak phase of integrated-circuit development

Source: McKinsey analysis

Private equity

# A second life for private equity in India?

**Vivek Pandit**

An overheated market has cooled down, dampening financing for many Indian businesses.

Private-equity firms began investing enthusiastically in India more than ten years ago, buoyed by fast GDP growth, youthful consumers, and a rising middle class. Private equity has accounted for 36 percent of equity financing over the past decade, and our research shows that private equity–backed companies of nearly all vintages and sectors increased their revenues and earnings faster than comparable public companies did. Improved governance often accompanied private-equity investment, an estimated 70 percent of which, by volume, has gone to family-owned businesses.

Returns on exit were strong at first (25 percent on investments made from 1998 to 2005) but fell sharply to 7 percent on funds placed between 2006 and 2009. During this later period, many candidates chose to raise private equity over IPOs, though often at the feverish public-market prices that prevailed in a pre-crisis environment dominated by intermediaries. That forced up private valuations.

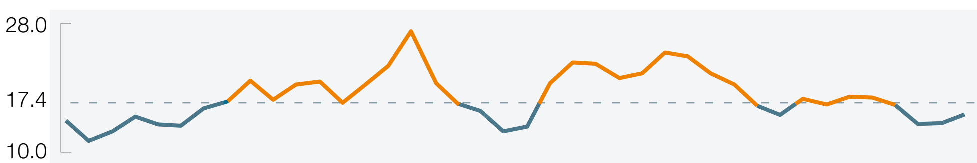
With contrarian views rare, most private-equity investments in India were made near capital-market peaks (exhibit). Some second-stage investments sought larger ticket-size deals that went to companies in industries that were more capital intensive and had longer gestation times, such as engineering and construction, hospitals, power generation, and real-estate development. These businesses are highly sensitive to rising input costs, debt availability, and policy delays. Many investors remain locked into several of those holdings and can't find a profitable exit. Of the $51 billion invested in companies from 2000 to 2008, less than a third has exited. The average holding period for exited deals rose from 3.5 years in 2004 to 5.2 years in 2013—a pattern found across nearly all sectors.

A pro-business government and progressive regulators recognize the important role private equity and other forms of risk capital play in development. With lessons learned, the industry is poised for a resurgence.

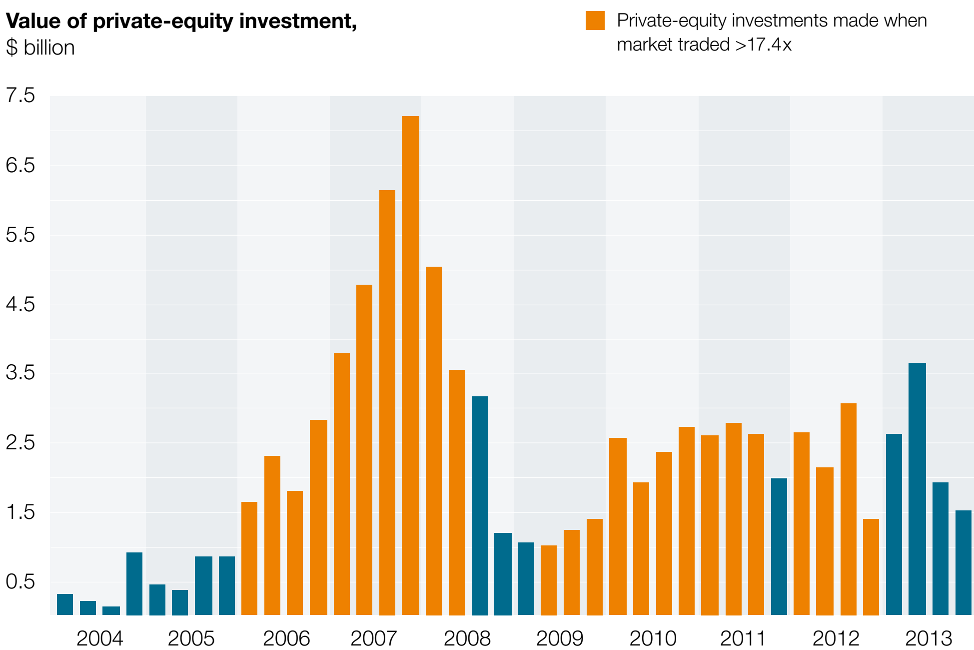
**Vivek Pandit** is a director in McKinsey's Mumbai office.

**Seventy percent (or approximately $65 billion) of private-equity investments in India were made during capital-market peaks.**

**Price-to-earnings (P/E) ratio,[1] 2004–13,**
10-year median = 17.4




**Value of private-equity investment,**
$ billion




[1] P/E is defined as current market capitalization divided by 12-month trailing earnings for top 200 Indian companies.

Source: *Asian Venture Capital Journal*; Thomson Reuters Datastream; McKinsey analysis

For more, see "Private equity in India: Once overestimated, now underserved," February 2015, on mckinsey.com.

# Revving up your innovation engine

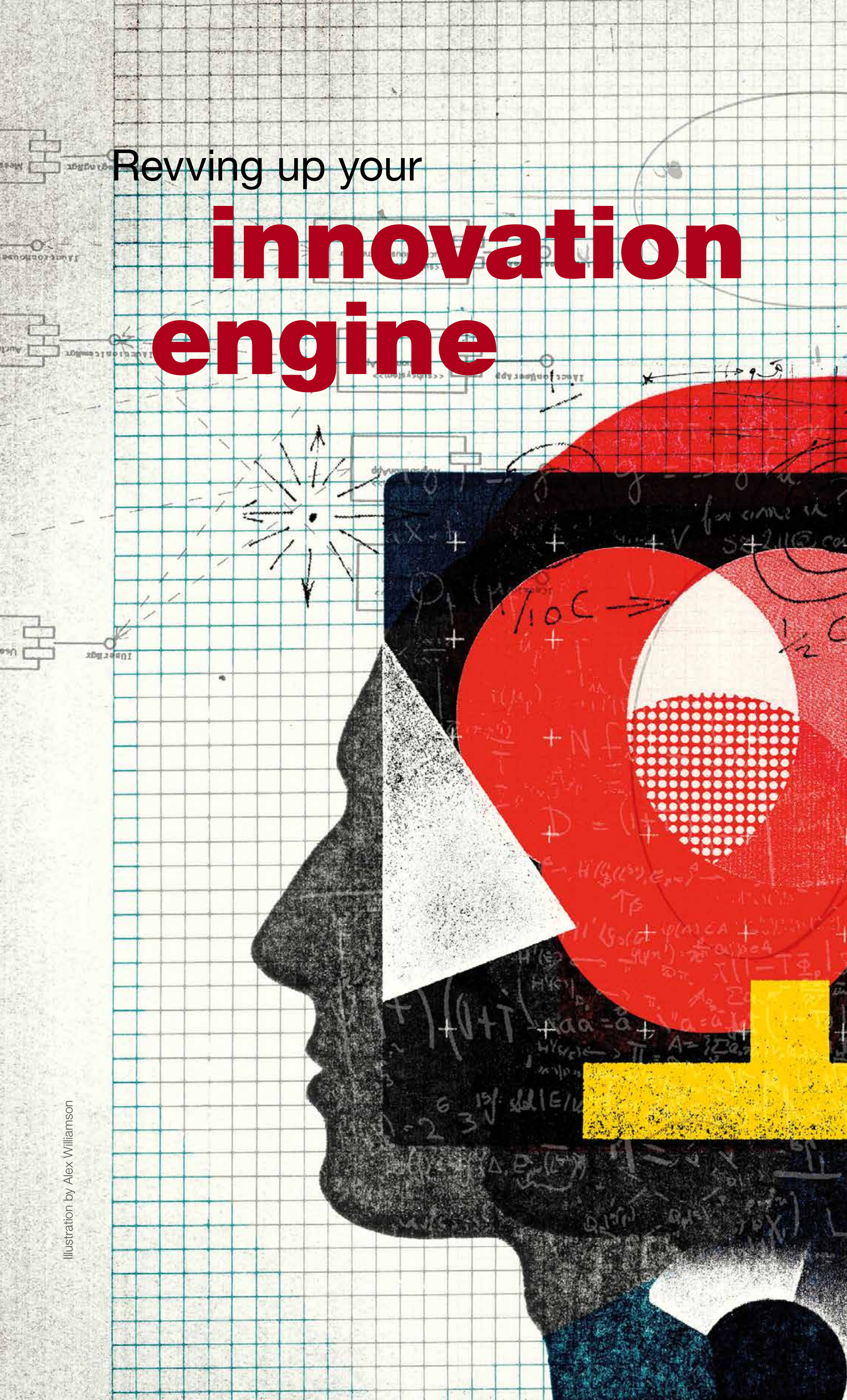


Illustration by Alex Williamson


New approaches make high-performance innovation and R&D a company-wide endeavor. The two articles in this package help companies pressure-test their innovation prowess while measuring the productivity of their R&D function.

**36**
**The eight essentials of innovation**

Marc de Jong, Nathan Marston, and Erik Roth

**48**
**Brightening the black box of R&D**

Eric Hannon, Sander Smits, and Florian Weig

# The eight essentials of innovation

**Marc de Jong, Nathan Marston, and Erik Roth**

Strategic and organizational factors are what separate successful big-company innovators from the rest of the field.

**It's no secret:** innovation is difficult for well-established companies. By and large, they are better executors than innovators, and most succeed less through game-changing creativity than by optimizing their existing businesses.

Yet hard as it is for such organizations to innovate, large ones as diverse as Alcoa, the Discovery Group, and NASA's Ames Research Center are actually doing so. What can other companies learn from their approaches and attributes? That question formed the core of a multiyear study comprising in-depth interviews, workshops, and surveys of more than 2,500 executives in over 300 companies, including both performance leaders and laggards, in a broad set of industries and countries (Exhibit 1). What we found were a set of eight essential attributes that are present, either in part or in full, at every big company that's a high performer in product, process, or business-model innovation.

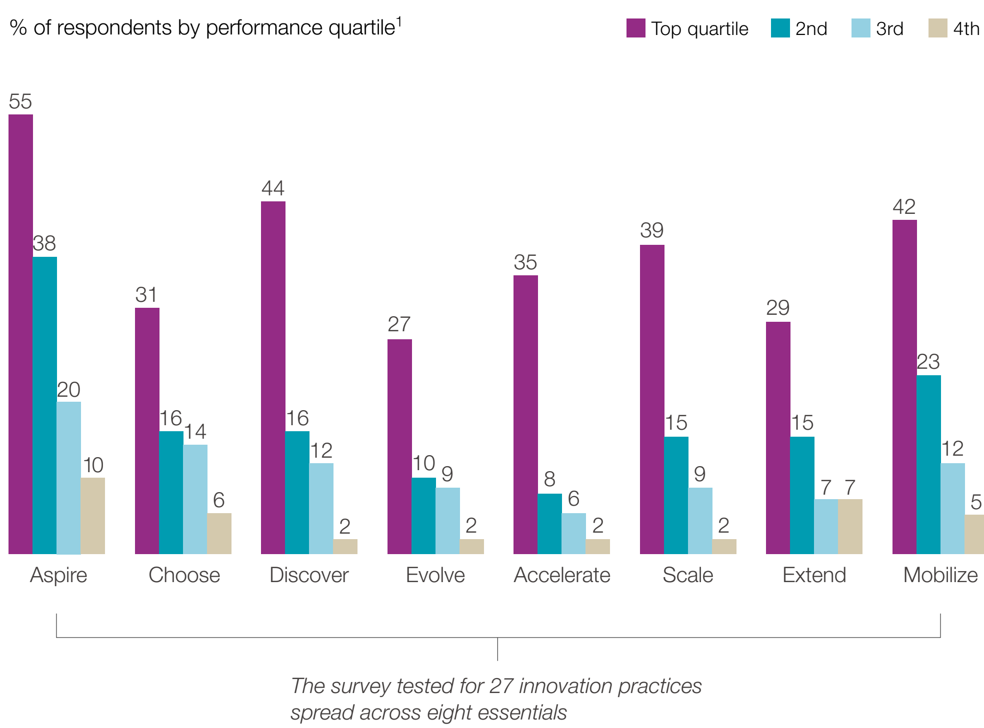
Since innovation is a complex, company-wide endeavor, it requires a set of crosscutting practices and processes to structure, organize, and encourage it. Taken together, the essentials described in this article constitute just such an operating system, as seen in Exhibit 2. These often overlapping, iterative, and nonsequential practices resist systematic categorization but can nonetheless be thought of in two groups. The first four, which are strategic and creative in nature, help set and prioritize the terms and conditions under which innovation is more likely to thrive. The next four essentials deal with how to deliver and organize for innovation repeatedly over time and with enough value to contribute meaningfully to overall performance.

To be sure, there's no proven formula for success, particularly when it comes to innovation. While our years of client-service experience provide strong indicators for the existence of a causal relationship between the attributes that survey respondents reported and the innovations of the companies we studied, the statistics described here can only *prove* correlation. Yet we firmly believe that if companies assimilate and apply these essentials—in their own way, in accordance with their particular context, capabilities, organizational culture, and appetite for risk—they will improve the likelihood that they, too, can rekindle the lost spark of innovation. In the digital age, the

Exhibit 1

**What innovation leaders say they do right**

% of respondents by performance quartile[1]




[1] N = 623. Performance defined as a weighted index of measures for organic growth (% of growth from new products or services developed in-house) and innovation performance (% of sales from new products and self-assessment of innovation performance). Respondents who answered "yes to some degree," "no," or "don't know/not applicable" are not shown.

Source: McKinsey survey of 2,500 global executives, Nov 2012 pace of change has gone into hyperspeed, so companies must get these strategic, creative, executional, and organizational factors right to innovate successfully.

Exhibit 2

## Testing for innovation

| | Do you really innovate? | Underlying elements |
|---|---|---|
| **Aspire** | Do you regard innovation-led growth as critical, and do you have cascaded targets that reflect this? | • Innovation vision and model<br>• Required growth contribution from innovation<br>• Cascaded targets and accountabilities |
| **Choose** | Do you invest in a coherent, time- and risk-balanced portfolio of initiatives with sufficient resources to win? | • Clarity of innovation themes<br>• Portfolio balancing time and risk<br>• Resources sufficient for initiatives to win<br>• Portfolio governance |
| **Discover** | Do you have differentiated business, market, and technology insights that translate into winning value propositions? | • Customer orientation<br>• Multiple-lens insight generation<br>• Differentiated value proposition |
| **Evolve** | Do you create new business models that provide defensible and scalable profit sources? | • Exploration of new business models<br>• Changing value-chain economics<br>• Diversifying profit streams<br>• Delivery-model changes and new customer groups |
| **Accelerate** | Do you beat the competition by developing and launching innovations quickly and effectively? | • Planning and execution rigor<br>• Cross-functional project culture<br>• Customer- and market-based learning |
| **Scale** | Do you launch innovations at the right scale in the relevant markets and segments? | • Go-to-market planning<br>• Launch management<br>• Operations ramp-up |
| **Extend** | Do you win by creating and capitalizing on external networks? | • Strategic external networks<br>• Collaboration skills<br>• Partner of choice |
| **Mobilize** | Are your people motivated, rewarded, and organized to innovate repeatedly? | • People priorities<br>• Enabling structure<br>• Supportive culture<br>• Learning and adaptive organization |

Source: McKinsey analysis

## Aspire

President John F. Kennedy's bold aspiration, in 1962, to "go to the moon in this decade" motivated a nation to unprecedented levels of innovation. A far-reaching vision can be a compelling catalyst, provided it's realistic enough to stimulate action today.

But in a corporate setting, as many CEOs have discovered, even the most inspiring words often are insufficient, no matter how many times they are repeated. It helps to combine high-level aspirations with estimates of the value that innovation should generate to meet financial-growth objectives. Quantifying an "innovation target for growth," and making it an explicit part of future strategic plans, helps solidify the importance of and accountability for innovation. The target itself must be large enough to force managers to include innovation investments in their business plans. If they can make their numbers using other, less risky tactics, our experience suggests that they (quite rationally) will.

Establishing a quantitative innovation aspiration is not enough, however. The target value needs to be apportioned to relevant business "owners" and cascaded down to their organizations in the form of performance targets and timelines. Anything less risks encouraging inaction or the belief that innovation is someone else's job.

For example, Lantmännen, a big Nordic agricultural cooperative, was challenged by flat organic growth and directionless innovation. Top executives created an aspirational vision and strategic plan linked to financial targets: 6 percent growth in the core business and 2 percent growth in new organic ventures. To encourage innovation projects, these quantitative targets were cascaded down to business units and, ultimately, to product groups. During the development of each innovation project, it had to show how it was helping to achieve the growth targets for its category and markets. As a result, Lantmännen went from 4 percent to 13 percent annual growth, underpinned by the successful launch of several new brands. Indeed, it became the market leader in premade food only four years after entry and created a new premium segment in this market.

Such performance parameters can seem painful to managers more accustomed to the traditional approach. In our experience, though, CEOs are likely just going through the motions if they don't use evaluations and remuneration to assess and recognize the contribution that all top managers make to innovation.

## Choose

Fresh, creative insights are invaluable, but in our experience many companies run into difficulty less from a scarcity of new ideas than from the struggle to determine *which* ideas to support and scale. At bigger companies, this can be particularly problematic during market discontinuities, when supporting the next wave of growth may seem too risky, at least until competitive dynamics force painful changes.

Innovation *is* inherently risky, to be sure, and getting the most from a portfolio of innovation initiatives is more about managing risk than eliminating it. Since no one knows exactly where valuable innovations will emerge, and searching everywhere is impractical, executives must create some boundary conditions for the opportunity spaces they want to explore. The process of identifying and bounding these spaces can run the gamut from intuitive visions of the future to carefully scrutinized strategic analyses. Thoughtfully prioritizing these spaces also allows companies to assess whether they have enough investment behind their most valuable opportunities.

During this process, companies should set in motion more projects than they will ultimately be able to finance, which makes it easier to kill those that prove less promising. RELX Group, for example, runs 10 to 15 experiments per major customer segment, each funded with a preliminary budget of around $200,000, through its innovation pipeline every year, choosing subsequently to invest more significant funds in one or two of them, and dropping the rest. "One of the hardest things to figure out is when to kill something," says Kumsal Bayazit, RELX Group's chief strategy officer. "It's a heck of a lot easier if you have a portfolio of ideas."

Once the opportunities are defined, companies need transparency into what people are working on and a governance process that constantly assesses not only the expected value, timing, and risk of the initiatives in the portfolio but also its overall composition.

There's no single mix that's universally right. Most established companies err on the side of overloading their innovation pipelines with relatively safe, short-term, and incremental projects that have little chance of realizing their growth targets or staying within their risk parameters. Some spread themselves thinly across too many projects instead of focusing on those with the highest potential for success and resourcing them to win.

These tendencies get reinforced by a sluggish resource-reallocation process. Our research shows that a company typically reallocates only a tiny fraction of its resources from year to year, thereby sentencing innovation to a stagnating march of incrementalism.[1]

## Discover

Innovation also requires actionable and differentiated insights—the kind that excite customers and bring new categories and markets into being. How do companies develop them? Genius is always an appealing approach, if you have or can get it. Fortunately, innovation yields to other approaches besides exceptional creativity.

The rest of us can look for insights by methodically and systematically scrutinizing three areas: a valuable problem to solve, a technology that enables a solution, and a business model that generates money from it. You could argue that nearly every successful innovation occurs at the intersection of these three elements. Companies that effectively collect, synthesize, and "collide" them stand the highest probability of success. "If you get the sweet spot of what the customer is struggling with, and at the same time get a deeper knowledge of the new technologies coming along and find a mechanism for how these two things can come together, then you are going to get good returns," says Alcoa chairman and chief executive Klaus Kleinfeld.

The insight-discovery process, which extends beyond a company's boundaries to include insight-generating partnerships, is the lifeblood of innovation. We won't belabor the matter here, though,

[1] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012; and Vanessa Chan, Marc de Jong, and Vidyadhar Ranade, "Finding the sweet spot for allocating innovation resources," *McKinsey Quarterly*, May 2014, both available on mckinsey.com.

because it's already the subject of countless articles and books.[2] One thing we can add is that discovery is iterative, and the active use of prototypes can help companies continue to learn as they develop, test, validate, and refine their innovations. Moreover, we firmly believe that without a fully developed innovation *system* encompassing the other elements described in this article, large organizations probably won't innovate successfully, no matter how effective their insight-generation process is.

## Evolve

Business-model innovations—which change the economics of the value chain, diversify profit streams, and/or modify delivery models—have always been a vital part of a strong innovation portfolio. As smartphones and mobile apps threaten to upend old-line industries, business-model innovation has become all the more urgent: established companies must reinvent their businesses before technology-driven upstarts do. Why, then, do most innovation systems so squarely emphasize new products? The reason, of course, is that most big companies are reluctant to risk tampering with their core business model until it's visibly under threat. At that point, they can only hope it's not too late.

Leading companies combat this troubling tendency in a number of ways. They up their game in market intelligence, the better to separate signal from noise. They establish funding vehicles for new businesses that don't fit into the current structure. They constantly reevaluate their position in the value chain, carefully considering business models that might deliver value to priority groups of new customers. They sponsor pilot projects and experiments away from the core business to help combat narrow conceptions of what they are and do. And they stress-test newly emerging value propositions and operating models against countermoves by competitors.

Amazon does a particularly strong job extending itself into new business models by addressing the emerging needs of its customers

[2] See, for example, Marla M. Capozzi, Reneé Dye, and Amy Howe, "Sparking creativity in teams: An executive's guide," *McKinsey Quarterly*, April 2011; and Marla M. Capozzi, John Horn, and Ari Kellen, "Battle-test your innovation strategy," *McKinsey Quarterly*, December 2012, both available on mckinsey.com.

and suppliers. In fact, it has included many of its suppliers in its customer base by offering them an increasingly wide range of services, from hosted computing to warehouse management. Another strong performer, the *Financial Times*, was already experimenting with its business model in response to the increasing digitalization of media when, in 2007, it launched an innovative subscription model, upending its relationship with advertisers and readers. "We went against the received wisdom of popular strategies at the time," says Caspar de Bono, *FT* board member and managing director of B2B. "We were very deliberate in getting ahead of the emerging structural change, and the decisions turned out to be very successful." In print's heyday, 80 percent of the *FT*'s revenue came from print advertising. Now, more than half of it comes from content, and two-thirds of circulation comes from digital subscriptions.

## Accelerate

Virulent antibodies undermine innovation at many large companies. Cautious governance processes make it easy for stifling bureaucracies in marketing, legal, IT, and other functions to find reasons to halt or slow approvals. Too often, companies simply get in the way of their own attempts to innovate. A surprising number of impressive innovations from companies were actually the fruit of their mavericks, who succeeded in bypassing their early-approval processes. Clearly, there's a balance to be maintained: bureaucracy must be held in check, yet the rush to market should not undermine the collaboration, continuous-learning cycles, and clear decision pathways that help enable innovation. Are managers with the right knowledge, skills, and experience making the crucial decisions in a timely manner, so that innovation continually moves through an organization in a way that creates and maintains competitive advantage, without exposing a company to unnecessary risk?

Companies also thrive by testing their promising ideas with customers early in the process, before internal forces impose modifications that blur the original value proposition. To end up with the innovation initially envisioned, it's necessary to knock down the barriers that stand between a great idea and the end user. Companies need a well-connected manager to take charge of a project and be responsible for the budget, time to market, and key specifications—

a person who can say yes rather than no. In addition, the project team needs to be cross-functional in reality, not just on paper. This means locating its members in a single place and ensuring that they give the project a significant amount of their time (at least half) to support a culture that puts the innovation project's success above the success of each function.

Cross-functional collaboration can help ensure end-user involvement throughout the development process. At many companies, marketing's role is to champion the interests of end users as development teams evolve products and to help ensure that the final result is what everyone first envisioned. But this responsibility is honored more often in the breach than in the observance. Other companies, meanwhile, rationalize that consumers don't necessarily know what they want until it becomes available. This may be true, but customers can certainly say what they *don't* like. And the more quickly and frequently a project team gets—and uses—feedback, the more quickly it gets a great end result.

## Scale

Some ideas, such as luxury goods and many smartphone apps, are destined for niche markets. Others, like social networks, work at global scale. Explicitly considering the appropriate magnitude and reach of a given idea is important to ensuring that the right resources and risks are involved in pursuing it. The seemingly safer option of scaling up over time can be a death sentence. Resources and capabilities must be marshaled to make sure a new product or service can be delivered quickly at the desired volume and quality. Manufacturing facilities, suppliers, distributors, and others must be prepared to execute a rapid and full rollout.

For example, when TomTom launched its first touch-screen navigational device, in 2004, the product flew off the shelves. By 2006, TomTom's line of portable navigation devices reached sales of about 5 million units a year, and by 2008, yearly volume had jumped to more than 12 million. "That's faster market penetration than mobile phones" had, says Harold Goddijn, TomTom's CEO and cofounder. While TomTom's initial accomplishment lay in combining a well-defined consumer problem with widely available technology components, rapid scaling was vital to the product's continuing success. "We doubled down on managing our cash, our operations, maintaining quality, all the parts of the iceberg no one sees," Goddijn adds. "We were hugely well organized."

## Extend

In the space of only a few years, companies in nearly every sector have conceded that innovation requires external collaborators. Flows of talent and knowledge increasingly transcend company and geographic boundaries. Successful innovators achieve significant multiples for every dollar invested in innovation by accessing the skills and talents of others. In this way, they speed up innovation and uncover new ways to create value for their customers and ecosystem partners.

Smart collaboration with external partners, though, goes beyond merely sourcing new ideas and insights; it can involve sharing costs and finding faster routes to market. Famously, the components of Apple's first iPod were developed almost entirely outside the company; by efficiently managing these external partnerships, Apple was able to move from initial concept to marketable product in only nine months. NASA's Ames Research Center teams up not just with international partners—launching joint satellites with nations as diverse as Lithuania, Saudi Arabia, and Sweden—but also with emerging companies, such as SpaceX.

High-performing innovators work hard to develop the ecosystems that help deliver these benefits. Indeed, they strive to become partners of choice, increasing the likelihood that the best ideas and people will come their way. That requires a systematic approach. First, these companies find out which partners they are already working with; surprisingly few companies know this. Then they decide which networks—say, four or five of them—they ideally need to support their innovation strategies. This step helps them to narrow and focus their collaboration efforts and to manage the flow of possibilities from outside the company. Strong innovators also regularly review their networks, extending and pruning them as appropriate and using sophisticated incentives and contractual structures to motivate high-performing business partners. Becoming a true partner of choice is, among other things, about clarifying what a partnership can offer the junior member: brand, reach, or access, perhaps. It is also about behavior. Partners of choice are fair and transparent in their dealings.

Moreover, companies that make the most of external networks have a good idea of what's most useful at which stages of the innovation process. In general, they cast a relatively wide net in the early going. But as they come closer to commercializing a new product or service, they become narrower and more specific in their sourcing, since by then the new offering's design is relatively set.

## Mobilize

How do leading companies stimulate, encourage, support, and reward innovative behavior and thinking among the right groups of people? The best companies find ways to embed innovation into the fibers of their culture, from the core to the periphery.

They start back where we began: with aspirations that forge tight connections among innovation, strategy, and performance. When a company sets financial targets for innovation and defines market spaces, minds become far more focused. As those aspirations come to life through individual projects across the company, innovation leaders clarify responsibilities using the appropriate incentives and rewards.

The Discovery Group, for example, is upending the medical and life-insurance industries in its native South Africa and also has operations in the United Kingdom, the United States, and China, among other locations. Innovation is a standard measure in the company's semi-annual divisional scorecards—a process that helps mobilize the organization and affects roughly 1,000 of the company's business leaders. "They are all required to innovate every year," Discovery founder and CEO Adrian Gore says of the company's business leaders. "They have no choice."

Organizational changes may be necessary, not because structural silver bullets exist—we've looked hard for them and don't think they do—but rather to promote collaboration, learning, and experimentation. Companies must help people to share ideas and knowledge freely, perhaps by locating teams working on different types of innovation in the same place, reviewing the structure of project teams to make sure they always have new blood, ensuring that lessons learned from success and failure are captured and assimilated, and recognizing innovation efforts even when they fall short of success.

Internal collaboration and experimentation can take years to establish, particularly in large, mature companies with strong cultures and ways of working that, in other respects, may have served them well. Some companies set up "innovation garages" where small groups can work on important projects unconstrained by the normal working environment while building new ways of working that can be scaled up and absorbed into the larger organization. NASA, for example, has ten field centers. But the space agency relies on the Ames Research Center, in Silicon Valley, to maintain what its former director, Dr. Pete Worden, calls "the character of rebels" to function as "a laboratory that's part of a much larger organization."

Big companies do not easily reinvent themselves as leading innovators. Too many fixed routines and cultural factors can get in the way. For those that do make the attempt, innovation excellence is often built in a multiyear effort that touches most, if not all, parts of the organization. Our experience and research suggest that any company looking to make this journey will maximize its probability of success by closely studying and appropriately assimilating the leading practices of high-performing innovators. Taken together, these form an essential operating system for innovation within a company's organizational structure and culture.

*The authors wish to thank Jill Hellman and McKinsey's Peet van Biljon for their contributions to this article.*

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# Brightening the black box of R&D

**Eric Hannon, Sander Smits, and Florian Weig**

An all-in-one, one-for-all formula to determine R&D's productivity can help companies see how well the function is performing.

**The question of R&D's productivity** has long resembled a Gordian knot. Look nearly anyplace else in today's corporations, and there's far less difficulty measuring productivity and performance. In manufacturing and logistics, you can get a sense of things just by looking around the production floor, the inventory room, or the loading dock. Even the performance of the advertising budget—once famously opaque—is now, thanks to digital technology, much easier to see.

But the R&D department provides fewer clues. There's no flow of tangible goods through the process, for one thing, but rather a stream of ideas and concepts that resist the efforts of efficiency experts and innovation gurus alike. In the face of this difficulty, most companies fall back on a few well-worn approaches: R&D as a percentage of revenue, the ratio of new products to sales, or the time it takes for new products to reach the market. None of these really gives a good idea of how well the R&D function is performing, either overall or by team—nor is it clear why (or when) any given project might suddenly prove a failure though it had earlier shown every promise of success.

We have endeavored to address this long-standing puzzle. We may not have answered it definitively, but we have developed a formula we believe will be useful to any company that wants to establish and maintain a comprehensive and transparent overview of the R&D organization's many platforms, hundreds of projects, and thousands of engineers, technicians, program managers, and lab workers. Just as

Alexander the Great is said to have undone the Gordian knot by the simple expedient of slicing through it with his sword—rather than trying to unravel it by hand, as others had attempted to do—our formula makes relatively quick, simple work of a knotty problem.

This formula takes a novel approach to measuring R&D outcomes: multiplying a project's total gross contribution by its rate of maturation and then dividing the result by the project's R&D cost. Since proposing this idea, we have worked with several companies to test it and introduced it to a diverse group of approximately 20 chief technology officers (CTOs) and other senior executives in a roundtable setting. So far, the formula demonstrates several virtues. First, it's a single metric rather than a collection of them. Second, it aims to measure what R&D contributes within the sphere of what R&D can actually influence. Finally, by measuring productivity both at the project level and across the entire R&D organization (the latter through simple aggregation), it endeavors to speak to the whole company, from the boardroom all the way to the cubicle. Refinements to the approach may be necessary, but for now at least, the formula seems to represent an advance in measuring R&D's productivity and performance.

## The case for a new approach

Before describing the formula in greater detail, let's examine what *doesn't* work in today's approaches to measuring R&D's productivity, and why that matters.

### Today's flaws . . .

The most common approach takes the ratio of R&D's costs to revenue. This method divides revenue from products developed in the past by what's currently being spent on products for the future. That might be useful in a stable or stagnant company whose prospective revenues are expected to grow very steadily or to remain flat. But for any other company, this assumption is artificially pessimistic for investing in future growth and falsely optimistic when the product pipeline is weakening. Indeed, repeated studies have shown no definite correlation between this R&D ratio and any measure of a company's success.[1]

Not that anything better has been proposed in the past—and not for lack of trying. One academic paper[2] found no single, top-level metric and therefore recommended that companies instead use a suite of metrics at different levels of the organization.

## . . . and why they matter

Maybe at one time, R&D's productivity mattered less. But today, myriad competitive forces drive down R&D budgets, and nearly every company we know—even those investing heavily in growth—continues to ask the R&D organization to achieve more with the same or fewer resources. (One CTO admits that his method is "to keep turning the budget dial down until the screaming gets too loud"; that's when he knows he's hit the right level.)

Meanwhile, as product variations, functional requirements, and customization needs (to say nothing of regulatory demands) proliferate, the complexity and cost of R&D continue to rise. Small wonder friction arises between R&D managers, struggling to articulate the scope of the challenges they face, and other executives, who are frustrated with the rising cost of product development. In some industries, such as semiconductors, where Moore's law is pushing the limits of physics, this friction is acutely apparent.

At the source of the frustration is the difficulty of generating lasting R&D-productivity improvements at many companies. One reason is the lack of repetitive tasks, at least compared with other parts of the organization. Another is the more frequent reshuffling of R&D project teams.

[1] Studies include Christoph H. Loch and U.A. Staffan Tappar, "Implementing a strategy-driven performance measurement system for an applied research group," *Journal of Product Innovation Management*, 2002, Volume 19, Number 3, pp. 185–98, wiley.com; Martin Falk, "Quantile estimates of the impact of R&D intensity on firm performance," *Small Business Economics*, 2012, Volume 39, Number 1, pp. 19–37, springer.com; and Raphael Braga da Silva et al, "Innovative intensity and its impact on the performance of firms in Brazil," *Research in International Business and Finance*, 2015, Volume 34, pp. 1–16, elsevier.com.

[2] See Christoph H. Loch and U.A. Staffan Tappar, "Implementing a strategy-driven performance measurement system for an applied research group," *Journal of Product Innovation Management*, 2002, Volume 19, Number 3, pp. 185–98, wiley.com.

Moreover, R&D managers usually can't identify troubled projects until they're well into an escalating spate of costly late changes and firefighting. Many of the technical shortfalls of products become clear only just before they are introduced into the market. As a result, it's often hard to determine, in the fire drill that accompanies the last weeks and months of a troubled project, exactly what all the engineering hours were spent on and who spent them.

## A new formula

When you dig more deeply into the R&D conundrum, you quickly encounter the problem of measuring what the R&D organization actually accomplishes—the outputs, so to speak. Any formula for productivity by definition divides outputs by inputs. The input variable, in this case, is straightforward: the cost of an R&D project. That's the one used by most existing measures of R&D's productivity and the one we too decided to use.

To capture the outputs—a stickier task—we settled on using, first, the gross contribution of a project and, second, a complementary measure: the rate of maturity, or a project's progress toward meeting its full technical and commercial requirements. We chose these measures for their overall explanatory power and the visibility they provide into certain aspects of the R&D process. They come together in the formula shown in the exhibit.

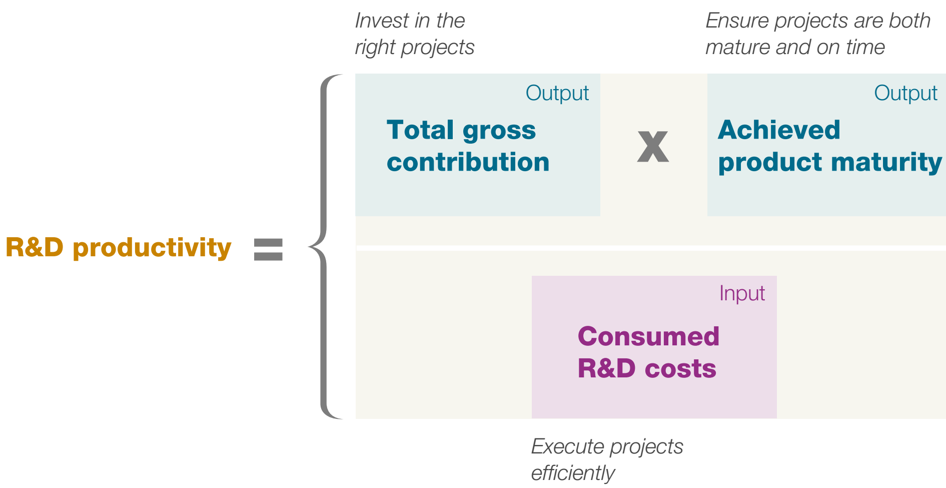
### Total gross contribution

We chose total gross contribution as one part of the formula's numerator because it represents, over time, a product's economic value to customers, while keeping fixed costs out of the equation. That allows us to home in on what R&D can directly influence. Also, by looking at the total gross contribution of projects over time, companies can highlight information that helps to evaluate the projects they have in process and to continue or cancel them. That nicely ties the metric to one kind of behavior it's meant to influence.

How do we know what the gross contribution is? Looking back in time, it's easy enough to determine. Thus, when a company calculates a project's rate of maturation (a step we'll describe in a moment), it can determine a completed R&D project's productivity retrospectively.

Exhibit

**A simple formula provides companies with a single measure to assess the productivity of the R&D function.**




Source: McKinsey analysis

However, when executives consider a project that's in process or has yet to be started, they don't know whether it will capture its potential gross contribution and must instead rely on a credible and reasonably accurate estimate. The more accurate the forecast, the better the formula will work as a leading indicator. You could even say, from a skeptical point of view, that the formula is only as good as the estimates that go into it—which is true, as far as it goes. But even for companies that tend to be overly optimistic or pessimistic in their business cases, faulty estimates will provide at least a basis for "go/no-go" decisions about different projects. In addition, even a flawed estimate can be used to see, earlier in the evaluation process, whether a project's productivity is dropping relative to the forecast. This is often a reliable indicator that a project won't return its predicted gross contribution.

That said, the formula we propose will work best for companies with incremental R&D processes and less well in start-ups with more uncertain R&D spending.

## Achieved product maturity

While a project's gross contribution may be necessary to measure R&D's output, it's not sufficient, because it isn't earned all at once but rather over time. The likelihood that a project will attain the projected gross contribution depends, in part, on the maturity of the product at the time of its market introduction—how close it is to verifying and validating its technical and commercial requirements. (Of course, other factors also influence whether a given product or service captures its full potential, including how well it was marketed and how well the company timed its introduction.) Our experience shows that the closer to full maturity a product is when introduced, the better the chance that it will fulfill its expected gross contribution.

That's not only because the product-maturity rate largely determines time to market but also because late changes to a developing product typically cost more to fix than earlier ones. Such late changes might, for example, require a company to rework expensive tooling or to redesign interface components or features. Higher costs mean a lower gross contribution.

The implication is that companies must be able to assess, in real time, how close their R&D projects are to full maturity. Few companies may in fact have this capability, but a rough-and-ready version of such a system *can* be built fairly quickly, often in two to three weeks. To do so, a company simply looks at critical dimensions (such as cost, functionality, and quality) during each of the quality gates a project passes through in its development. These provide a fair proxy in a rudimentary system if they are reported in consistent fashion throughout a company.

But if we are going to find the precise productivity formula we're seeking, we need a more sophisticated and systematic method—for example, one that checks on a project's progress toward meeting its performance requirements within a narrowing allowable deviation corridor over its lifespan. This method uses technical and commercial metrics specific to each product instead of the more generic metrics used in the rough-and-ready version. It lets companies drill down to the maturity of single components within a project and to zoom out and gauge the maturity of an entire product and service pipeline.

Of course, there's a broader reason, beyond time to market, why the rate of maturity is an important measure of the R&D function's output: designing and maturing the products that the strategy and marketing functions conceive is the primary reason R&D exists.

## Integrating the elements

These three elements—total gross contribution, rate of maturity, and cost of R&D—come together in a formula that attempts to quantify R&D's overall performance and to shed light on separate aspects of productivity. This, in turn, facilitates more confident managerial interventions to improve them.

By weighting projects according to their expected gross contribution, for instance, we keep our focus on efforts critical to a company's success, while also articulating the value R&D generates over a defined time period. By tracking the race to a mature product, we make sure R&D gets credit for its value contribution only if it delivers such a product. Projects that reach maturity in timely fashion are acknowledged for having justified the full business case for them. Project teams that launch immature products, which are less likely to capture their full expected gross contribution, get penalized.

The formula's usefulness, then, lies in the way it drives the right behavior. By more heavily weighting projects forecast to make a higher gross contribution, our approach helps focus management's attention on the ongoing projects most critical to a company's future success. Furthermore, the formula encourages a faster time to market, since products that reach maturity more quickly will show a higher level of productivity. Finally, the formula encourages the efficient execution of projects because those that consume less investment will also have a higher productivity value.

# The formula in action

Measuring productivity, valuable though that may be, is just a starting point—it won't change R&D's efficiency on its own. The formula must be integrated into existing management processes or lead to the creation of new ones. One company used the approach to perform a one-time analysis looking at all of its R&D projects for the previous five years. The idea was to establish a baseline R&D-productivity measure that would serve as a yardstick for future efforts. To see how productivity is changing, the company now runs each of its current projects and each of its project teams through the formula two and four times a year, respectively. It will take a few years before the company can trace the results all the way to specific products and their marketplace performance. But already, we can see its benefits when confronting some perennial challenges: setting the direction of R&D, improving the performance of teams, making decisions, and driving change.

## Setting direction

A key benefit of this productivity formula is its ability to address, through a single metric, all levels of the organization—from individual engineering teams to the full R&D pipeline. As such, it provides a backbone for an integrated performance-management system that unifies an entire company's R&D efforts. This unity comes with significant flexibility: companies can select separate parts of the formula to gain insights into the different elements of the R&D function and thus to influence both the particulars and the whole.

CTOs can convincingly quantify for their boards any increase, over the preceding year, in the productivity of the entire R&D organization by annually measuring its productivity. By looking only at the numerator, executives can report R&D's overall value contribution. By multiplying the product portfolio's expected gross contribution by the respective increase in maturity achieved over the measured time period, they can determine the total value R&D generates.

And that's not all. By taking the formula's left-hand elements—the total gross contribution and R&D costs of individual projects—executives can develop a metric to help prioritize the overall product-development pipeline and thereby make better portfolio and resource-allocation decisions. (Are critical and valuable projects being deprived? Has organizational momentum allowed bloated projects to consume too many resources?) And by looking at the formula's right-hand elements—the rate of maturation divided by the cost of R&D—executives can better assess the efficiency of working teams. Such transparency is a powerful tool for improving their performance.

## Improving teams

In any R&D organization, some teams perform at an extremely high level and others struggle. This range of performance can be difficult to identify, at least objectively. Naturally, individual managers often have an instinct for high-performing teams but lack a means to quantify that performance or to make comparisons.

Publishing a ranking of productivity by using the right-hand elements of the formula—the rate of maturation over the corresponding R&D cost—makes a team's performance immediately apparent. Obviously, that insight does not, in and of itself, drive improvement. But by enabling investigations into what specific kinds of behavior truly make teams excel, the formula provides an important first step.

Companies can therefore avoid the broad, one-size-fits-all improvement approaches that rightly make executives leery. Particularly in large organizations, it's almost impossible to improve all the engineering teams at once. The starting points and improvement needs of different projects and teams are simply too diverse. Companies are better off focusing their limited resources on teams with the most potential for improvement. By applying the methodology described here, a company should avoid employees' "not invented here" hostility toward the practices of external organizations. The practices identified through the formula, after all, are internal to the company that carries out the analysis, and lower-ranking teams can simply walk across the hall, so to speak, to see and learn from their higher-performing peers.

We have seen R&D teams that apply internal practices commit themselves voluntarily to improving their performance (in the most important indicators) by more than 20 percent, on average. One company, for example, significantly increased its ability to hit its technical objectives by implementing a systematic process for the engineering release of a highly complex industrial component.

## Making objective decisions

This productivity-based method improves the management of R&D in a third way, as well: by providing an objective and numerical basis for making decisions and setting targets. It bypasses gut-feeling decisions and the sort of arbitrary budget and performance-improvement targets so often divorced from the reality of R&D challenges. The formula allows executives to better understand the demands they're placing on the function in the context of its historical productivity performance, creating a more reliable budget for the product-development portfolio. When executives know the productivity of individual R&D teams, they can calculate the likely cost of a project, even down to the contribution of individual functional areas.

## Driving change

The transparency this system of performance measurement provides is an invaluable companion to any large-scale R&D-productivity initiative. Compared with initiatives in other parts of a company—for example, programs to reduce the cost of materials, where any gain is very tangibly demonstrable in the piece price—improvements in R&D are often ephemeral. In our experience, many large-scale transformations identify millions of dollars in R&D-efficiency benefits only to leave the function's budget unchanged.

Our method allows managers to measure a change program's impact objectively. And even if the R&D budget does stay the same, faster or better development should be reflected in overall productivity. By quantifying the impact of any change program, moreover, executives will be better able to communicate its success in a credible and convincing way.

• • •

R&D is one of the few areas that often remain opaque to executives in today's corporations. Quantifying what it actually accomplishes has resisted the efforts of executives and academics alike. By clarifying the outputs, the simple formula proposed here endeavors to generate a single measure companies can use to determine and agree on the R&D function's productivity—the better to assist decision making and to improve performance.

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For a guide to finding the right balance of responsibility between management and HR, see "Getting beyond bureaucracy in human resources," on page 67.

Illustration by Bill Butcher

# Toward a new HR philosophy

**Peter L. Allen**

HR should empower managers to decide on standards, hire how they choose, and develop company-wide leaders.

**What is the appropriate role** for the human-resources function? Many companies view it as merely administrative, with little or no strategic impact. Of course, HR leaders bridle at this perception and regularly seek ways to have a seat at the table. In the quest to be viewed as more strategic and more important, HR often tries to take on greater responsibility. (For more, see "Getting beyond bureaucracy in human resources," on page 67.) Yet the gap between HR's aspirations and actual role persists.

I've observed this gap in a variety of organizations, both as a consultant and as an in-house manager at several multinationals. Fundamentally, I believe, the gap arises from two complementary causes. First, executives and managers often think their job is to get financial results rather than to manage people. Second, when executives and managers neglect people management, the HR function worries about lapses and tends to "lean in" to right them itself. On the surface, this approach seems to meet an organization's needs: management moves away from areas it views as unrewarding (and perhaps uncomfortable), while HR moves in, takes on responsibilities, solves problems, and gains some glory in the process.

But this approach is based on erroneous thinking. It is bad for management and bad for the company as a whole. When HR sees itself as manager, mediator, and nurturer, it further separates managers from their employees and reinforces a results-versus-people dichotomy.[1] That's why many HR teams refer to the rest of the company as "the business"; too often, they don't really perceive *themselves* as a core part of that business.

## Helping managers manage

I joined the online travel agency Agoda.com three years ago to lead the HR function. Mindful both of problematic patterns in other organizations and of a CEO deeply averse to traditional HR, I have tried to build a different model. My department's fundamental goal is to help managers manage better, not to manage on their behalf. While we have a long way to go—Agoda is still in many ways in start-up mode, despite having over 2,000 employees in 28 countries—we've made significant progress.

I believe that sharing our experience may prove useful for other organizations as well. Our approach is based on a few core principles:

- Managers, not HR, should define, live, and develop the company's leadership.

- Managers, not HR, should do the hard work of managing people—hiring, evaluating, rewarding, and disciplining employees—and managers should be evaluated on their results.

- Employees, not HR, should "manage up" and take responsibility for solving problems directly with their managers.

In addition, we've taken the symbolic but important step of renaming our department People and Organization Development rather than Human Resources. We've also tried to hire the smartest and most talented people we can find, regardless of whether they have traditional HR backgrounds. Results so far have been promising.

[1] McKinsey research shows that performance and organizational health are closely intertwined. See the extensive body of research on performance and health led by Scott Keller and Colin Price, "Organizational health: The ultimate competitive advantage," *McKinsey Quarterly*, June 2011, on mckinsey.com; and the book *Beyond Performance: How Great Organizations Build Ultimate Competitive Advantage*, first edition, Hoboken, NJ: John Wiley & Sons, 2011.

## Developing leaders

While leadership development should always be a top priority for HR, many companies approach it in counterproductive ways. One major division of a Nasdaq 100 company, for example, outsourced leadership development to an external provider—not uncommon given the proliferation of specialist consultancies offering this sort of service.

Outsourcing leadership development, though, is risky. Perhaps not surprisingly, the management of this division was ultimately taken over by a different part of the organization. In another multinational I worked with, every level of employee development (from job candidates to executives) was evaluated on a different set of leadership criteria, creating confusion about what mattered for success. In addition, this company's high-potential pool varied by as much as 40 percent from year to year because the assessment was so subjective. Although HR tried to treat these employees as privileged and told them they were destined for great things, senior management continued to fill open senior roles from the outside because it did not value the "high-pos." Predictably, many of them left the organization.

Rather than hand leadership development in its entirety over to external experts, we've tried to build it from the inside. Our CEO and senior leaders worked to clarify our own leadership characteristics, the qualities that make people successful at Agoda, and the behavior and principles that make it grow. We've shied away from evaluations based on leadership potential because we are skeptical of our own ability to predict future performance. Instead, we focus on behavior that we can observe now.

Individually, the leadership characteristics we esteem are not unusual: most organizations, after all, value qualities such as integrity and intelligence. But when we combine these with "thinking like an owner," innovation, and the ability to inspire others, we begin to define leadership in ways that really matter in the Agoda context. We apply the same leadership principles to every stage of the employee life cycle. We use them to guide hiring decisions; we teach them in new-hire orientation sessions; we rate them in semiannual performance evaluations; and we use them to assess an employee's readiness for promotion. This approach means that we have a set of criteria for the skills and behavior managers should live by and employees should believe in. It helps us to select and reward employees who contribute the most to the organization, both in the short and the long run. Leadership at Agoda is truly suited to the company.

Leadership is also something we expect of all our employees, whether or not they have people-management responsibilities or direct reports. We start teaching this principle and the relevant leadership skills during the orientation of new hires, so that our values are clear from the beginning. To make sure that the leadership style we teach is really our own, we involve managers heavily in assessing the needs of the company, designing and building curricula, and teaching. Not all managers are born to play that role, of course, but we teach them teaching skills and cofacilitate where appropriate. We strive to make it clear to everybody that our leadership values are specific to our company. They are the rules we live by.

## Letting management manage

As often as possible, we strive to ensure that managers make the critical HR decisions. Managers have to live with the results the people on their teams produce, so managers should be empowered to make relevant decisions and held responsible for outcomes. If HR constrains decisions too closely—by determining who should be hired, how much they get paid, or their performance ratings—managers no longer have the freedom to obtain the results they desire. In that case, it is neither logical nor productive to hold those managers accountable.

With freedom, of course, comes responsibility, especially the responsibility to make good decisions. One example is recruitment. Our People and Organization Development team provides a flow of qualified candidates, but it is the managers who conduct the interviews and choose whom to hire. Our role is to provide managers with actionable data and useful tools, such as an in-house recruitment certification program we are building to develop hiring skills.

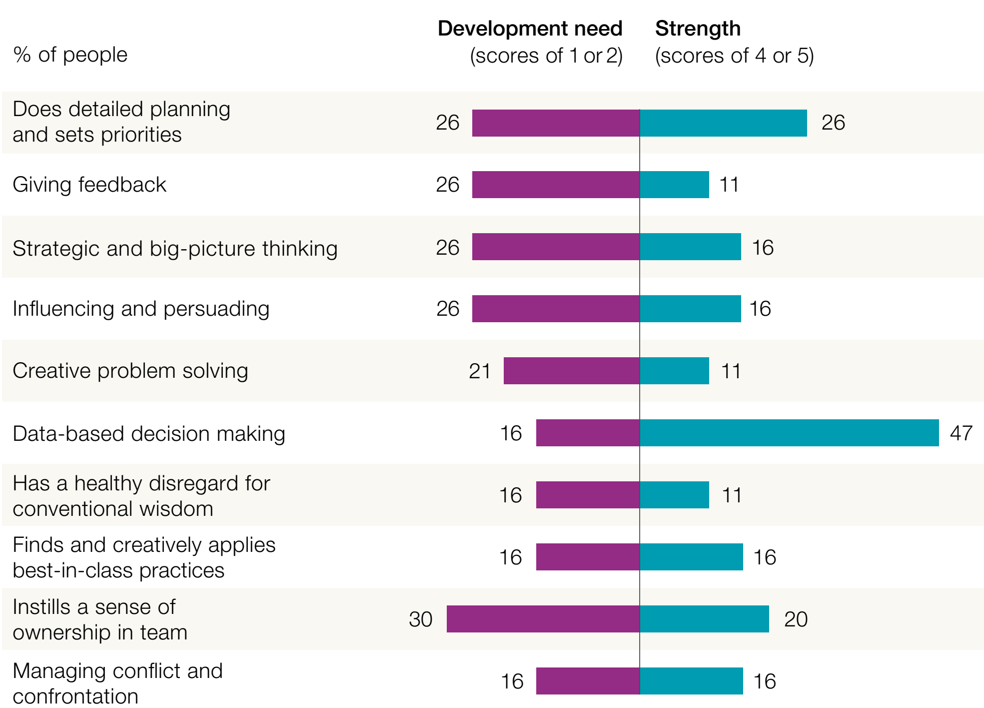
We also evaluate our candidates using an array of standardized tests—an important approach for our global company, which, at last count, employed people of 65 nationalities. Test scores help us compare different candidates in a group with each other and with our current employees. While we don't have strict cutoffs, we are building guidelines that correlate with performance. The goal is to enable managers to make better hiring decisions through objective data.

Agoda applies the same philosophy to other people processes, including performance assessment; our goal is to help shape management decisions rather than make them. We've adopted an employee-scoring system and work hard to communicate what the five-point scoring range means for managers and employees (exhibit). We do not try to

Exhibit

**At Agoda, aggregating data from a midyear performance review reveals a department's underlying development needs.**

Departmental midyear review (disguised example), top 10 areas for personnel development[1]




[1] Defined as skills with highest share of 1 or 2 scores on a scale of 1 to 5, where 1 is poor and 5 is excellent.

Source: Agoda

fit every department's scores to a predetermined ratio. Instead, we take the data from each review cycle back to department heads and ask them whether their evaluations really reflect their departments' performance—and what their underlying development needs really are. We ask a lot of questions and share lots of data, but we don't come up with the answers. This approach, we believe, builds responsibility and makes for better management over time.

## Compensation

As with performance, so with compensation: the People and Organization Development team consults rather than controls. We do not set strict minimum and maximum pay numbers. Instead, we research market salaries and provide guidelines (but not limits) to managers. Departments make compensation decisions because they are responsible for hiring the right people and managing how those people perform. We make a particular point of not setting predetermined caps for jobs (in technology, for example) that provide a significant competitive advantage for the company.

Perhaps surprisingly, this approach does not fuel extravagant pay. Department heads have an incentive to be conservative with pay packages because senior management's compensation depends on the company's profitability. At times, indeed, we encourage departments to pay more than they first proposed to do. In addition, our CEO reviews all annual compensation, providing a company-wide check and balance. If we conclude that an employee's contribution will justify his or her cost, we can compensate at levels higher than industry norms. While this approach may lead to inconsistencies in the pay of employees who are nominally at the same level,

We ask a lot of questions and share lots of data, but we don't come up with the answers. This approach builds responsibility and makes for better management over time.

we're willing to accept this outcome. We believe that the resulting improvement in company performance benefits all of our employees.

## Dealing with conflict

Our philosophy of helping managers to manage plays an important role when people problems arise. Traditional HR departments often find themselves—or put themselves—in the position of mediator between managers and employees. We try to avoid this role. Instead, our goal is to empower both managers and employees with the skills, information, and best practices to resolve problems together. We teach people-management skills not only to managers but also to employees, who need to know that they are responsible for helping to resolve problems by having difficult conversations and "managing up." This belief reflects our philosophy that leadership skills are critical for everyone in the company.

Obviously, problems do arise, but we teach employees that when they do, their next port of call is not HR but the manager's manager—or even managers further up the chain, up to and including the department heads who report directly to the CEO. This approach is a challenge, but it works when management is prepared to take on greater management responsibility rather than say, "HR can handle it."

## People people

Last, we take a somewhat unconventional approach to hiring into People and Organization Development itself. Our function is quite lean, and we are rigorous about whom we hire. We test candidates and make sure they are interviewed extensively, both by senior members of the department and by our internal clients. And while some department members do have direct experience in HR fields, a number—even some in senior roles—do not. In fact, we usually rule out candidates with too much big-company HR experience; we find them excessively bound to an HR-knows-best philosophy. Instead, we look for very smart people with an interest in the field and a desire to enhance the company's performance from a people perspective. International education, high test scores, emotional intelligence, and commitment matter more to us than résumés that check the HR boxes.

Creating a different kind of people function requires a shift in perspective from the department and company management alike. We believe that HR best serves the company's interest by analyzing and sharing data, building skills, and developing leaders. The company's management, for its part, must take real responsibility for hiring, evaluating performance, determining compensation, and releasing underperformers. This shift is still a work in progress. But as both sides let go of old attitudes, the false dichotomy between employees and managers is beginning to fade. Our people are working together, and our company is becoming more productive. By taking what appears to be a less active role than other HR departments do, we are actually gradually achieving greater influence and greater success—both for the company and for ourselves.

*The author wishes to thank Agoda's CEO, Robert Rosenstein, as well as Agoda team members Laura Cabantous, Jeffrey Lee, Harmen Nieuwenhuis, and Tanisara Pimsamarn, for their contributions to this article.*

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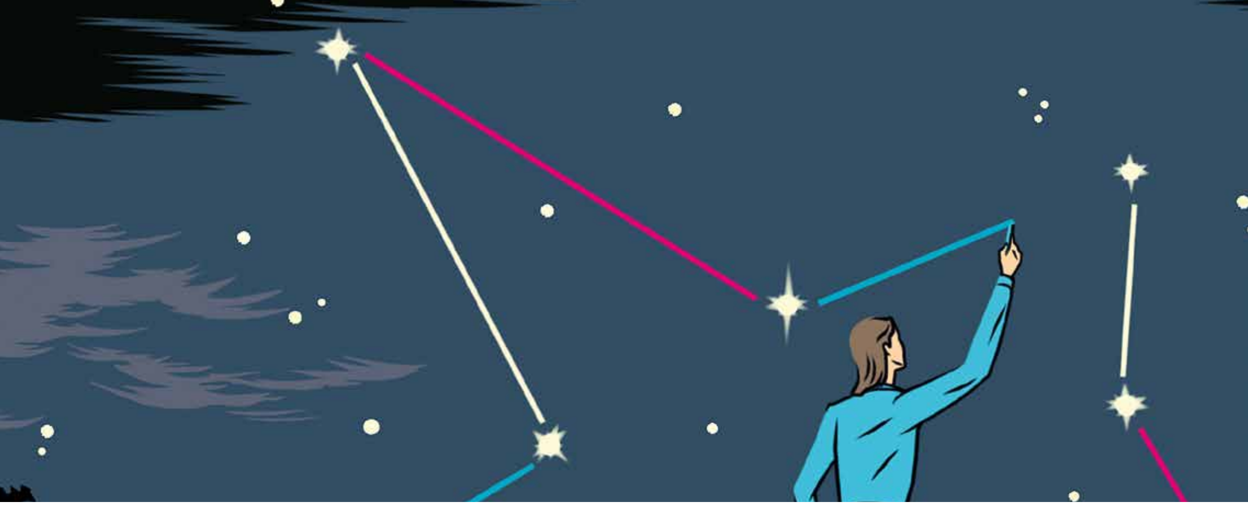

# Getting beyond bureaucracy in human resources

**Neel Gandhi and Bryan Hancock**

By becoming more strategic and operating with an edge, corporate HR departments can boost their effectiveness and shed their bureaucratic reputation.

At big corporations, human-resource organizations frequently conjure up images of bureaucratic weight and paper pushing. Need that be true? This question comes into sharp relief in McKinsey alumnus Peter L. Allen's description of HR approaches at his company, Agoda, which has been trying, with some success, to minimize the need for many traditional HR processes while transferring others to business leaders. (See "Toward a new HR philosophy," on page 58.) Although it's easiest to see how some of Agoda's human-resource initiatives apply to start-ups, our experience shows that it's also possible to right the balance in large organizations without going too far. Getting more strategic and operating with an edge often are two keys to success.

## Getting more strategic

One reason large organizations end up with a supersized human-resource infrastructure is that the business rationale for HR processes has been lost. But there's an antidote to massive HR systems, questionnaire overload, and multipage templates: stimulating a dialogue about the underlying strategic purpose of those tools—a dialogue that often helps management realize that they can be controlled and applied more effectively. A global healthcare company, for example, realized that its performance-review process gave it only a superficial understanding of who its high performers were and what feedback helped them to develop. It decided to deemphasize a time-honored nine-box calibration grid in its evaluation procedures and radically simplified employee reviews. We also know a senior leader who reduced his company's performance-review form from four pages to four questions—but who rightly insisted that those four questions had to be answered and tracked more rigorously.

In the latter case, the leader was a chief human resources officer (CHRO) with the insight to identify core business issues and the discipline to eliminate redundancies. Strategic leadership can come from outside HR, too. A financial-services company recently charged its second-highest-ranking executive with personally directing talent-review procedures for top professionals across the firm. That required him to take a step back and assess the business's most significant talent indicators, which turned out to be poorly reflected in its HR systems. The company's leaders, previously stuck in a process-oriented rut, have now articulated the strategic rationale for what they are doing and why it's important—in this case, to understand the company's people, help fill talent gaps, and thereby improve returns. It is now building a database and infrastructure to capture those results and make the highest performers more visible. HR might have had a difficult time, on its own, committing the company to new performance criteria and gaining the resources to update its systems, but collaboration with a major leader gave the effort teeth.

## Operating with an edge

It's easy to say, "HR needs to let go and get out of the way," but the pendulum can easily swing too far in the other direction: granting managers unlimited freedom in making HR decisions can generate too much variability, potential liability exposure, and cost creep. Moreover, when HR pulls back too far, it misses opportunities for using rigor and facts to gain predictive insights, whose potential is growing with big data and advanced analytics.[1]

### Talent pools and gaps

High-quality, timely information about talent pools and gaps represents a competitive advantage that HR is uniquely positioned to provide. For example, a grocery line manager in a global retail organization may have proved herself in Argentina just as a gap opened up in Mexico. An oil and gas organization may have a budding leader who is running out of growth headroom in the Middle East and a need for similar expertise in a bigger role in Houston. HR should ensure that these critical connections get made and then help line managers seize opportunities. The best HR organizations also offer a perspective on emerging gaps. For example, as digitization becomes more critical to cars,[2] leading automakers need to put more emphasis on recruiting computer engineers—a challenge for organizations accustomed to recruiting mechanical engineers.

### Compliance

Compliance efforts in areas such as labor and antidiscrimination obligations can easily make forms and layers of bureaucracy proliferate. But while an overly assertive HR department can constrain the smooth functioning of a business, companies are no better served by a "wallflower" department that misses red flags or neglects to enforce discipline. A rigorous HR function—an "adviser with an edge"—should track and interpret data and assert a point of view: "yes, we are doing well realizing internal goals or meeting industry benchmarks" or "no, we may be beginning to run off the rails."

One leading consumer-packaged-goods manufacturer and distributor, where on-site generalists had previously taken the lead, recently created a "SWAT team" for labor relations and compliance. The team discreetly monitors metrics for proven warning signs and moves in when the company needs subject-matter expertise. Oversight has improved and line managers have clear incentives to get compliance right—without forcing HR professionals to become omnipresent process police. Rather, their mission is to interpret events and respond rapidly to potentially significant breakdowns.

### Leadership development

Many leadership-development efforts don't achieve their goals, because they ignore the business context and offer insufficient opportunities for personal reflection and individualization.[3] While it would be easy to conclude that corporate HR can add little value to leadership development, the reality is more complicated. Letting "a thousand flowers bloom" often means that leadership gets ignored in some corners of a company and that others reinvent the wheel too often. An assertive HR department clarifies expectations for leadership development across the company, provides a baseline backbone of proven tools and methodologies, and flags priorities to adapt them to the needs of businesses and individuals. HR and business-unit leaders then collaborate to fine-tune programs.

• • •

Managers must lead, and HR must help them to do so. But the well-founded inclination to swing the HR-process pendulum away from bureaucracy and toward a freer hand for management should not lead organizations to veer from "ditch to ditch." Shifting too drastically is plainly a bad idea; in many cases, a complete HR overhaul is unnecessary. At all events, HR has opportunities to assert its expertise and strategic thinking in a low-profile, nonintrusive way. That requires both rigor and restraint—but, we've found, provides the sort of insights about talent, leadership, and performance management that all companies need, regardless of their size. ○

[1] See Bruce Fecheyr-Lippens, Bill Schaninger, and Karen Tanner, "Power to the new people analytics," *McKinsey Quarterly*, March 2015, mckinsey.com.

[2] See Paul Gao, Russell Hensley, and Andreas Zielke, "A road map to the future for the auto industry," *McKinsey Quarterly*, October 2014, mckinsey.com.

[3] See Pierre Gurdjian, Thomas Halbeisen, and Kevin Lane, "Why leadership-development programs fail," *McKinsey Quarterly*, January 2014, mckinsey.com.

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Illustration by Thom Sevalrud

# **Digital hives:** Creating a surge around change

**Arne Gast and Raul Lansink**

Online communities are helping companies engage with employees to accelerate change.

**New lessons are emerging** for executives striving to harness the power of social media in the cause of wider employee participation. Clearly, there's more to success than just investing heavily in the latest Enterprise 2.0 technology platforms. Large-scale engagement of the workforce requires, first and foremost, a firm grasp of organizational culture and its social dynamics, a psychological understanding of what triggers new behavior, a determination by management to loosen if not relinquish its traditional top-down approach, and an ability to demonstrate how digital activities complement offline or other real-world events.

Those attributes are often absent, so we find that many companies struggle to maintain the momentum of initiatives to encourage broad- and digitally based employee involvement. Indeed, that's true whether these efforts focus on the formulation of strategy, transformational change, customer service, or other business contexts where fresh ideas or new ways of working are needed for competitiveness. Some initiatives fail to "mobilize the masses" to any significant degree, dissipating energy and effort as the message gets stuck in middle management. Others get going but never reach the organization's perimeter, thereby missing an opportunity to collect valuable feedback and ideas from the front line.

## Four ways to drive change

Here we present four specific approaches to the creation of what we call digital "hives"—electronic hubs bristling with collective activity and designed to solve a particular problem or set of problems, to drive new habits, and to encourage organizational change (see "Designing the digital hive"). Digital tools to facilitate networking and collaboration propel these "horizontal" cascades, which at their best can weave new patterns of engagement across geographic and other organizational boundaries. In this way, they make it possible to have new conversations around problem solving, unlock previously tacit knowledge, and speed up execution.

### 1. Engaging the workforce in better strategy

Best practice in the formulation of strategy and in organizational change has long been to craft a "story" at the top and then to cascade it through lower echelons of the organization. Some companies refine the message in the light of feedback from middle managers, but however well communicated the refined story may be, it is still *management's* second attempt. Employees on the shop or office floor often feel like passive recipients.

That's beginning to change, though, thanks to social technologies. In a 2012 *Quarterly* article, we described the emergence of an approach that provides for extensive employee input and modifications. *Telling* thus equates with *sharing*, so the narrative grows as it diffuses throughout the organization.[1] There are still relatively few social strategy-development processes, but the tools are getting more powerful, and the scale and scope of such efforts are more impressive.

Using the "management hackathon" concept—an integrated multi-stage platform that allows participants to discuss ideas, express opinions, and contribute expertise collectively[2]—a successful consumer-goods company recently involved its entire organization in an open-source strategy process. This effort started with an organization-wide online discussion about risks to the company's

[1] See Arne Gast and Michele Zanini, "The social side of strategy," *McKinsey Quarterly*, May 2012, mckinsey.com.

[2] For more information on management hackathons, developed by the Management Information eXchange (MIX), visit mhackathon.com.

growth engine from higher input costs, stagnant industry growth, and a growing competitive threat from imitators to certain products and the business model. These risks then formed the basis for a bottom-up process that spawned over a thousand new strategic insights using a combination of in-person meetings and workshops as well as online channels.

These insights were aggregated into roughly ten strategic themes—from reengineering the retail experience and digital technology to

**Designing the digital hive**

creating service ecosystems around the company's strongest brands. All employees were asked, via an online platform, to provide a rank order for these insights and to suggest specific business ideas embodying them. The input from the hive helped management to narrow the strategic themes down to three and to identify several high-priority opportunities. The company is currently developing them, leveraging both online and offline channels to harvest more insights from across the organization and to identify volunteers who want to be involved.

Early experience suggests that better results follow when a problem is presented in stages to avoid overwhelming the participants, when a company uses volunteers rather than conscripts, when it offers training on how to think about innovation, when energy- and community-building offline events (such as workshops or weekly cafeteria sessions) supplement the online discussions, and when executives strike an authentic tone.

## 2. Connecting silos with a social chain

One of the biggest organizational challenges is to break siloed behavior and get employees talking to one another and cooperating across intracompany boundaries. It's one thing to diagnose a problem and aspire to collaboration. It's quite another, once the initial excitement wears off, to maintain momentum through mechanisms that underpin the new behavior and prevent managers and employees from slipping back into old habits.

One promising social-technology experiment we've observed is what we call the "social chain": a digital platform that links everyone working in a particular value chain inside a company. (Value chains often comprise people in different silos or departments working, say, to fulfill a customer order.) The social chain allows employees to work "out loud" online by sharing how they do things. It also encourages people who were previously isolated in part of the chain to identify areas where they depend on others and to tackle problems or bottlenecks collaboratively. Chain leaders can monitor these conversations and inject their own insights when appropriate. The chain can help them to expose old behavior and to highlight the sort of tacit understanding that drives more efficient operations.

The Dutch bank ABN AMRO has been a pioneer in using social chains. The banking crisis, a merger with Fortis, and the ensuing nationalization saw the company embark on a sweeping change program to cut costs, increase the efficiency of the value chain, and make employees more responsive. In the group's wholesale arm, for example, senior managers discovered that there was no uniform approach to tracking and reporting problems: employees could detect defects at the customer end more quickly through the Internet than through the company's internal systems. Needing a way to stimulate proactive, real-time problem solving, ABN AMRO introduced a social chain dedicated to employees working in its Acquiring and Issuing Cards unit, who spanned different silos, including IT, customer service, and operations. To push people into the hive, managers discouraged communication through meetings and e-mail.

Eighteen months later, the results were clear. ABN AMRO's social chain had enabled its employees to share their expertise, in real time, beyond a narrow circle of peers. They could therefore become true ambassadors for, and identify with, the chain as a whole.

### 3. Enlisting key customers to improve the proposition

A company's most regular and trusted customers—a group we call the "client rim"—can be a powerful force for change when they provide feedback on service standards or product quality. The opinion of these customers counts; they have extensive experience with the company and its ways of working, are generally committed to its success, know the people, and are typically both its most enthusiastic ambassadors and its strongest critics. Thanks to the power of social technologies, a company that mobilizes such people can solicit specific ideas for improving its customer proposition and demonstrate its client-centricity more broadly.

KLM, the Dutch airline, has successfully used this approach to foster a stronger client-centric mind-set among its employees. Operating in a highly competitive market with tight margins, the airline decided to target the lucrative segment of small and midsize enterprises directly. This approach required a significant shift in perceptions, not least because KLM traditionally focused on larger corporate clients and was often seen as distant, even arrogant, by smaller businesses.

Rather than taking the traditional focus-group route to find new ways to improve the offering, the company's executives opted for a large-scale digital dialogue between KLM and its emerging customers in this segment. The resulting Bluelab idea-management platform involved 1,500 participants from small and midsize businesses, who generated more than 1,000 concrete ideas and 4,000 other contributions. Both management and customer-facing staff from KLM Netherlands actively participated in these discussions. According to one senior executive, the initiative has "opened our eyes to the possibilities of social media to build a far stronger customer focus among our staff." KLM has since become one of the airline industry's foremost social-media exponents.

Companies can embrace key customers in a variety of ways. Mobile apps can transmit a continually updated stream of client quotes on the product and service experience. A buddy system can allow individual customers and employees to have online conversations—preceded, perhaps, by a customer-experience event at which clients and employees explore new paths to common goals. Idea-management platforms can solicit customers' help in solving vexing problems. Or a company might create social "mystery shoppers" who follow internal conversations anonymously and comment on them.

## 4. Uniting a dispersed sales force to drive higher sales

We're all creatures of habit, often reluctant to ditch comfortable routines and to apply new ways of doing things. The desire to address exactly this problem recently prompted a leading beverage company in Africa to employ social media to engage with its far-flung sales force (1,000 reps servicing around 100,000 individual outlets) and win back market share. These reps traditionally had spent several weeks at a time on the road, rarely checking in with the head office and therefore operating in a feedback and knowledge vacuum. Inevitably, they had become disconnected from the organization, and performance suffered.

The turnaround started after the company implemented a simple, low-budget system that uses the hive's collective wisdom to give each sales rep and call-center agent regular, real-time, and personalized information. Given time pressures, cash constraints, and concerns over the rate of thefts in African townships, the company opted to issue simple mobiles rather than the latest smartphones with a specialized app.

Staff at the center collected ideas based on intelligence gleaned from the calls and e-mails of the sales reps themselves and from district managers familiar with current issues in the beverage trade. The company also analyzed customer data highlighting pockets of fiercer-than-normal competition or SKUs that were selling particularly well. Such insights were then shared with reps and agents, who each received two or three personalized SMS messages a day. Managers could further use this rudimentary social platform to communicate with the sales force by, for example, congratulating teams when they hit milestones and generally celebrating success. The company also created a call-center "leaderboard" allowing executives to track the agents most responsive to the new information at their disposal. The executives then freed up time for these "early adopters" to coach their peers, provide feedback, and strengthen the system with additional insights.

The new network, implemented at minimal cost, puts collective expertise in the hands of each of the frontline reps, binds them more closely to the organization, and generates faster performance feedback. Within a year of the start, the company has increased cross- and upselling rates to more than 50 percent, from 4 percent, realizing an increase in gross margins of $25 million.

## A new mind-set for senior managers

The examples in this article illustrate the range of business contexts in which executives are increasingly making use of social media's growing influence in their employees' private lives and their increased familiarity with new digital-communication tools. As managers contemplate how to drive broader and deeper employee engagement in their companies, they should bear in mind the following considerations:

## Leading while letting go

Digital hives involve large numbers of previously "disenfranchised" employees in setting strategy, company-wide transformations, and customer-outreach initiatives. Creating these hives requires a delicate balancing act—not least a willingness by top managers to let go. Managers should not be afraid to commit themselves explicitly to acting on the results of these initiatives and should encourage unrestrained participation, however unpredictable the consequences.

But that doesn't mean playing a passive role. Our research consistently shows that without substantial involvement by the CEO or other top leaders, the vast majority of such initiatives fail to achieve their objectives. What's more, change programs that involve large numbers of people are up to two times more successful than those that do not.[3] When we ask change leaders what they would do differently next time, the top three responses always include spending more effort on engaging people and on developing and communicating change stories.

## Looking inward

The growing use of social tools to drive employee engagement provides particular opportunities for senior executives to improve role modeling. When people reflect on their behavior, they tend to rely on their own often sketchy perceptions and faulty memories. With many digital technologies, however, people can now track their behavioral footprint—for example, by analyzing conversational threads in microblogs and comparing their actual behavior with the leadership style to which they aspire. Managers at an international insurance company we know did so and found a clear gap between the effect they thought they were creating as leaders and the actual results.

## Becoming more responsive

Mobilizing a crowd requires companies to anticipate the crowd's expectations. Executives can maintain pace and encourage deeper engagement only through transparent feedback and rapid follow-up. We often see companies respond too slowly and erratically, so that employees can only guess what comes next. Radio silence or

[3] See "What successful transformations share: McKinsey Global Survey results," March 2010; and Carolyn B. Aiken and Scott P. Keller, "The CEO's role in leading transformation," February 2007, both available on mckinsey.com.

a prolonged hiatus strongly diminishes any sense of urgency and disrupts the rhythm, or pulse, of participation. Worse, it may spark lingering skepticism. Unleashing collective intelligence through a hive will be more successful if managers think ahead and develop an agile, scrum-like response capability outpacing that of smaller offline programs.

Given the speed of technology's development, we recognize that digital hives are still an area of fertile experimentation and that new models will evolve over time. What we know already is that the hive's transparent, inclusive, and egalitarian nature amplifies well-established psychological mechanisms, such as peer pressure and social recognition. Out in the limelight, with clear rules of engagement and a level playing field, people tend to stimulate and encourage others, perform well, and seek recognition. Collective adoption and participation can grow in hives as each one of them becomes a catalyst for change and causes a wider ripple effect throughout the organization.

*The authors wish to thank McKinsey's Wesley Smith and Michele Zanini, a Boston office alumnus who is managing director of the Management Information eXchange (MIX).*

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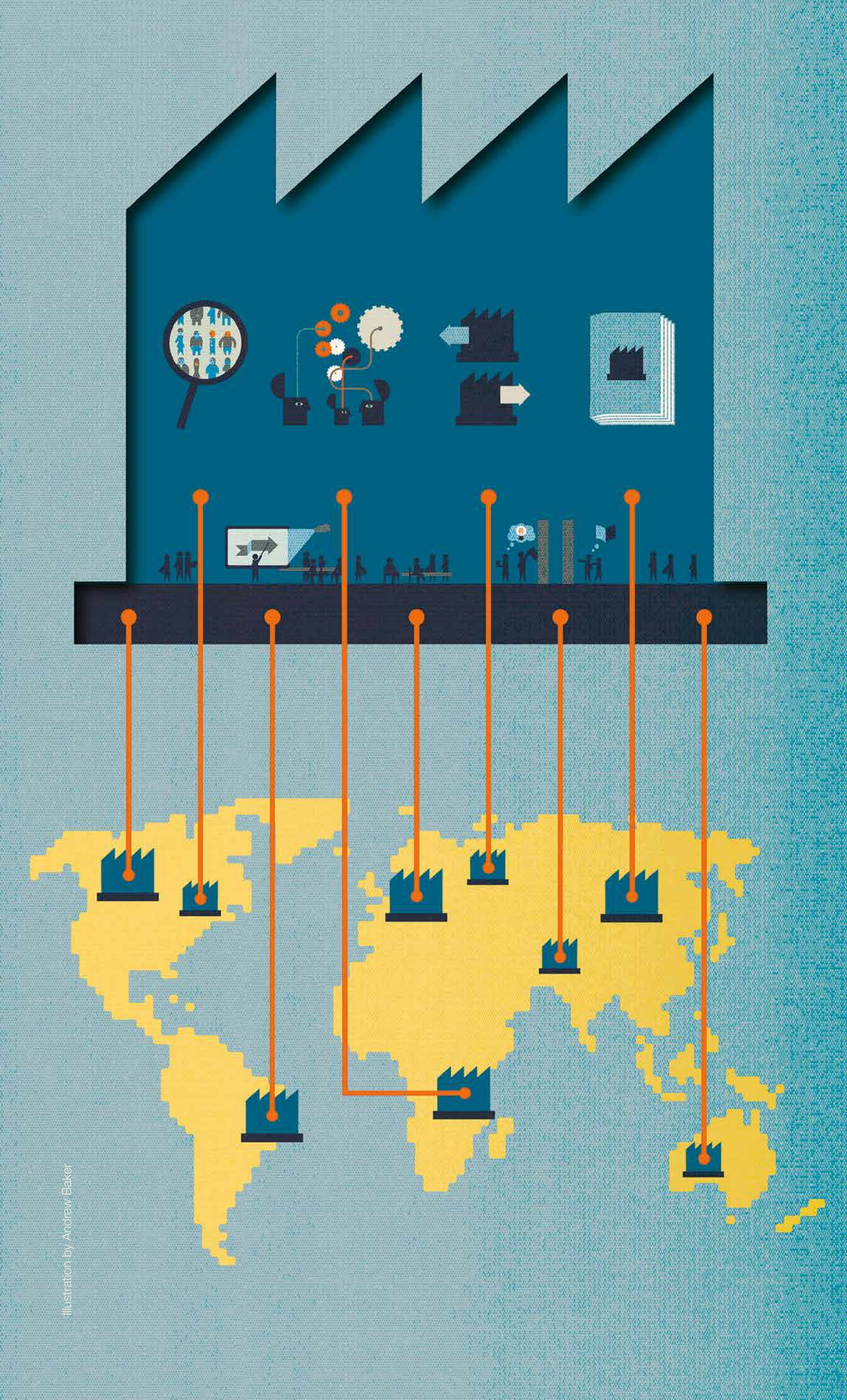

Illustration by Andrew Baker

# The globally effective enterprise

**Pascal Visée**

Today's technology enables integrated operations that can change the globalization penalty into a premium.

**International operations** beget complexity. As most multinational companies have come to understand—at times, the hard way—going global often produces organizational clutter and reduces agility. Scaling up can also create fundamental confusion about roles and responsibilities, often contributing to the large number of e-mails, meetings, and scorecards. Sometimes, multinationals mandate globally scaled solutions that cater to a theoretical average but have little relevance for local operations. Other times, multinationals tailor solutions too much to each local subsidiary's specific circumstances. Predictably, many of scaling's benefits and cost savings evaporate.

A 2011 *McKinsey Quarterly* article called this problem the "globalization penalty": leadership's attention wanders, the cost structures of regional subsidiaries (including global head-office charges) soar, and local operations buckle under internal bureaucracy. What's more, McKinsey research shows that high-performing global companies consistently score lower on several critical dimensions of organizational health than more locally focused companies do.[1] Customer service suffers too as multinationals struggle to compete with leaner local or "new economy" competitors.

[1] See Martin Dewhurst, Jonathan Harris, and Suzanne Heywood, "Understanding your 'globalization penalty,'" *McKinsey Quarterly*, July 2011, mckinsey.com.

Over my long career, I've experienced various flavors of the globalization penalty at major multinationals. From 2009 to 2013, at Unilever, I helped lead an initiative to remove organizational complexity customers didn't value while retaining essential elements of organizational scale. In this article, I elaborate on the underlying challenges that vex global organizations and suggest some new solutions that have been emerging through advances in information technology. Then I present a case study of Unilever's experiences in trying to adapt its organization and to create a new architecture for global services. That journey is far from complete, but it has already delivered some of the speed and organizational simplicity that motivated us to undertake it. Unilever's experience also suggests some useful lessons—for example, about the power and limits of technology.

## The perils of functional silos

Just about every multinational company was once a local enterprise—and a very successful one at that. This is not ancient history. As recently as the 1980s, many multinationals were managed largely on a local-for-local basis: in nearly every country where they did business, there was a site with a factory, a warehouse, sales, marketing, some R&D, and support staff. Problems could often be solved within a radius of 200 meters. The business was well understood because oversight was local. Most important, a company was close to its customers and could act as quickly as circumstances required.

More recently, however, multinationals have moved away from the local-for-local model. Through a combination of organic growth and acquisitions, the businesses of multinational companies began to replicate in new markets. Consolidation was in order—often for compelling reasons, such as cost synergies and lower duplication of effort. As a result, the majority of processes have been scaled up. R&D, for example, came to operate in a network of R&D centers; supply chains were managed regionally or globally; and procurement often stretched around the world. But consolidation also led to new sorts of complications, typically manifested by matrix organizations, which combine profit-responsible business groups or divisions, often by region or country, with vertical, functional pillars.

While there is nothing wrong with matrix organizations per se, they do place particularly heavy demands on the coordination of core functions such as R&D, marketing, and sales, as well as support functions such as finance, IT, and HR. Each function generally has four responsibilities: setting and executing a company's strategy for that function, managing its area of expertise, partnering with the rest of the organization, and running its own functional operations to serve business units.

In matrix organizations, this last responsibility too often becomes the neglected stepchild. Ask HR directors about their priorities, and they will probably respond by mentioning organizational development, managing talent, or diversity. But push them on operations, particularly at the local level, and they will probably refer any day-to-day questions to a regional subordinate. Many of their colleagues in other functions will do the same.

Operations are not only undermanaged but also mismanaged because functional silos almost assure suboptimal outcomes. Most business processes cross functional boundaries. One example is order to cash: sales receives an order, logistics undertakes fulfillment, and finance handles invoicing and cash. Managing a process through separate silos almost guarantees complexity. It creates internal inconsistencies and punishes the customer with foreseeable mistakes.

There are exceptions, of course. One is the supply chain, which in many multinational companies is organized on a truly end-to-end basis, from purchasing to production to delivery ("make to deliver"). Most operations, however, are not managed on an end-to-end basis. The telling results include late payments to creditors, high overdues resulting from invoicing errors, cluttered information landscapes with a myriad of intranets, imprecise headcount data, and unsorted master data, to name but a few of the complications. When day-to-day operations are managed in functional silos, the rationale for those operations—serving the customer—is obscured.

## Technology-enabled solutions

Today, technology is leading multinational companies to an inflection point. Global enterprises can now imagine a radically different, and far more effective, way of managing operations: by reorganizing functional ones to focus on key processes. This approach allows the enterprise to maintain advantages of scale while enabling its subsidiaries to become more nimble in each of their local markets.[2]

Technology is delivering several major benefits. One is a growing level of automation, which serves to localize and simplify transactions and service. Improved network capacity and reduced response times mean that local operations, even in continents far removed from the head office, can run on global enterprise-resource-planning (ERP) software from remote data centers.

Furthermore, multinationals can now centralize and analyze data far more efficiently. As the size and speed of databases have grown exponentially, the goal of building a single global data warehouse is coming within reach. Most significantly, global companies are now more able to act "as one" through powerful, cost-effective devices and applications. High-end videoconferencing systems enable robust global communication over a variety of media in real time, connecting far-flung employees on the fly. Flexible and adaptive solutions, often run from the cloud, help employees to work together remotely and solve problems on a global basis. For instance, at Nestlé, Chatter—a platform developed by Salesforce.com—is now the go-to collaboration tool for over 200,000 people, who use it to crowdsource innovation.

Ironically, today's advanced technology can help multinationals recapture the simplicity of their founding days. As user-friendly but powerful technological platforms sweep away complex systems, companies can release functional operations from their constraining silos. This development promotes more integrated global operations and allows companies to become effective in every local market in which they compete.

[2] For more on the emerging power of process-centered operating models, see Wouter Aghina, Aaron de Smet, and Suzanne Heywood, "The past and future of global organizations," *McKinsey Quarterly*, September 2014, on mckinsey.com.

## Carving out functional operations at Unilever

Late in 2009, Unilever embarked on a journey to implement global business services (GBS). I helped lead this initiative, which came to be named Enterprise & Technology Solutions, or ETS. Paul Polman, Unilever's CEO, charged us "to take out the complexity that consumers do not want to pay for." Activities that ultimately fell within the scope of ETS included finance, HR, IT, information management, real estate and facilities management, and indirect procurement. In all, the initiative addressed about 40 separate service lines, including purchase to pay, record to report, recruitment, master data, and facilities services. We aimed to make each of these service-line operations simpler, cheaper, and better.

### A global, virtual delivery organization

To achieve these goals, our team carved service lines out of their respective functions to manage them end-to-end. We created a global, virtual delivery organization and based team members around the world (most meetings are conducted by videoconference). Operating centers running multiple service lines were set up primarily in locations in emerging markets, such as Bangalore, India; Istanbul, Turkey; Katowice, Poland; Omsk, Russia; and Shanghai, China. These centers, charged with coordinating the global delivery of services, work in close conjunction with ETS personnel now present in every market to ensure that things run smoothly.

Operational performance is measured on a single global dashboard, which is visible to ETS operators, internal clients, and top management. Under the mantra "what gets measured gets done," the dashboard's quantitative and qualitative service metrics have consistently improved, year over year. Since the initiative was launched, it has contributed significantly to Unilever's reduction in overhead of about 200 basis points.

### A new architecture for global services

When we designed the new architecture for global business services, we started with a holistic process map (for a highly simplified version, see the exhibit). This process-oriented view guided us in carving out existing functional operations and regrouping them under more rational, end-to-end ETS service lines. Business-excellence process teams working hand-in-hand with IT-development

Exhibit

## A process view on integrated business operations

Unilever created a business-process map to develop a service catalog for its Enterprise & Technology Solutions (ETS).

| Business development | Business core operations | Business resources | |
|---|---|---|---|
| Strategy to portfolio | Purchase to pay | Funding to capital return | ▶ **Money** |
| Communications to change | Produce to deliver | Hire to retire | ▶ **People** |
| Market research to consumer insight | Order to cash | Lease to buy | ▶ **Capital goods** |
| R&D to product | Plan to report | Data to insight | ▶ **Information** |
| Marketing to sales | Safety/health to environment | Improve to excel | ▶ **Knowledge** |

Source: Unilever level-1 process model (modified by the author, Pascal Visée)

personnel played a key role in this transformation. Together, they created and implemented service-line strategies to combine global scale with local relevance—often achieving both through radical simplification. Examples include the following:

Plan to report. Financial reporting at Unilever has been streamlined and centralized. As a result, the company has gone from worst- to best-in-class in time to market. In 2015, it was the first FTSE 100 company to report its annual results (that is, results covering the 2014 calendar year), saving top management weeks in extra time.

Communications to change. Unilever had maintained more than 400 intranets, one for almost every country, product group, brand, and function. Communications were not aligned, and employees often felt unsure where to search for the right information. Maintaining those sites also proved expensive. ETS instituted a single global intranet accessible in more than 20 languages. A common setup—a one-stop shop in English and local languages alike—now unites the company. This arrangement has also been replicated for external partners, so that the end-to-end process now includes the operations of Unilever's suppliers and could eventually include customers, as well.

Data to insight. We required internal management reports to be posted on the company's single intranet ("two clicks away") rather than submitted by e-mail. For the first time ever, Unilever now has a single repository for reports. We realized that the company had well over 12,000 of them, though by our calculus a typical subsidiary should need no more than 120. We therefore initiated a program to simplify information—an effort that has already reduced the number of reports by 40 percent, with further reductions to come. Standardized reports are increasingly produced from the center in Bangalore, which over time will transform from a reporting center into an analytics powerhouse. In fact, the program's real value lies not so much in greater efficiency as in clearer management alignment and faster, better decision making.

Market research to consumer insight. Historically, Unilever had outsourced its marketing-mix modeling to specialized agencies. The complexity and expense, however, often limited the exercise to larger categories and countries. The ETS team recommended hiring a number of specialists, including several with advanced degrees, at the Bangalore center, which now provides low-cost, standardized, and high-quality marketing-mix modeling across Unilever. Consumer insights have vastly improved.

Purchase to pay and order to cash. Prior to the ETS initiative, Unilever had managed its requisitions and payment processes differently across its local subsidiaries. Performance suffered, and costs were often too high. After identifying inconsistencies and best practices, our team turned a weakness into a strength. Unilever is also taking the same approach in order to cash. Where the company ran about 200 separate systems more than a decade ago, it now has just four ERP instances, which are managed as one. This standardization has increased the efficiency of delivery and setup, which are global in scale but served locally to keep customers happy.

Hire to retire. Before undertaking the ETS initiative, Unilever had different HR processes in different countries, varied learning curricula, and inconsistent employee data. ETS provided employees with easy-to-use self-serve interfaces on laptops and tablets. We also standardized HR processes where possible, so that reliable personnel data could be accessed throughout the company. As a result, Unilever now draws upon high-quality analytics and manages its talent to far better effect.

Strategy to portfolio. Like many multinational companies, Unilever had managed its acquisitions on a case-by-case basis, and the integration of newly acquired businesses could be lengthy and uneven. ETS adopted a now-standard company protocol, so that acquisitions are integrated quickly and well, even for complex multibillion-dollar businesses, such as Sara Lee Personal Care and European Laundry and Alberto Culver.

## The way forward

The ETS initiative is an experiment in action, but its twin central themes—enforcing radical simplification and combining global scale with local relevance—are already proving themselves. Slowly but perceptibly, Unilever is reclaiming its founding simplicity. Still, simplification isn't easy. Every process and service line has its own characteristics; what's good for one can be catastrophic for another. Integrating business operations is also about more than just following the process manual; the softer aspects of large-scale transformation are at least as significant. And there are other important lessons about global business services, as well.

Technology isn't a cure-all. Although absolutely critical to a successful GBS program, technology is only a means to global effectiveness, not an end in itself. Launching GBS is a business decision, and business decision makers, not IT, should lead the execution. Nor should functions surrender their influence. Their core responsibilities remain the same—but in a new construct, which shifts day-to-day operational management to a truly integrated, end-to-end process under uniform global leadership. Functional bias must end, and technical expertise must support business objectives.

Banish "back office" from the corporate vocabulary. The support operations of a multinational company should never be considered back-office activities. In many businesses, a significant portion of all administrative employees typically support front-office functions, such as sales and marketing. Overstaffing at the administrative level is often a symptom of deeper complexities. It also holds the potential for radical simplification and significantly lower costs. But cost cutting, however welcome, is merely a byproduct; GBS is not primarily about reducing expenses. The point, instead, is to simplify a company and better serve its customers. Implementing GBS should therefore be a strategic, front-and-center effort, not a tactical, behind-the-scenes one.

A top-management imperative. Unilever is one global company that's rising to meet the challenge; many others have also succeeded in making GBS a priority. In companies such as Alcoa, Novartis, and UPS, GBS has become a C-suite responsibility. The experience of these companies suggests that any drive toward integration must be supported in full by a company's senior leaders.

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GBS requires a strong operational framework and an appropriate governance structure. The service organization must be populated with top talent, and a stint in operations should become a "must" for functional leaders. Finally, the need for effective communications and change-management policies cannot be underestimated. Shifting the behavior of employees, driving the adoption of changes, and dealing with internal politics are typical challenges on the road toward integrated business operations. Meeting these challenges demands careful planning, as well as clear accountability for turning plans into action. ○

*The author wishes to thank McKinsey's Michael Bloch and Jonathan Silver for their insights on global business services and contributions to this article.*

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Illustration by Scott Bakal

# Delighting in the possible

**Zafer Achi and Jennifer Garvey Berger**

**In an unpredictable world, executives should stretch beyond managing the probable.**

**It's only natural** to seek certainty, especially in the face of the unknown. Long ago, shamans performed intricate dances to summon rain. It didn't matter that any success they enjoyed was random, as long as the tribe felt that its water supply was in capable hands. Nowadays, late nights of number crunching, feasts of modeling, and the familiar rituals of presentations have replaced the rain dances of old. But often, the odds of generating reliable insights are not much better.

Perhaps that's because our approach to the hardest problems—and the anxiety those problems create—is fundamentally misdirected. When most of us face a challenge, we typically fall back on our standard operating procedures. Call this "managing the probable." In much of our education, and in many of our formative experiences, we've learned that some simple problems have one right answer. For more complicated problems, accepted algorithms can help us work out the best answer from among available options. We respond to uncertainty with analysis or leave that analysis to the experienced hands of others. We look for leaders who know the way forward and offer some assurance of predictability.

This way of approaching situations involves a whole suite of routines grounded in a mind-set of clarity if not outright certainty. To that end, they are characterized by sharp-edged questions intended to narrow our focus: What is the expected return on this investment? What is the three-year plan for this venture? At what cost are they willing to settle? But asking these kinds of questions, very often legitimate in business-as-usual settings, may constrain management teams in atypical, complex situations, such as responding to a quickly changing market or revitalizing a privatized utility's culture. Our tendency to place one perspective above all others—the proverbial "fact-based view" or "maximizing key stakeholders' alignment"—can be dangerous. All too often, we operate with an excessively simple model in enormously messy circumstances. We fail to perceive how different pieces of reality interact and how to foster better outcomes.

Moving from "managing the probable" to "leading the possible" requires us to address challenges in a fundamentally different way. Rather than simply disaggregating complexities into pieces we find more tractable, we should also broaden our range of interventions by breaking out of familiar patterns and using a whole new approach that allows us to expand our options, experiment in low-risk ways, and realize potentially outsized payoffs. But be warned: leading the possible involves coping with our own anxieties about an unknowable and uncontrollable world. A few simple habits of mind presented here can prod us toward thinking and acting differently. These should not be considered a checklist of to-dos; indeed, the very point is to move beyond a check-the-box mentality.

## Unexpected possibilities

We relish stories of unexpected possibilities—little bets that created huge and unforeseen benefits. Twitter, for instance, was born when its creators noticed how alive and engaged they felt when communicating with each other in real time over SMS. The concept was brilliant, and the platform has reshaped the way the world communicates. But the initiative arose from brainstorming rather than an elaborate business plan. Tweeting caught on, in large part, because it grants its users freedom. In fact, Twitter cofounder Evan Williams has explained that, in general, his rule is to do less. We can't foresee how uncertain conditions will unfold or how complex systems will evolve, but we can conduct thoughtful experiments to explore the possibilities.

That's what happened at the birth of Emirates Airline. We've grown accustomed to thinking of Dubai as a major transit hub, but its development was hardly inevitable. During the mid-1980s, Gulf Air, the area's regional flag carrier at the time, began to cut back its services to the city. Faced with the possibility of hundreds of stranded passengers in the short term, and the threat of long-term decline, the government tried something new. With a small infusion of cash

**A new approach to addressing complex challenges requires breaking out of familiar patterns.**


Source: Zafer Achi and Jennifer Garvey Berger (by airline standards), it leased two planes with crews from another airline and converted a couple of jets from the royal fleet for commercial use. In time, the fledgling Emirates Airline flew high. Traffic through Dubai International Airport seeded a local tourism industry and, on the cargo side, a logistics platform. This in turn attracted ever more traffic in what became a fantastically virtuous cycle. Not even the most optimistic of the airline's founders could have reasonably imagined that Emirates Airline would be an industry giant—or that Dubai would become the world's busiest international-passenger airport.

The leaders of these new ventures used unconventional approaches to try new, unexpected moves—with enormous payoffs. But it's not just large innovations that make a difference. When people think in new ways, very small shifts can have unexpected and significant consequences.

## Habits of mind

Uncertainty can't be solved with pat procedures; it takes new habits of mind to lead the possible. In our experience, three such habits stretch the capabilities of leaders and help them not only to lead the possible but also to delight in it.

### Ask different questions

The questions we ask emerge from our typical patterns of thought. We focus on narrowing down a problem so that we can find a solution. But we often fail to notice that in doing so we constrain the solution and make it ordinary. Asking different questions helps slow down the process. We begin to take in the full range of data available to us and in consequence have a significantly wider set of possible options. Examples of such questions include the following:

- What do I expect *not* to find? How could I attune to the unexpected?
- What might I be discounting or explaining away a little too quickly?
- What would happen if I shifted one of my core assumptions on an issue, just as an experiment?

> The senior team, tired of running in circles searching for untapped financing streams or arguing over which core services to cut, intentionally explored a new idea. Asking a different question opened up dynamic possibilities.

The two of us have seen this approach applied successfully to real-life situations. For example, a government agency struggling with ever-shrinking resources and ever-increasing demands had asked two questions for years: “How will we get enough money to meet the demands?” and “Which services can we cut to stay within our budget?” The senior team, tired of running in circles searching for untapped financing streams or arguing over which core services to cut, intentionally explored a new idea: “How can we share our workload with others so that our current financing becomes sufficient without cutting back on services?” This new question significantly widened the available possibilities, and the organization set out to conduct a long series of small-scale experiments with businesses, other government departments, and community members to keep the same level of service for far less money. Asking a different question opened up dynamic possibilities.

### Take multiple perspectives

No one can predict when or where the next vital idea will emerge, but we can support an expansive view of our present conditions. We can start by pushing back on our natural inclination to believe that the data we see are all the data we need and by distrusting our natural craving for alignment. Considering multiple perspectives opens up our field of vision. Diversity might create more disagreement and short-term conflict, but in an uncertain environment, a more expansive set of solutions is desirable.

We can try these approaches:

- Take the perspective of someone who frustrates or irritates us. What might that person have to teach us?

- Seek out the opinions of people beyond our comfort zone. The perspectives of, among others, younger people, more junior staff, and dissatisfied customers can be insightful and surprising.

- Listen to what other people have to say. We should not try to convince them to change their conclusions; we should listen to learn. If we can understand their perspectives well enough, we might even find that our own conclusions change.

New perspectives often arise from unexpected sources. At a large consumer-goods organization that prided itself on its customer-centric approach, the leadership team rightly asserted that it understood the perspectives of its diverse customer base and key suppliers. The team was asked whether any group—anywhere at all—“just wasn’t getting it.” Rueful laughter followed; of course there was such a group: a set of consumers written off some time ago and now never considered. Taking a new approach, the leaders probed that group’s perspectives, not to win over these consumers or to sell them something but to learn from them. The leaders discovered the possibility of a whole new product line that slipped easily into the company’s supply chain but hadn’t been on the horizon previously. Taking multiple perspectives radically opened up a new set of possibilities.

## See systems

This approach is about seeing patterns of behavior, and then developing and trying small “safe-to-fail” experiments to nudge the system in a more helpful direction. Leaders are best served when they get a wider, more systemic view of the present. Yet we’ve been trained to follow our natural inclination to examine the component parts. We assume a straightforward and linear connection between cause and effect. Finally, we look for root causes at the center of problems. In doing these things, we often fail to perceive the broader forces at work. The more we can hold on to the special features of systems, the more we can create experiments in unexpected places to open up new possibilities.

To best understand systems, it's helpful to resist the urge to disaggregate problems and to solve them right away. Here are some alternatives:

- We can hold opposing ideas without reconciling them. If it looks as though we're confronting an either/or choice, we can reconsider our narrow framing and wonder what we're missing.

- We shouldn't waste time arguing about the best solution; instead, we can pick several good but different solutions and experiment with them all in a small way.

- We can give up the hunt for the root cause and instead look to the edges of an issue for our experiments. The system's center is most resistant to change, but tinkering at the periphery can deliver outsized returns.

Elements in a system can be connected in ways that are not immediately apparent. For example, call-center employee turnover is notoriously high across industries—an expensive drain on this particular system. Many managers have tried to develop better hiring practices to eliminate some of the turnover before it begins; others beef up their HR departments to deal with the inevitable churn.

One executive, looking at the edges of the issue in his district, noticed that many skilled people outside the workforce care for their children or sick parents. He experimented with ways to bring these

people into his call center in a flexible way: working from home, setting their own shift lengths and hours (a revolutionary idea in call centers), and managing their own performance targets. Over time, he nudged the model so that it became enormously successful. After 12 months of the new system, when the call-center staff had been ramped up to more than 200 employees, upward of 90 percent of them felt engaged with their work—a remarkable achievement in the traditionally transient and disengaged world of call centers—and turnover fell to under 10 percent a year. Looking at the whole system and experimenting with (and learning from) different approaches helped the executive to solve a number of related problems: turnover, customer satisfaction, local unemployment, and even rates of depression among people who provide care for family members.

## Leadership implications

Of course, such shifts of mind have implications, and opening ourselves up to the delights of the possible comes at a cost. One casualty may be our cherished image of the traditional leader. The default model of a clear-minded person, certain of his or her outlook and ideas, is not consistent with the qualities that allow possibilities to flourish. In a complex world, we're often better served by leaders with humility, a keen sense of their own limitations, an insatiable curiosity, and an orientation to learning and development.

Understanding this can have significant implications. For example, a group of private-equity leaders began to chart different leadership styles required at their various portfolio companies. Eventually, they realized that CEO searches were too often based on a one-size-fits-all model. Even as they fought their anxiety about breaking the standard mold, they came to understand that fluid circumstances require flexibility. Their awareness of the very different requirements of leadership in unpredictable settings helped them select—and develop—the leaders they really needed.

Transformative change is certain to happen, often in unforeseen ways and not necessarily led from the front. Unintended repercussions often stymie our best-laid plans. The world is neither simple nor static. It is patterned but not predictable. In the face of new challenges, we all default to how we think we should act and to what seems to have worked before. Managing the probable is reassuring but leaves us more open to being blindsided. Some problems do not lend themselves to rote methods, simple models, or sophisticated algorithms. When we treat them as different, complex, and uncertain, we can unlock solutions of immense creativity and power. And by exercising three simple habits of mind, we can begin to delight in the possible.

*The authors would like to thank McKinsey's Claudio Feser and Keith Johnston, a partner at Cultivating Leadership, for their contributions to this article.*

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Illustration by Patric Sandri

# The real business of business

**Marc Goedhart, Tim Koller, and David Wessels**

Shareholder-oriented capitalism is still the best path to broad economic prosperity, as long as companies focus on the long term.

**The guiding principle of business** value creation is a refreshingly simple construct: companies that grow and earn a return on capital that exceeds their cost of capital create value. The financial crisis of 2007–08 and the Great Recession that followed are only the most recent reminders that when managers, boards of directors, and investors forget this guiding principle, the consequences are disastrous—so much so, in fact, that some economists now call into question the very foundations of shareholder-oriented capitalism. Confidence in business has tumbled.[1] Politicians and commentators are pushing for more regulation and fundamental changes in corporate governance. Academics and even some business leaders have called for companies to change their focus from increasing shareholder value to a broader focus on all stakeholders, including customers, employees, suppliers, and local communities.

No question, the complexity of managing the interests of myriad owners and stakeholders in a modern corporation demands that any reform discussion begin with a large dose of humility and tolerance for ambiguity in defining the purpose of business. But we believe the current debate has muddied a fundamental truth: creating shareholder value is not the same as maximizing short-term profits—and

[1] An annual Gallup poll in the United States showed that the percent of respondents with little or no confidence in big business increased from 27 percent in the 1983–86 period to 38 percent in the 2011–14 period. For more, see “Confidence in institutions,” gallup.com.

companies that confuse the two often put both shareholder value and stakeholder interests at risk. Indeed, a system focused on creating shareholder value from business isn't the problem; short-termism is. Great managers don't skimp on safety, don't make value-destroying investments just because their peers are doing it, and don't use accounting or financial gimmicks to boost short-term profits, because ultimately such moves undermine intrinsic value.

What's needed at this time of reflection on the virtues and vices of capitalism is a clearer definition of shareholder value creation that can guide managers and board directors, rather than blurring their focus with a vague stakeholder agenda. We do believe that companies are better able to deliver long-term value to shareholders when they consider stakeholder concerns; the key is for managers to examine those concerns systematically for opportunities to do both.

## What does it mean to create shareholder value?

If investors knew as much about a company as its managers, maximizing its current share price might be equivalent to maximizing value over time. In the real world, investors have only a company's published financial results and their own assessment of the quality and integrity of its management team. For large companies, it's difficult even for insiders to know how the financial results are generated. Investors in most companies don't know what's really going on inside a company or what decisions managers are making. They can't know, for example, whether the company is improving its margins by finding more efficient ways to work or by simply skimping on product development, maintenance, or marketing.

Since investors don't have complete information, it's not difficult for companies to pump up their share price in the short term. For example, from 1997 to 2003, a global consumer-products company consistently generated annual growth in earnings per share (EPS) between 11 and 16 percent. Managers attributed the company's success to improved efficiency. Impressed, investors pushed the company's share price above that of its peers—unaware that the company was shortchanging its investment in product development and brand building to inflate short-term profits, even as revenue growth declined.

In 2003, managers were compelled to admit what they'd done. Not surprisingly, the company went through a painful period of rebuilding, and its stock price took years to recover.

In contrast, the evidence makes it clear that companies with a long strategic horizon create more value. The banks that had the insight and courage to forgo short-term profits during the real-estate bubble earned much better returns for shareholders over the longer term.[2] Oil and gas companies known for investing in safety outperform those that haven't. We've found, empirically, that long-term revenue growth—particularly organic revenue growth—is the most important driver of shareholder returns for companies with high returns on capital (though not for companies with low returns on capital).[3] We've also found a strong positive correlation between long-term shareholder returns and investments in R&D—evidence of a commitment to creating value in the longer term.[4]

The weight of such evidence and our experience supports a clear definition of what it means to create shareholder value, which is to create value for the collective of all shareholders, *present and future*. This means managers should not take actions to increase today's share price if they will reduce it down the road. It's the task of management and the board to have the courage to make long-term value-creating decisions despite the short-term consequences.

## Can stakeholder interests be reconciled?

Much recent criticism of shareholder-oriented capitalism has called on companies to focus on a broader set of stakeholders, not just shareholders. It's a view that has long been influential in continental Europe, where it is frequently embedded in the governance structures

[2] Bin Jiang and Tim Koller, "How to choose between growth and ROIC," *McKinsey on Finance*, September 2007, mckinsey.com.

[3] Jiang and Koller, "How to choose between growth and ROIC."

[4] Tim Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010.

of the corporate form of organization. And we agree that for most companies anywhere in the world, pursuing the creation of long-term shareholder value requires satisfying other stakeholders as well.

We would go even further. We believe that companies dedicated to value creation are healthier and more robust—and that investing for sustainable growth also builds stronger economies, higher living standards, and more opportunities for individuals. Our research shows, for example, that many corporate-social-responsibility initiatives also create shareholder value, and managers should seek out such opportunities.[5] For example, IBM's free web-based resources on business management not only help to build small and midsize enterprises but also improve IBM's reputation and relationships in new markets and develop relationships with potential customers. In another case, Novo Nordisk's "Triple Bottom Line" philosophy of social responsibility, environmental soundness, and economic viability has led to programs to improve diabetes care in China. According to the company, its programs have burnished its brand, added to its market share, and increased sales—at the same time as improving physician education and patient outcomes. Similarly, Best Buy's efforts to reduce attrition among women employees not only lowered turnover among women by more than 5 percent, it also helped them create their own support networks and build leadership skills.

But what should be done when the interests of stakeholders don't naturally complement those of a company, for instance, when it comes to questions of employee compensation and benefits, supplier management, and local community relationships? Most advocates of managing for stakeholders appear to argue that companies can maximize value for all stakeholders and shareholders simultaneously—without making trade-offs among them. This includes, for example, Cornell Law School professor Lynn Stout's book, *The Shareholder Value Myth*,[6] in which Stout argues persuasively that nothing in US corporate law requires companies to focus on shareholder value creation. But her argument that putting shareholders first harms nearly everyone is really an argument against short-termism, not a

[5] Sheila Bonini, Tim Koller, and Philip H. Mirvis, "Valuing social responsibility programs," *McKinsey Quarterly*, July 2009, mckinsey.com.

[6] Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*, first edition, Oakland, CA: Berrett-Koehler Publishers, 2012.

prescription for how to make trade-offs. Similarly, R. Edward Freeman, a professor at the University of Virginia's Darden School of Business, has written at length proposing a stakeholder value orientation. In his recent book, *Managing for Stakeholders*, he and his coauthors assert that "there is really no inherent conflict between the interests of financiers and other stakeholders."[7] John Mackey, founder and co-CEO of Whole Foods, recently wrote *Conscious Capitalism*,[8] in which he, too, asserts that there are no trade-offs to be made.

Such criticism is naive. Strategic decisions often require myriad trade-offs among the interests of different groups that are often at odds with one another. And in the absence of other principled guidelines for such decisions, when there are trade-offs to be made, prioritizing long-term value creation is best for the allocation of resources and the health of the economy.

Consider employee stakeholders. A company that tries to boost profits by providing a shabby work environment relative to competitors, underpaying employees, or skimping on benefits will have trouble attracting and retaining high-quality employees. Lower-quality employees can mean lower-quality products, reducing demand and hurting reputation. More injury and illness can invite regulatory scrutiny and more union pressure. More turnover will inevitably increase training costs. With today's more mobile and more educated workforce, such a company would struggle in the long term against competitors offering more attractive environments. If the company earns more than its cost of capital, it might afford to pay above-market wages and still prosper—and treating employees well can be good business. But how well is well enough? A stakeholder focus doesn't provide an answer. A shareholder focus does. Pay wages that are just enough to attract quality employees and keep them happy and productive, pairing those with a range of nonmonetary benefits and rewards.

Or consider how high a price a company should charge for its products. A shareholder focus would weigh price, volume, and customer satisfaction to determine a price that creates the most shareholder

[7] R. Edward Freeman, Jeffrey S. Harrison, and Andrew C. Wicks, *Managing for Stakeholders: Survival, Reputation, and Success*, first edition, New Haven, CT: Yale University Press, 2007.

[8] John Mackey and Rajendra Sisodia, *Conscious Capitalism: Liberating the Heroic Spirit of Business*, first edition, Boston, MA: Harvard Business School Publishing, 2013.

value. However, that price would also have to entice consumers to buy the products—and not just once but multiple times, for different generations of products. A company might still thrive if it charged lower prices, but there's no way to determine whether the value of a lower price is greater for consumers than the value of a higher price to its shareholders. Finally, consider whether companies in mature, competitive industries should keep open high-cost plants that lose money just to keep employees working and prevent suppliers from going bankrupt. To do so in a globalizing industry would distort the allocation of resources in the economy.

These can be agonizing decisions for managers and are difficult all around. But consumers benefit when goods are produced at the lowest possible cost, and the economy benefits when unproductive plants are closed and employees move to new jobs with more competitive companies. And while it's true that employees often can't just pick up and relocate, it's also true that value-creating companies create more jobs. When examining employment, we found that the European and US companies that created the most shareholder value in the past 15 years have shown stronger employment growth.[9]

## Short-termism runs deep

What's most relevant about Stout's argument, and that of others, is its implicit criticism of short-termism—and that is a fair critique of today's capitalism. Despite overwhelming evidence linking intrinsic investor preferences to long-term value creation,[10] too many managers continue to plan and execute strategy, and then report their performance against shorter-term measures, EPS in particular.

As a result of their focus on short-term EPS, major companies often pass up value-creating opportunities. In a survey of 400 CFOs, two Duke University professors found that fully 80 percent of the CFOs said they would reduce discretionary spending on potentially value-creating activities such as marketing and R&D in order to meet their short-term earnings targets.[11] In addition, 39 percent

[9] Koller, Goedhart, and Wessels, *Valuation*, fifth edition.

[10] Robert N. Palter, Werner Rehm, and Jonathan Shih, "Communicating with the right investors," *McKinsey Quarterly*, April 2008, mckinsey.com.

[11] John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, "Value destruction and financial reporting decisions," *Financial Analysts Journal*, 2006, Volume 62, Number 6, pp. 27–39.

said they would give discounts to customers to make purchases this quarter, rather than next, in order to hit quarterly EPS targets. Such biases shortchange all stakeholders.

As an illustration of how executives get caught up in a short-term EPS focus, consider our experience with companies analyzing a prospective acquisition. The most frequent question managers ask is whether the transaction will dilute EPS over the first year or two. Given the popularity of EPS as a yardstick for company decisions, you might think that a predicted improvement in EPS would be an important indication of an acquisition's potential to create value. However, there is no empirical evidence linking increased EPS with the value created by a transaction.[12] Deals that strengthen EPS and deals that dilute EPS are equally likely to create or destroy value.

If such fallacies have no impact on value, why do they prevail? The impetus for short-termism varies. Some executives argue that investors won't let them focus on the long term; others fault the rise of shareholder activists in particular. Yet our research shows that even if short-term investors cause day-to-day fluctuations in a company's share price and dominate quarterly earnings calls, longer-term investors are the ones who align market prices with intrinsic value.[13] Moreover, the evidence shows that, on average, activist investors strengthen the long-term health of the companies they pursue, often challenging existing compensation structures, for example, that encourage short-termism.[14] Instead, we often find that executives themselves or their boards are usually the source of short-termism. A 2013 survey of more than 1,000 executives and board members found, for example, that most cited their own executive teams and boards (rather than investors, analysts, and others outside the company) as the greatest sources of pressure for short-term performance.[15]

[12] Richard Dobbs, Billy Nand, and Werner Rehm, "Merger valuation: Time to jettison EPS," *McKinsey Quarterly*, March 2005, mckinsey.com.

[13] Palter, Rehm, and Shih, "Communicating with the right investors."

[14] Joseph Cyriac, Ruth De Backer, and Justin Sanders, "Preparing for bigger, bolder shareholder activists," *McKinsey on Finance*, March 2014, mckinsey.com.

[15] Commissioned by the Canada Pension Plan Investment Board and McKinsey & Company, the online survey, "Looking toward the long term," ran from April 30 to May 10, 2013, and garnered responses from 1,038 executives representing the full range of industries and company sizes globally. Of these respondents, 722 identified themselves as C-level executives and answered questions in the context of that role, and 316 identified themselves as board directors and answered accordingly. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP. For more, see fclt.org.

The results can defy logic. We recently participated in a discussion with a company pursuing a major acquisition about whether the deal's likely earnings dilution was important. One of the company's bankers opined that he knew any impact on EPS would be irrelevant to value, but he used it as a simple way to communicate with boards of directors. Elsewhere, we've heard company executives acknowledge that they, too, doubt that the impact on EPS is so important—but they use it anyway, they say, for the benefit of Wall Street analysts. Investors also tell us that a deal's short-term impact on EPS is not that important. Apparently everyone knows that a transaction's short-term impact on EPS doesn't matter, yet they all pay attention to it.

## Shareholder capitalism won't solve all social issues

There are some trade-offs that company managers can't make—and neither a shareholder nor a stakeholder approach to governance can help. This is especially true when it comes to issues that affect people who aren't immediately involved with the company as investors, customers, or suppliers. These so-called externalities—parties affected by a company who did not choose to be so—are often beyond the ken of corporate decision making because there is no objective basis for making trade-offs among parties.

If, for example, climate change is one of the largest social issues facing the world, then one natural place to look for a solution is coal-fired power plants, among the largest man-made sources of carbon emissions. But how are the managers of a coal-mining company to make all the trade-offs needed to begin solving our environmental problems? If a long-term shareholder focus led them to anticipate potential regulatory changes, they should modify their investment strategies accordingly; they may not want to open new mines, for example. But if the company abruptly stopped operating existing ones, not only would its shareholders be wiped out but so would its bondholders (since bonds are often held by pension funds). All of its employees would be out of work, with magnifying effects on the entire local community. Second-order effects would be unpredictable.

Without concerted action among all coal producers, another supplier could step up to meet demand. Even with concerted action, power plants might be unable to produce electricity, idling their workers and causing electricity shortages that undermine the economy. What objective criteria would any individual company use to weigh the economic and environmental trade-offs of such decisions—whether they're privileging shareholders or stakeholders?

In some cases, individual companies won't be able to satisfy all stakeholders. For any individual company, the complexity of addressing universal social issues such as climate change leaves us with an unresolved question: If not them, then who? Some might argue that it would be better for the government to develop incentives, regulations, and taxes, for example, to encourage a migration away from polluting sources of energy. Others may espouse a free-market approach, allowing creative destruction to replace aging technologies and systems with cleaner, more efficient sources of power.

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Shareholder capitalism has taken its lumps in recent years, no question. And given the complexity of the issues, it's unlikely that either the shareholder or stakeholder model of governance can be analytically proved superior. Yet we see in our work that the shareholder model, thoughtfully embraced as a collective approach to present and future value creation, is the best at bridging the broad and varied interests of shareholders and stakeholders alike.

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# Changing the nature of **board engagement**

*Five tips for directors and CEOs striving to make the most of their limited time.*

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**Rodney Zemmel** is a director in the New York office.

"Ask me for anything," Napoleon Bonaparte once remarked, "but time."[1] Board members today also don't have that luxury. Directors remain under pressure from activist investors and other constituents, regulation is becoming more demanding, and businesses are growing more complex. McKinsey research suggests that the most effective directors are meeting these challenges by spending twice as many days a year on board activities as other directors do.[2]

As directors and management teams adapt, they're bumping into limits—both on the amount of time directors can be asked to spend before the role is no longer attractive and on the scope of the activities they can undertake before creating organizational noise or concerns among top executives about micromanagement. We recently discussed some of these tensions with board members and executives at Prium, a New York–based forum for CEOs.[3] The ideas that emerged, while far from definitive, provide constructive lessons for boardrooms. If there's one overriding theme, it's that boosting effectiveness isn't just about spending more time; it's also about changing the nature of the engagement between directors and the executive teams they work with.

Engaging between meetings. Maggie Wilderotter, chairman and CEO of Frontier Communications (and a member of the boards of P&G and Xerox) stresses that "it's not just about the meetings. It's about being able to touch base in between meetings and staying current." Such impromptu discussions strengthen a board's hand on the company's pulse. Keeping board members informed also minimizes the background time that slows up regular board meetings. And the communication works both ways. "I also want board members to elevate issues that they're seeing on the horizon that we should be thinking about," explains Wilderotter. "To me, it's really more of a two-way street." Directors and executive teams will need to work out what rhythm and frequency are right for them. Denise Ramos, president and CEO of ITT, notes that “conversations with board members every week or every two weeks may be too much.” For boards seeking to boost their level of engagement between meetings, experimentation and course correction when things get out of balance are likely to be necessary.

Engaging with strategy as it’s forming. Strategy, especially corporate strategy, is an area where the diverse experiences and pattern-recognition skills of experienced directors enable them to add significant value. But that’s only possible if they’re participating early in the formation of strategy and stress-testing it along the way, as opposed to reviewing a strategy that’s fully baked by executives.[4] In the description of Wilderotter, strategy needs to become “a collaborative process where different opinions can be put on the table” and “different options can be reviewed and discarded.” This shifts the board’s attitude from reactive to proactive and can infuse a degree of radicalism into the boardroom. Effective directors don’t shy away from bold strategic questions, such as “what businesses should this company own?” and “what businesses should this company not own?” We were impressed by one board that even dared ask, “should this company continue to exist?” In fact, that board concluded that the company should *not* continue to exist, and effected a highly successful reorganization separating the firm into several freestanding enterprises.

Engaging on talent. Directors have long assumed responsibility for selecting and replacing CEOs, both in the normal course of business and in “hit by a bus” scenarios. Many also find it useful to track succession and promotion—for example, by holding annual reviews of a company’s top 30 to 50 key executives. But to raise the bar, some boards are moving from simply observing talent to actively cultivating it. Case in point: directors who tap their networks to source new hires. Donald Gogel, the chairman and CEO of Clayton, Dubilier & Rice, explains that “our board members can operate like a highly effective search firm. There’s nothing like recruiting an executive who worked for you for a long time, particularly in some functional areas where you know that he or she is both capable and a great fit.” Other boards actively mentor high-performing executives, which allows those executives to draw upon the directors’ experience and enables the board to evaluate in-house successors more fully.

Engaging the field. Another way to enhance board engagement is to assign directors specific operational areas to engage on. Board members can assume roles in specific company initiatives, such as cybersecurity, clean technologies, or risk—becoming not only "the board's eyes and ears," notes Eduardo Mestre, senior advisor for Evercore Partners and a board director of Comcast and Avis Budget, "but really being a very active participant in the process." Jack Krol, chairman of Delphi Automotive and former chairman and CEO of DuPont, requires board members to visit at least one business site every 12 months. At the same time, directors should be mindful

**Steps toward changing the nature of board engagement**

**Connect between meetings**—Touch base in between formal board meetings to stay current

**Help form strategy**—Don't just review a strategy that executives have already fully baked

**Cultivate talent**—Consider recruiting executives and mentoring high performers

**Engage the field**—Target specific projects and act on a collaborative basis

**Ask tough questions**—Understand how the company and its divisions create and destroy value not to interfere with operational teams or to supplant managers. The goal is to target specific projects that are particularly appropriate for individual directors and to encourage participating board members to be, as one director says, “collaborative, not intrusive.”

Engaging on the tough questions. We noted above the value of probing difficult strategic issues, but the importance of asking uncomfortable questions extends beyond strategy sessions, to a wide range of issues. “You should have some directors—perhaps 20 percent of the board—who know the industry and can challenge any operating executive in that company on industry content,” says Dennis Carey, a Korn Ferry vice chairman who has served on several boards. “But the problem is not too few people on boards who know their industries. The problem is too *many* people who know the industries, who are looking in the rearview mirror and assuming that what made money over the past 20 years will make money again.” Michael Campbell, a former chairman, CEO, and president of Arch Chemicals, builds on this theme by adding that “every board member does not necessarily need to have industry experience. But they must have the courage in the boardroom to ask difficult questions.”

Our McKinsey colleagues have noted in past articles that understanding how a company creates (and destroys) value makes it much easier to identify critical issues promptly.[5] In fact, it is worth asking whether everyone in the boardroom does indeed understand how the company and each of its divisions make money. Gogel even suggests that “boards should have at least one person who has the responsibility to think like an activist investor. Many boards are caught unaware because no director is playing that role.”

As boards raise and grapple with uncomfortable questions, it’s important to connect the dots between issues—perhaps by tasking one director with serving in an “integrator” role. “We get into a boardroom,” Wilderotter remarked, “and everybody’s a peer. But having a specific capacity to bring disparate points together is critical to keeping a board functional versus having it be dysfunctional."

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Ultimately, there are no shortcuts to building and maintaining well-attuned board and executive mechanics. Each of the measures requires hard work from the board members—and, sometimes, a CEO with thick skin. But a good director will provide the extra effort, and an effective CEO will make the most of an engaged board's limited time.

[1] See John Strawson, *If by Chance: Military Turning Points that Changed History*, London: Macmillan, 2003.

[2] See Christian Casal and Christian Caspar, "Building a forward-looking board," *McKinsey Quarterly*, February 2014; Chinta Bhagat and Conor Kehoe, "High-performing boards: What's on their agenda?," *McKinsey Quarterly*, April 2014; and "Improving board governance: McKinsey Global Survey results," August 2013, all available on mckinsey.com.

[3] McKinsey is a knowledge partner with Prium.

[4] See Christian Casal and Christian Caspar, "Building a forward-looking board," *McKinsey Quarterly*, February 2014, mckinsey.com.

[5] See Chinta Bhagat, Martin Hirt, and Conor Kehoe, "Tapping the strategic potential of boards," *McKinsey Quarterly*, February 2013, mckinsey.com.

A version of this article, "How the best board directors stay involved," was previously published by *Harvard Business Review*, on hbr.org.

# **CEO succession** starts with developing your leaders

*Focusing on future priorities and debiasing decisions help, too.*

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**Claudio Feser** is a director in the Zürich office.

Two-thirds of US public and private companies still admit that they have no formal CEO succession plan in place, according to a survey conducted by the National Association of Corporate Directors last year.[1] And only one-third of the executives who told headhunter Korn Ferry this year that their companies do have such a program were satisfied with the outcome. These figures are alarming. CEO succession planning is a critical process that many companies either neglect or get wrong. While choosing a CEO is unambiguously the board's responsibility, the incumbent CEO has a critical leadership role to play in preparing and developing candidates—just as any manager worth his or her salt will worry about grooming a successor.

## An ongoing process

Many companies treat the CEO succession as a one-off event triggered by the abrupt departure of the old CEO rather than a structured process. The succession is therefore often reactive, divorced from the wider system of leadership development and talent management. This approach has significant risks: potentially good candidates may not have sufficient time or encouragement to work on areas for improvement, unpolished talent could be overlooked, and companies may gain a damaging reputation for not developing their management ranks.

Ideally, succession planning should be a multiyear *structured* process tied to leadership development. The CEO succession then becomes the result of initiatives that actively develop potential candidates. For instance, the chairman of one Asian company appointed three potential CEOs to the position of co-chief operating officer, rotating them over a two-year period through key leadership roles in sales, operations, and R&D. One of the three subsequently dropped out, leaving two in competition for the top post.

Rotation is a great way to create stretch moments exposing candidates to exceptional learning opportunities. However, rotation is not enough in itself. A leadership-succession process should be a tailored combination of on-the-job stretch assignments along with coaching, mentoring, and other regular leadership-development initiatives. Companies that take this approach draw up a development plan for each candidate and feed it into the annual talent-management review, providing opportunities for supportive and constructive feedback. In effect, the selection of the new chief executive is the final step in a carefully constructed and individually tailored leadership-development plan for CEO candidates.

## Looking to the future

Too often, companies forget to shape their candidate-selection criteria in the light of their future strategic direction or the organizational context. Many focus on selecting a supposedly ideal CEO rather than asking themselves what may be the right CEO profile given their priorities in the years ahead. The succession-planning process should therefore focus on the market and competitive context the new CEO will confront after appointment. One Latin American construction company, for example, began by conducting a strategy review of each business in its portfolio. Only when that had been completed did it create a CEO job profile, using the output of the review to determine who was best suited to deliver the strategy.

Ideally, succession planning should be a multiyear *structured* process tied to leadership development. The CEO succession then becomes the result of initiatives that actively develop potential candidates.

More broadly, three clusters of criteria can help companies evaluate potential candidates: know-how, such as technical knowledge and industry experience; leadership skills, such as the ability to execute strategies, manage change, or inspire others; and personal attributes, such as personality traits and values. These criteria should be tailored to the strategic, industry, and organizational requirements of the business on, say, a five- to eight-year view. Mandates for CEOs change with the times and the teams they work with. The evaluation criteria should change, as well. For example, the leadership style of a CEO in a media business emphasized a robust approach to cost cutting and firefighting through the economic crisis. His successor faced a significantly different situation requiring very different skills, since profitability was up and a changed economic context demanded a compelling vision for sustained growth. When industries and organizations are in flux and a fresh perspective seems like it could be valuable, it's often important to complement the internal-candidate pipeline with external candidates.

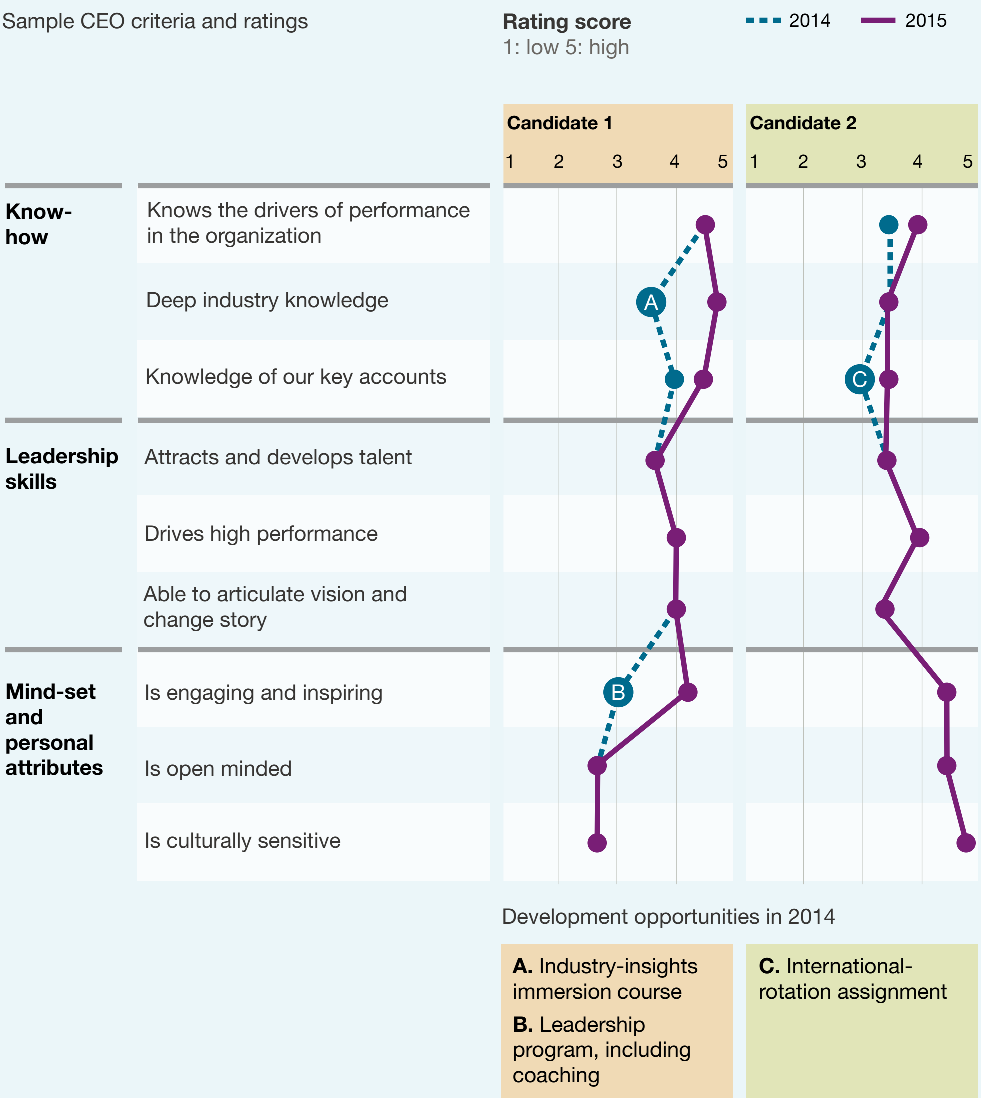
Much as the needs of a business change over time, so do the qualities required of internal candidates as a company's development programs take effect. It's therefore vital to update, compare, and contrast the profiles of candidates against the relevant criteria regularly. This isn't a hard science, of course, but without rigor and tracking it is easy to overlook. For example, the picture painted by the exhibit on the following page might stimulate a rich discussion about the importance to the evolving business of these candidates' natural strengths and weaknesses, as well as the progress they are making to improve them. Other candidates may be evolving different profiles. Regularly reviewing these changes helps companies ensure that the succession process is sufficiently forward looking.

## Debiasing succession

Many biases routinely creep into CEO-succession planning, and their outcome is the appointment of a specific individual. As we well know, decision making is biased. Three biases seem most prevalent in the context of CEO succession. CEOs afflicted by the MOM ("more of me") bias look for or try to develop a copy of themselves. Incumbents under the influence of the sabotage

Exhibit

**CEO candidates will respond to development opportunities.**




Source: McKinsey analysis

bias consciously or unconsciously undermine the process by promoting a candidate who may not be ready for the top job (or is otherwise weak) and therefore seems likely to prolong the current CEO's reign.[2] The herding bias comes into play when the members of the committee in charge of the process consciously or unconsciously adjust their views to those of the incumbent CEO or the chairman of the board.

Contrary to what you might conclude from all this, the lead in developing (though not selecting) the next leader should be taken by the current CEO, not by the board, the remuneration committee, or external experts. The incumbent's powerful understanding of the company's strategy and its implications for the mandate of the successor (what stakeholder expectations to manage, as well as what to deliver, when, and to what standard) creates a unique role for him or her in developing that successor. This approach encourages the CEO to think about the longer term and to "reverse engineer" a plan to create a legacy by acting as a steward for the next generation.

That said, companies must work hard to filter out bias and depersonalize the process by institutionalizing it. A task force (comprising, perhaps, the CEO, the head of HR, and selected board members) should regularly review the criteria for selecting internal candidates, assess or reassess short-listed ones, provide feedback to them, and develop and implement a plan for their development needs. The task force should identify the right evaluation criteria *in advance* rather than fit them to the pool of available candidates and should ensure that its members rate candidates anonymously and independently. The resulting assessment ought to be the sum of these individual assessments. Relatively few companies use such a task force, according to a 2012 Conference Board survey on CEO succession.

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One in three CEO successions fails. A forward-looking, multiyear planning process that involves the incumbent CEO would increase the odds of success.

[1] In 2007 a similar study found 60 percent of large US companies had no meaningful CEO succession plan. See Joseph L. Bower, "Solve the succession crisis by growing inside-outside leaders," *Harvard Business Review*, November 2007, Volume 85, Number 11, pp. 90–6, hbr.org.

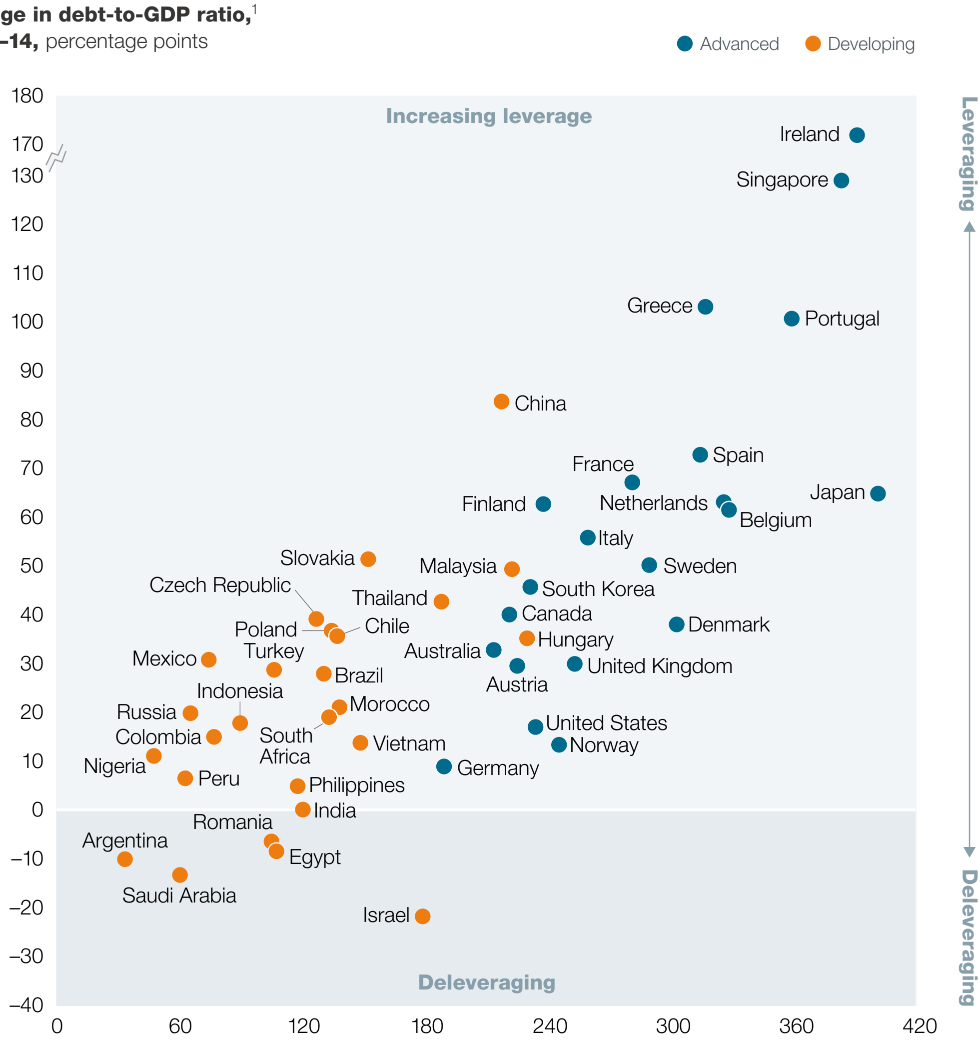
[2] Manfred F. R. Kets de Vries, "The dark side of CEO succession," *Harvard Business Review*, January–February 1988, Volume 66, Number 1, pp. 56–60, hbr.org.

**Extra Point**

# Debt and (not much) deleveraging

Seven years after the bursting of a global credit bubble resulted in the worst financial crisis since the Great Depression, debt continues to grow. In fact, all major economies today have higher levels of borrowing relative to GDP than they did in 2007. In a recent analysis of debt in the real economy (comprising governments, nonfinancial corporations, and households) across 47 countries, the McKinsey Global Institute found that debt-to-GDP ratios have risen in all 21 advanced economies studied and in many of the developing ones as well.

**Change in debt-to-GDP ratio,**[1] **2007–14,** percentage points




**Debt-to-GDP ratio, Q2 2014,**[1] %

[1] Debt owed by households, nonfinancial corporations, and governments; Q2 2014 data for advanced economies and China; Q4 2013 data for other developing countries.

Note: Although any classification is a simplification of the complexities involved, countries here are classified based on multiple criteria—not only per-capita GDP but also the depth and diversity of a country's financial system, among others.

Source: Haver Analytics; national sources; McKinsey Global Institute analysis

See the February 2015 McKinsey Global Institute report, *Debt and (not much) deleveraging*, on mckinsey.com.

**Highlights:**

8 essentials for fostering innovation

A formula for tracking R&D productivity

The globally effective enterprise: One company's push to integrate operations

A checklist for reducing bias in corporate decision making

Digital hives: How online communities can accelerate change

How CEOs can help prepare their own successors

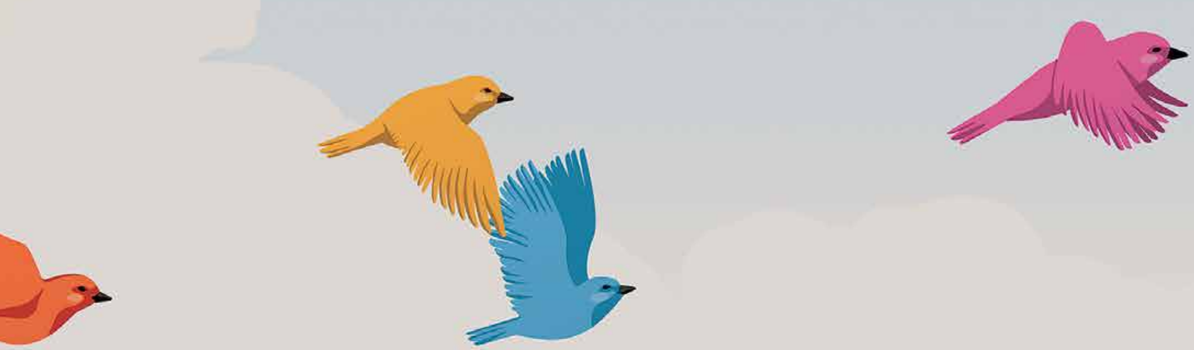
What the airlines can teach bankers

Delighting in the possible: The benefits of open-minded leadership

Moving beyond bureaucracy in HR

Lessons from Japan on hyperaging societies

New research on private equity in India and supply-chain agility



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