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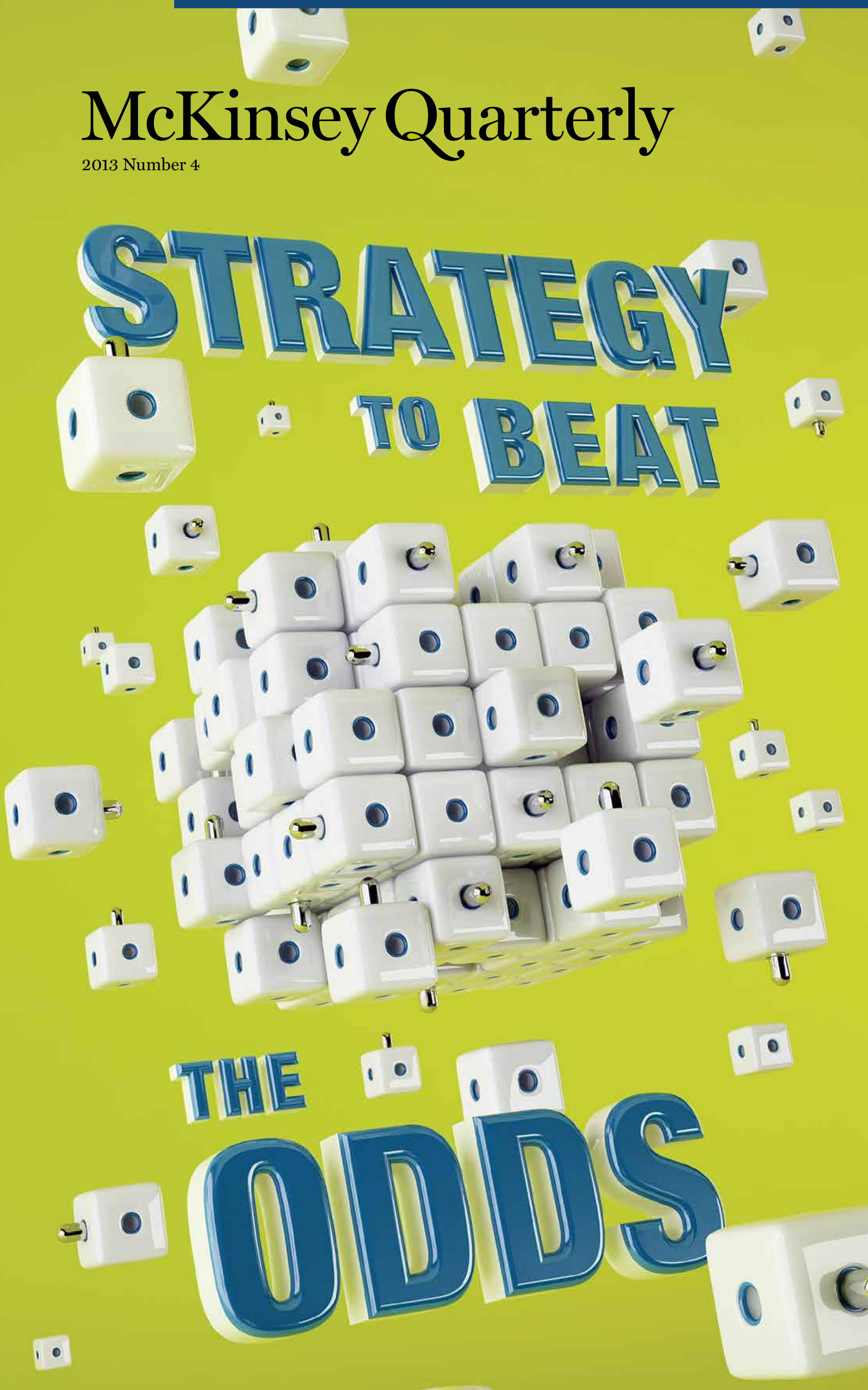
# McKinsey Quarterly

2013 Number 4



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# This Quarter

The essence of strategy is easy to define: it involves making wise choices about where and how to compete, so companies can counteract the competitive forces that inexorably deplete profits. By this definition, perhaps 3 to 5 percent of the world's companies have extraordinarily successful strategies, and a similarly small proportion have colossally poor ones. A great many operate in the dynamic middle ground, neither quite mastering, nor yet being overcome by, the market forces swirling around them.

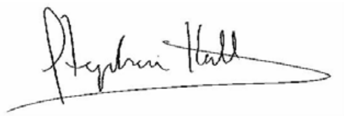
That has always been the case, but this reality is brought into sharp relief by a new analysis detailing the economic profit—what's left after subtracting the cost of a company's capital from its net operating profit—that nearly 3,000 global companies have created or destroyed. We also learned through this research that companies in a favorable industry are three times more likely than others to generate a market-beating economic profit. But a below-average company in a good industry appears no more likely to win than an above-average company in a bad one.

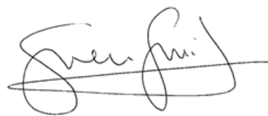
The crucial question, of course, is how to be one of those good companies that create and execute market-beating strategies. Part of the answer, we believe, lies in following a strategy-formulation process that's simultaneously rigorous—unlikely to ignore important issues—yet embraces the sort of ambiguity that allows executives to identify and harness valuable strategic insights. "Mastering the building blocks of strategy" proposes a way to strike the right balance. Another issue to think about in this context is regulatory strategy, a potentially vast source of value as companies work more closely with

governments to influence the ground rules of industries. "Organizing the government-affairs function for impact" explains the principles that leading businesses adopt to get the best out of it.

But strategic insight and more agile organizational structures, on their own, aren't enough to win. Research we unveiled 18 months ago suggested that companies exhibit a remarkable inertia in allocating resources across their business units from year to year. For the most part, they seem incapable of shifting scarce resources to put them in line with their strategies. We have now extended our analysis through the recent economic downturn, demonstrating that resource "activism" yields even greater returns in such periods. We also show that new CEOs who make significant resource moves early in their tenure outperform those who are slower to make changes—and tend to keep their jobs longer. To help leaders revamp their companies, we outline a set of practical adjustments to traditional corporate processes. In addition, we asked two prominent CEOs who have made major strategic shifts to share their stories. Jean-Pierre Clamadieu of global chemical producer Solvay describes its dramatic reorientation toward higher-growth markets. Randall Hogan of US-based Pentair relates how the manufacturing company shifted its business portfolio through acquisitions and divestitures.

Taken together, the ideas presented here for understanding the dynamics of strategic value creation, constructing powerful strategies, and then mobilizing resources to pursue them represent a state-of-the-art tour for senior executives. Every executive team could benefit from exploring how it might deploy these ideas to ensure that its strategy beats the odds.





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Director, Amsterdam office

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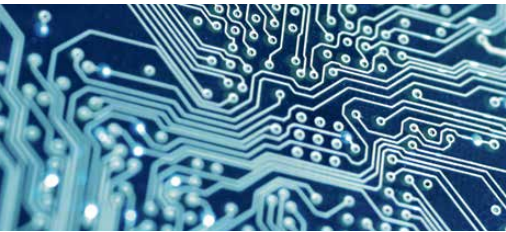

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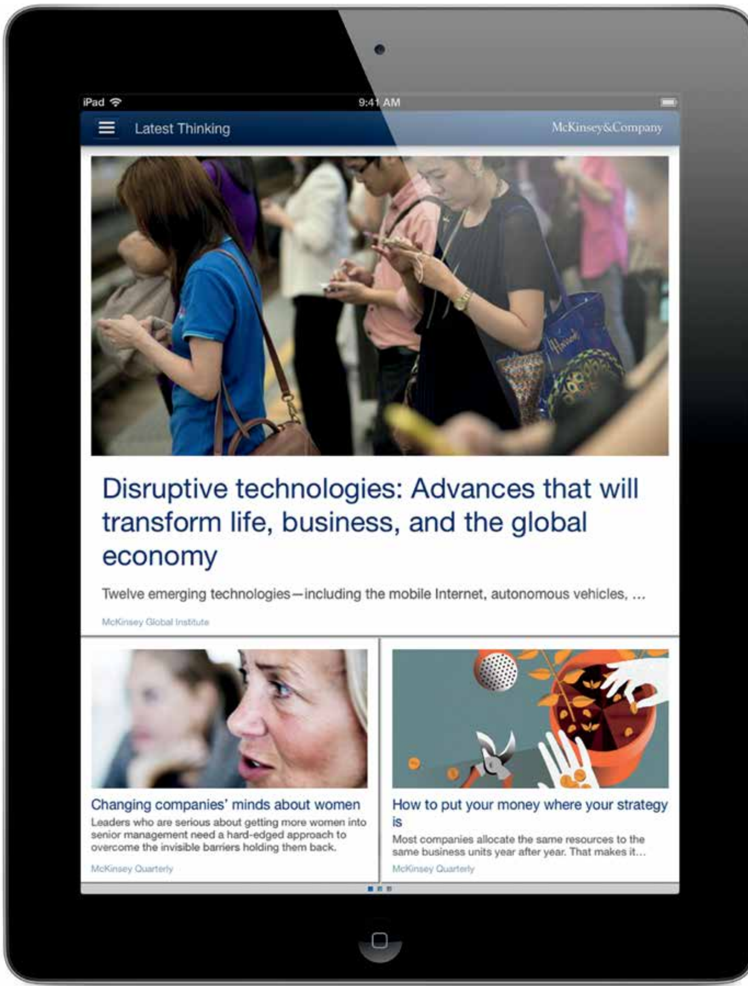


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# Building the social enterprise

**Michael Chui, Martin Dewhurst, and Lindsay Pollak**

By following a few simple principles, leaders can realize the vast potential of social technologies to engage employees and transform organizations.

Why do so few companies capture the full value of social technologies? There's no doubt organizations have begun to realize significant value from largely external uses of social.[1] Yet *internal* applications have barely begun to tap their full potential, even though about two-thirds of social's estimated economic value stems from improved collaboration and communication within enterprises.[2] Although more than 80 percent of executives say their companies deploy social technologies,[3] few have figured out how to use them in ways that could have a large-scale, replicable, and measurable impact at an enterprise level. Just over a quarter of executives say that their companies have significantly incorporated social technologies into the day-to-day work flow by, for example, adapting internal structures, systems, processes, and practices to the greater connectedness they enable. Maximizing the odds of successful integration by coupling them with a robust organizational-change program is generally an afterthought, at best.

Companies are missing a potentially huge prize. The McKinsey Global Institute last year estimated that $900 billion to $1.3 trillion in annual value could

be unlocked in just four sectors by products and services that enable social interactions in the digital realm. That's not easy to do, but a large part of the problem is that many companies, viewing social technologies as yet another tool to be implemented rather than as an enabler of organizational transformation, fail to identify the specific organizational problems social technologies can solve.

These companies find that mind-sets are hard to shift, whether they're trying to persuade employees to use social technologies rather than e-mail or to evolve into an environment where information sharing is standard. Often, leaders think social technologies can be left to IT or marketing, while others are simply intimidated by possible risks. And many are so focused on the technologies themselves that their ability to empower a dynamic, integrated business- and cultural-change program that drives productivity, innovation, and collaboration in core business processes is largely ignored.

So what should be done? We see four principles that should guide the implementation of social technologies.

## Add value, not complexity

Social technologies add the most value when they become central to the organization and complement (or, ideally, substitute for) existing processes. They shouldn't be distracting "extras"—they should be embedded into the day-to-day work flow. Consider the experience of The MITRE Corporation, a not-for-profit organization that provides IT, research-and-development, and systems-engineering expertise to the US government. When the company identified an urgent need for employees to collaborate more easily with colleagues and external partners, it used open-source social-networking software to build and customize its own social platform, called Handshake. The platform is secure, invitation only, and integrated with MITRE's collaboration- and knowledge-management tools, so staff can start using the tool and make it part of their daily work seamlessly.

## Provide essential organizational support

No particular social technology can transform organizations on its own. Companies must define their objective, select a technology, and then consider the additional elements of organizational change required to support it. That might mean everything from role modeling to fostering understanding and conviction, building capabilities, and aligning systems and structures. We call this approach the influence model—it encourages mind-set and behavioral shifts that assist organizational transformation.

When Canadian financial-services company TD Bank Group launched an internal social-media network, using

IBM's Connections platform, for example, individuals were designated as "Connections Geniuses" to spur its adoption. This group helped colleagues learn how to use the platform and evangelized for its ability to improve day-to-day work, thus making the potential impact more relevant to individual users. The support that's required to maximize the odds that social technologies will be implemented successfully should obviously be customized to the needs and culture of individual organizations. But make no mistake—support *is* essential.

## Experiment and learn

Top-down implementation directives don't work for social technologies—and in fact directly contradict their very purpose. Organizations should adopt approaches that emphasize testing and learning; any lack of impact must be viewed not as a failure but as a lesson learned. Developing an atmosphere of experimentation enables organizational learning and keeps alive the possibility that technologies may have unexpected successes.

The mantra "Think big, start small, show impact" guided TD's social-platform launch for its 85,000 employees around the world. A small pilot program launched in 2011 allowed the company to manage technology risks and thoughtfully identify communities for the platform. As examples of success became clear, TD leveraged its Geniuses to help it scale up the effort. This process of testing, learning, and thoughtful growth was instrumental in expanding the platform, which now has thousands of communities, blogs, and wikis that help colleagues find relevant knowledge and skills quickly and easily.

## Track impact and evolve metrics

The head of social media at global shipping company Maersk Line, Jonathan Wichmann, discovered some 14,000 images in its photographic archive during his first week at work.[4] Recognizing an opportunity to share the company's rich history and engage both employees and outsiders, Maersk Line launched a low-cost, experimental social-media campaign. No metrics were attached; at this stage, the company was unsure of what to measure.

After the initiative took off—it's currently delivering more than 170,000 unique social interactions a month and has doubled the number of the company's job applicants—appropriate metrics were developed. What began as an outward-facing effort is now driving performance internally: Maersk Line executives now seek to track social media's impact on everything from persuading recruits that they should join the company to aiding innovation and the gathering of customer insights. This is the best approach to metrics; while it's important to be open minded about social initiatives, and not always possible

to have robust metrics from the start, it's critical to put rigorous ones in place once you find that something clearly adds value.

Employees, customers, external stakeholders, and future talent are all embracing social technologies. While the true impact of building them into the culture, structure, and work flow of organizations remains to be seen, we know that companies adapting to a more open, sharing, and flexible world stand to create tremendous value. They could also be the pioneers of new, more nimble and entrepreneurial operating models that will change business as we know it. In that sense, understanding social media is now a critical element of every executive's tool kit.

[1] Roxane Divol, David Edelman, and Hugo Sarrazin, "Demystifying social media," *McKinsey Quarterly*, 2012 Number 2, mckinsey.com.

[2] See the full McKinsey Global Institute report, *The social economy: Unlocking value and productivity through social technologies*, July 2012, mckinsey.com.

[3] See "Evolution of the networked enterprise: McKinsey Global Survey results," March 2013, mckinsey.com.

[4] For more on Maersk Line's social-media initiative, see Jonathan Wichmann, interview by David Edelman, "Being B2B social: A conversation with Maersk Line's head of social media," May 2013, mckinsey.com.

*The authors wish to acknowledge the contributions of Roxane Divol and James Manyika to the development of this article.*

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# How B2B companies talk past their customers

**Tjark Freundt, Philipp Hillenbrand, and Sascha Lehmann**

New research shows there's a surprising gap between the brand messages that suppliers offer to customers and what their customers really want to know.

Although the digital-marketing revolution's clearest ramifications and earliest impact may have come in the consumer arena, it's also roiling the world of business-to-business (B2B) brand building. Business customers, like consumers, engage with companies through search, online communities, and Web-based video, so these are potentially powerful tools for delivering B2B brand messages and amplifying their impact. Our research suggests a potential stumbling block, though: a marked apparent divergence between the core messages companies communicate about their brands and the characteristics their customers value most.

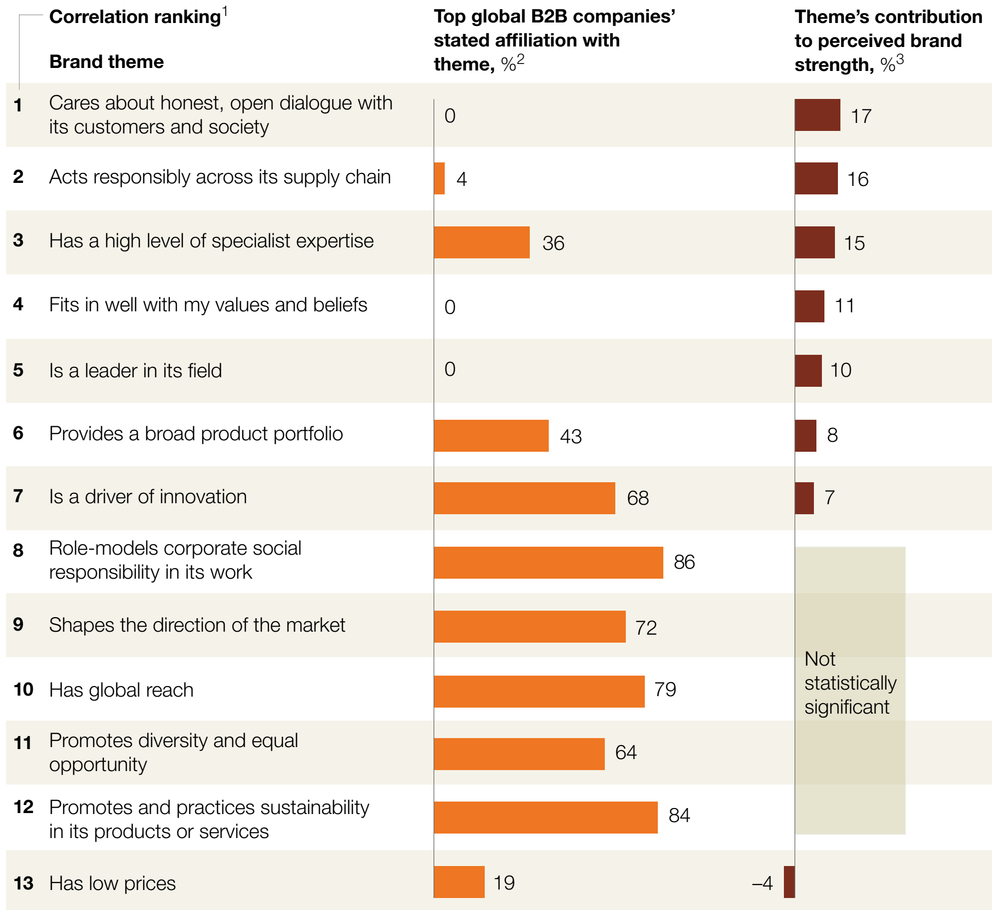
In our research, we examined publicly available documents of Fortune 500 and DAX 30 companies to develop a list of 13 themes and topic areas that companies use to position their brands. These were broad ranging, from the extremely practical (low prices) to the more elevated (corporate social responsibility). We then selected the top 90 global B2B companies by market capitalization across six surveyed sectors.[1] We reviewed the public documents of the companies to verify how many of their brand messages were clearly linked to the 13 themes that emerged from the broader sample (3 of them didn't appear among the 90 companies). Then we assessed the degree to which the companies aligned their brand messages with the remaining 10 themes.

To discover how customers viewed these same themes, we surveyed more than 700 global executives[2] across the six sectors, asking how important each theme was to the way they evaluated the brand strengths of their primary and secondary suppliers. We used multiple regression analysis to determine the extent to which a theme influenced the correlation.

The results were revealing (exhibit). Themes such as social responsibility, sustainability, and global reach, which many B2B companies cast in a leading role for brand imaging, appeared to have a minimal influence on buyers'

Exhibit

**The themes that many B2B companies consider important for brand imaging appear to have minimal influence on buyers' perceptions of brand strength.**




[1]Correlations statistically significant at $p < 0.1$.
[2]Top 90 companies from 6 sectors by 2012 market capitalization.
[3]Coefficient's explanatory power on perceived brand strength expressed as a percentage; analysis based on 704 global executives' ratings of the brand strength of their primary and secondary suppliers; figures do not sum to 100%, because of coefficients that are not statistically significant.

Source: 2012 McKinsey B2B branding survey of 1,408 global executives; McKinsey analysis

perceptions of brand strength. The inverse was true, as well: two of the most important themes for customer perceptions of brand strength—effective supply-chain management and specialist market knowledge—were among those least mentioned by B2B suppliers. Honest and open dialogue, which customers considered most important, was one of the three themes not emphasized at all by the 90 companies in our sample. In addition to these disconnects, our analysis showed a surprising similarity among the brand themes that leading B2B companies emphasized, suggesting a tendency to follow the herd rather than create strongly differentiated brand messages.[3] Here are three questions whose answers may point to opportunities for improvement.

### Are you telling the same story as your competitors?

Given the prevalence of similar messages, this is an important checkpoint for many companies. For example, if both you and your rivals claim that your (and their) products derive from renewable sources, this probably won't move the needle when customers consider your brand. Contrast that with IBM's Smarter Planet branding effort, which tells a story emphasizing the company's special capabilities in the digital economy and guides not just external communications but also product development and other forms of employee engagement.

### Does your sales force say it is facing headwinds?

Even in the digital era, our surveys show that personal interactions with sales reps remain the most influential factor—across touch points—for B2B customers.[4] That makes salespeople a great source of information about the degree to which customers see your products as differentiated or worth a premium. Have an honest dialogue with your sales staff. If you hear about consistent pushback on pricing or an inability to articulate a compelling argument for the value of your products, you've got a problem. It could be your product or service, of course. But it also may involve disconnects between what your customers value and the messages you send them in your broader (digital and more traditional) marketing activities. Use your sales force to inform these strategies. Leading companies make extensive use of frontline interaction and market research to stay in tune with customer needs and perceptions. For example, Hilti, a maker of professional construction tools, has its salespeople do double duty as distributors and hands-on market researchers at customer construction sites.

### Do you deliver your brand in a consistent way?

Especially at a time when opportunities to deliver brand messages are proliferating as never before, consistency is crucial. If anything, today's

increasingly fragmented environment calls for a more disciplined communication of values and messages across a wider range of channels, including some quite traditional ones, for a longer period of time. DHL's rebranding effort after its acquisition by Deutsche Post is one example. More than a hundred planes, tens of thousands of trucks, and countless uniforms were repainted or replaced to boost brand visibility. Internal company-wide training was designed to turn employees into brand ambassadors, and a set of binding rules for corporate identity and design govern all campaigns and materials.

Don't mistake consistency for inertia, though: changes in the market environment should influence brand-messaging priorities. To stay abreast of market shifts, American Express, for example, created Open Forum, a virtual platform that helps small-business owners connect with the company and with one another. Amex acts as an adviser, helping its small- and midsize enterprise customers understand the constant variations in the retail marketplace—and learning, in the process, how it can best differentiate its own offerings. Consistently gathering information such as this and evolving in response are valuable ways of closing any gaps that may be opening up between your brand messaging and your customers' needs.

[1] The selected companies were publicly traded, with dominant share deriving from B2B activities. These 90 companies (by 2012 market cap) compete in six sectors: banking and insurance; machines and components; utility services; IT-related products and services; chemicals, commodities, and basic materials; and telecommunications products and services. The survey questionnaire also included a seventh sector, logistics services, which had to be excluded from this analysis as a result of insufficient answers for brand-strength ratings.

[2] Executives chosen for the survey, conducted in mid-2012, had a substantial influence on the choice of their companies' suppliers.

[3] In additional research, we found that companies with brands that survey respondents considered strong often had higher EBIT (earnings before interest and taxes) margins than those with weaker brands.

[4] Face-to-face and phone contact with sales representatives ranked highest among B2B customers considering, evaluating, and purchasing products, as well as in product-loyalty decisions. This was true across all industries and regions in our sample.

*The authors would like to acknowledge the valuable contributions of Agnes Claye, Blair Crawford, and Jeff Jacobs.*

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For more on headquarters in emerging-market cities, see the full McKinsey Global Institute report *Urban world: The shifting global business landscape*, on mckinsey.com.

# The shifting global corporate landscape

**Richard Dobbs, Jaana Remes, and Sven Smit**

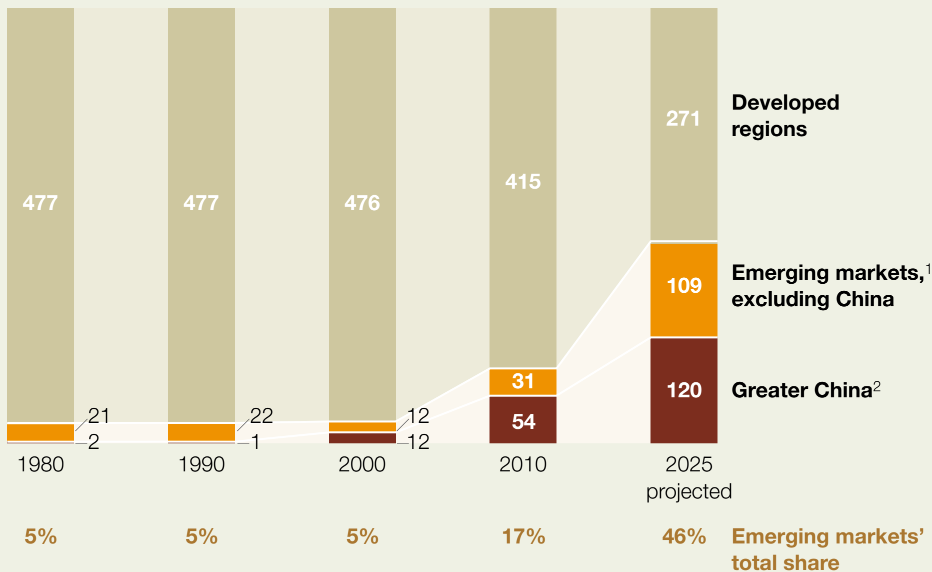
Cities in emerging markets will probably host many of the world's major new companies—and become thriving hubs for capital, innovation, and talent.

Growth rates in emerging markets may recently have slowed, but their long-term potential to generate a rising share of global consumption and GDP remains extraordinary. Also on the way: a tidal wave of new companies, many of which could soon rank among the world's corporate giants and profoundly alter competitive dynamics. New McKinsey Global Institute research suggests that the emerging world's share of Fortune Global 500 companies, which stood at only 5 percent in 2000, is on course to jump up to more than 45 percent by 2025.[1] The Greater China region should be the biggest gainer: in little more than a decade, it could be home to the headquarters of more large companies than the United States or Western Europe.[2]

[1] Projections are based on the McKinsey Global Institute CompanyScope database of large companies, which tracks the world's 8,000 largest public and private companies, including state-owned enterprises—all with annual revenues of $1 billion or more.

[2] Even though the number of large companies will rise more in emerging markets than in North America and Western Europe, these mature regions are expected to be home to almost 2,000 new large companies, an increase of over 40 percent.

**The Fortune Global 500 by headquarters location,** number of companies




[1] Africa, Eastern Europe and Central Asia, Latin America, Middle East, South Asia, and Southeast Asia.
[2] China, Hong Kong, Macau, and Taiwan.

Source: McKinsey Global Institute CompanyScope database (comprising companies with revenues exceeding $1 billion a year)

Global companies need to stay on top of this shift and all it portends:

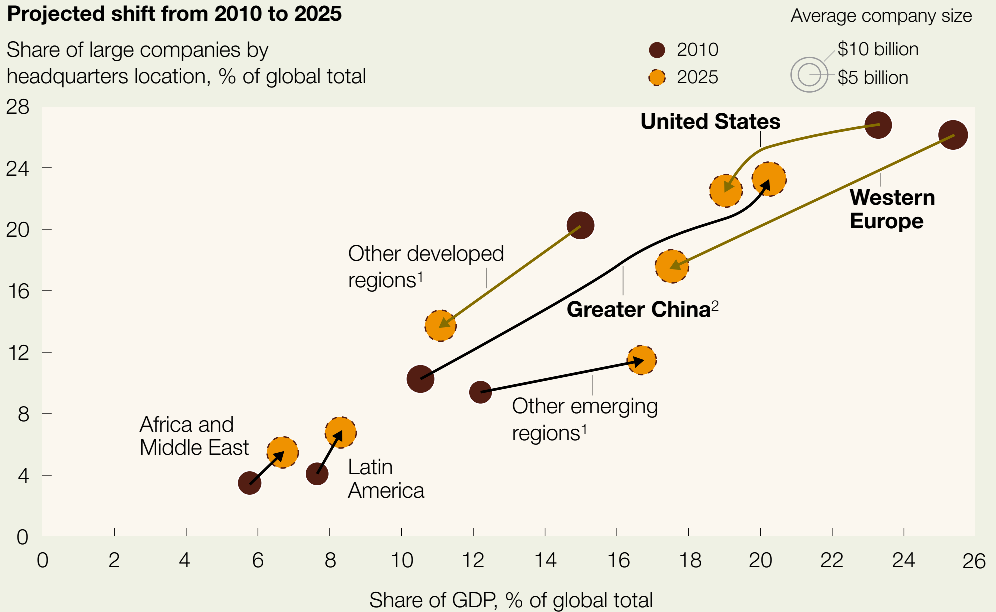
**New competitors.** The most direct and obvious change is that large companies in emerging regions will increasingly move beyond their home markets and shape global economic competition through their investment and expansion decisions. Business leaders should prepare to compete not only for global customers but also for talent, capital, and natural resources. Much as Japanese and South Korean companies successfully challenged incumbent industry leaders in the West, new strategic threats and innovative products or services may appear on the horizon quite suddenly.

**New customers.** Global B2B companies will find a large and fast-growing base of corporate customers in the up-and-coming business hubs of the emerging world. The challenge will be to rethink sales networks to better serve the needs of these customers and learn how their executives make purchasing decisions.

**New footprints.** Global companies need to think hard about whether their physical footprints and organizational structures fit the changing environment. The traditional single-headquarters model may have to give way to new approaches, with secondary headquarters or important functional units located in new emerging-market hot spots. That will help global players keep abreast of market developments, respond to new approaches by competitors, and build pipelines to local talent.

**Projected shift from 2010 to 2025**

Share of large companies by headquarters location, % of global total




[1]Other developed regions: Australasia, Northeast Asia, and Canada; other emerging regions: Eastern Europe and Central Asia, South Asia, and Southeast Asia.
[2]China, Hong Kong, Macau, and Taiwan.

Source: McKinsey Global Institute analysis

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Industry dynamics

# Bringing the voice of the customer into the factory

**Dave Fedewa and Guillermo Lopez Velarde**

Consumer-facing companies typically know more about their end customers than contract manufacturers do. Passing that knowledge along is good for everyone.

Many companies are quite successful at outsourcing their design and manufacturing to cut costs or fill gaps in expertise. Yet it's always a good idea to examine these relationships closely, since there may be opportunities to sharpen product features and further reduce costs. The private-label offerings of retailers, for example—despite producing margins that are typically more than 20 percent better than those of similar branded goods—sometimes contain features and specifications that customers don't particularly value, while lacking others they consider critical. For example, one hardware retailer's private-label measuring tape had a sturdier, heavier retraction coil than those of competitive models. But what customers really wanted, the retailer found, was a smooth retraction movement, not a strong coil. By getting the supplier to use a lighter, smoother one, the retailer reduced the product's cost and increased its value to customers.

Product teardowns have revealed similar "design to value" opportunities across many other product categories.[1] We estimate that global retailers could save at least $55 billion by pushing contractors to rewrite product designs and specifications—while maintaining or improving consumer perceptions (exhibit). Those savings opportunities extend far beyond consumer packaged goods, to include consumer electronics, auto parts, office supplies, and home-improvement products.

[1] Our research uses proprietary data from 4,870 product teardowns. For additional insights, see Ananth Narayanan, Asutosh Padhi, and Jim Williams, "Designing products for value," *McKinsey Quarterly*, 2012 Number 4, mckinsey.com.

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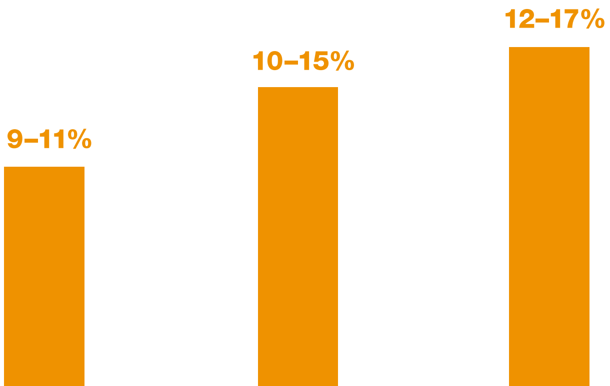
**Design-to-value opportunities across a number of consumer-facing industries suggest the potential for $55 billion or more in aggregate annual savings.**

Savings on product COGS[1]




Affected industries

- Groceries
- Pharmacies

- Discount stores
- Consumer electronics
- Auto parts

- Department stores
- Home improvement
- Office products

Savings on global scale, $ billion

**21–26** **21–31** **13–19**

**Total potential savings = $55 billion to $76 billion**

[1]Cost of goods sold.

Source: Industry experts; McKinsey analysis

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Industry dynamics

# The economics underlying airline competition

**Urs Binggeli, Alex Dichter, and Mathieu Weber**

Budget carriers face difficult odds moving into the most profitable sector of the airline industry.

Over the past quarter century, low-cost-carrier (LCC) airlines have made strong inroads in a number of short-haul markets while largely shying away from the long-haul routes that generate over 90 percent of the mainline network carriers' operating profits. A comparison of the cost structures for short- and long-haul routes suggests an explanation: input costs, such as labor rates and administrative expenses—a sizable share of the LCC cost advantage on short-haul routes—are a much smaller share of the average cost per available-seat kilometer on long-haul ones (exhibit). At the same time, government taxes, fees, and surcharges account for around 80 percent of the ticket price in some long-haul markets—particularly in lower-fare categories—also leaving the LCCs with less maneuvering room to stimulate demand.

LCCs can reap savings on long-haul routes by squeezing more people onto the same types of planes, though this strategy is one that network carriers could imitate if they believed the volume would make up for lost margins from replaced business- or first-class seats. Given these realities, some LCCs are now turning their attention to medium-haul routes in Asia, where the economics are more favorable. ○

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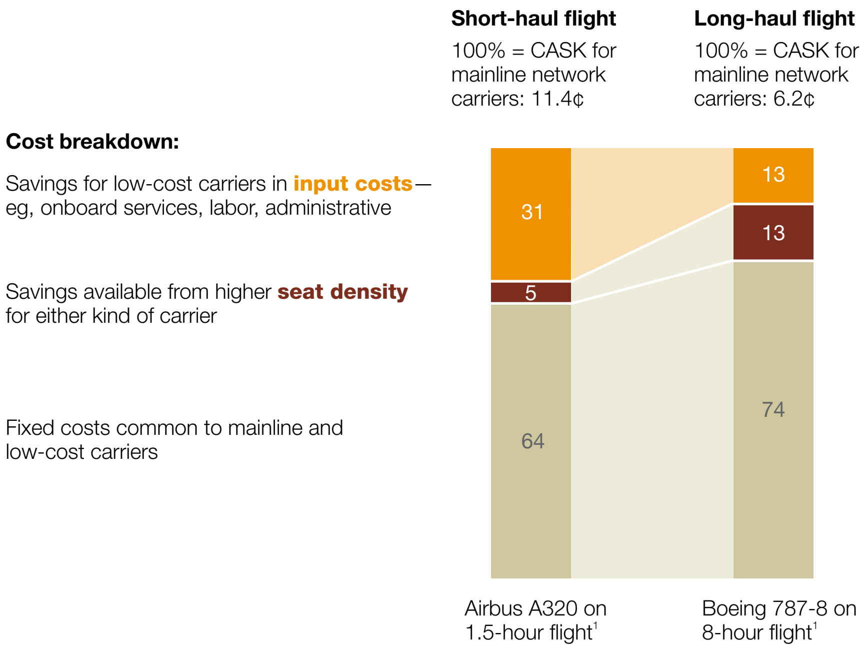
**Low-cost carriers' input-cost edge is larger for short-haul flights than for long-haul ones.**

Share of cost per available-seat kilometer (CASK), %




[1] Seat counts based on announced configurations by carriers that fit the respective archetypes; Airbus A320: 180 seats for low-cost carrier compared with 168 for mainline carrier; Boeing 787-8: 291 seats for low-cost carrier compared with 247 for mainline carrier.

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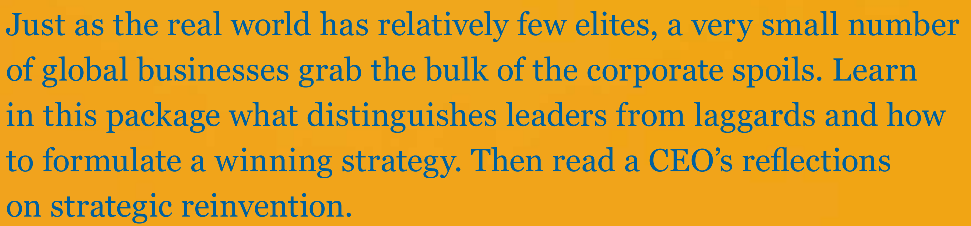
# SEARCHING FOR STRATEGY THAT BEATS THE ODDS

Illustration by FOREAL™



Just as the real world has relatively few elites, a very small number of global businesses grab the bulk of the corporate spoils. Learn in this package what distinguishes leaders from laggards and how to formulate a winning strategy. Then read a CEO's reflections on strategic reinvention.

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**The strategic yardstick you can't afford to ignore**
Chris Bradley, Angus Dawson, and Sven Smit

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**Mastering the building blocks of strategy**
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**Rethinking where to compete: An interview with the CEO of Pentair**

# The strategic yardstick you can't afford to ignore

**Chris Bradley, Angus Dawson, and Sven Smit**

A systematic scan of the economic-profit performance of nearly 3,000 global companies yields fresh insight about where and how to compete.

**At first blush,** "beating the market" might sound like an expression better suited to investing or financial management than to business strategy. When you think about it, though, overcoming the profit-depleting effects of market forces is the essence of good strategy—what separates winners from losers, headline makers from also-rans.[1] A focus on the presence, absence, or possibility of market-beating value creation should therefore help transform any discussion of strategy from something vague and conceptual into something specific and concrete.

While there are many indicators of market-beating strategies, in our experience economic profit (EP)—what's left over after subtracting the cost of capital from net operating profit—is highly revealing. Using this lens, individual companies can take a hard-boiled look at the effectiveness of their strategies. Recently, we undertook a large-scale analysis of economic profit for nearly 3,000 large nonfinancial companies in McKinsey's proprietary corporate-performance database.[2] That effort enabled us to test some deeply held truths and distill generalizable lessons about what it takes to win consistently.

[1] For more, see Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, 2011 Number 1, mckinsey.com.

[2] For technical details on the calculation of economic profit, including its relationship with the key drivers of corporate value (ROIC and growth), see chapter six and appendix A of Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies,* fifth edition, Hoboken, NJ: John Wiley & Sons, 2010.

For example, we saw that the corporate world, like the world beyond it, has a relatively small number of elites and that, just as society grapples with the contemporary challenge of limited social mobility, many companies seem stuck in their strategic "class." Escaping the gravity of the corporate middle class, indeed, requires businesses to expand or reinvent themselves unusually rapidly, often in the context of an industry whose overall performance is improving.

This article focuses on eight analyses emerging from our economic-profit exercise.

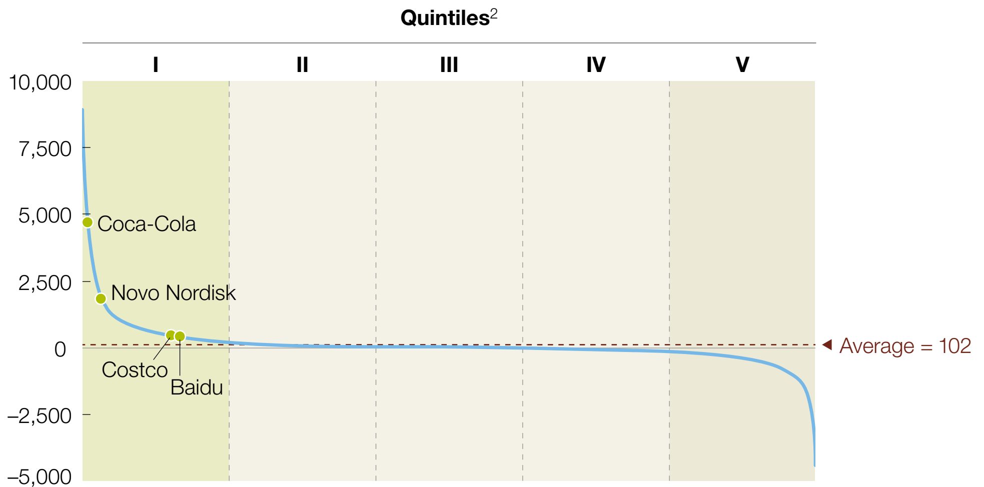
## Strategy is rife with inequality

Economic profit is distributed in a far from democratic way (Exhibit 1). The 60 percent of companies in the middle three quintiles generate

Exhibit 1

### Distribution of economic profit

**Average economic profit** for top 3,000 companies by FY2011 revenues, (excluding outliers),[1] 2007–11, $ million




**By quintile**

| | I | II | III | IV | V |
|---|---|---|---|---|---|
| Average | 1,180 | 121 | 10 | –80 | –709 |
| Total | 677,298 | 69,724 | 5,704 | –45,991 | –410,963 |
| | | Total of 3 middle quintiles = $29,437 million | | | |

[1]Actual sample = 2,875; excludes outliers and companies with insufficient data to calculate average economic profit for given period. Outliers are companies with economic profit >$10 billion (ie, Apple, BHP Billiton, China Mobile, Exxon Mobil, Gazprom, and Microsoft) and those with <–$5 billion.

[2]Defined as: I = average economic profit >$262 million; II = $262 million to $49 million; III = $49 million to –$24 million; IV = –$24 million to –$160 million; V = below –$160 million.

a little over $29 billion in economic profit, or around $17 million each—only 10 percent of the total pie. This share is dwarfed by the $677 billion generated in the top quintile, where each company creates almost 70 times more economic profit than do companies in the middle three, and by the nearly $411 billion destroyed in the bottom quintile.

For companies in the majority group, at least, market forces appear to be a very powerful constraint to creating value.

## What separates the corporate classes?

Economic profit has four components: revenues, margins, asset turns, and the tangible-capital ratio (TCR). Revenues and margins are familiar enough. Asset turns, sometimes described as asset leverage, measure the capacity to extract revenue from a given quantity of assets. TCR is the ratio of physical to total capital, including goodwill[3] (the more M&A a company does, and the higher the premium it pays over book value, the lower its TCR). Every company has a "fingerprint," hinting at its value formula, across these drivers. Exhibit 2 decomposes the four determinants of value by quintile.

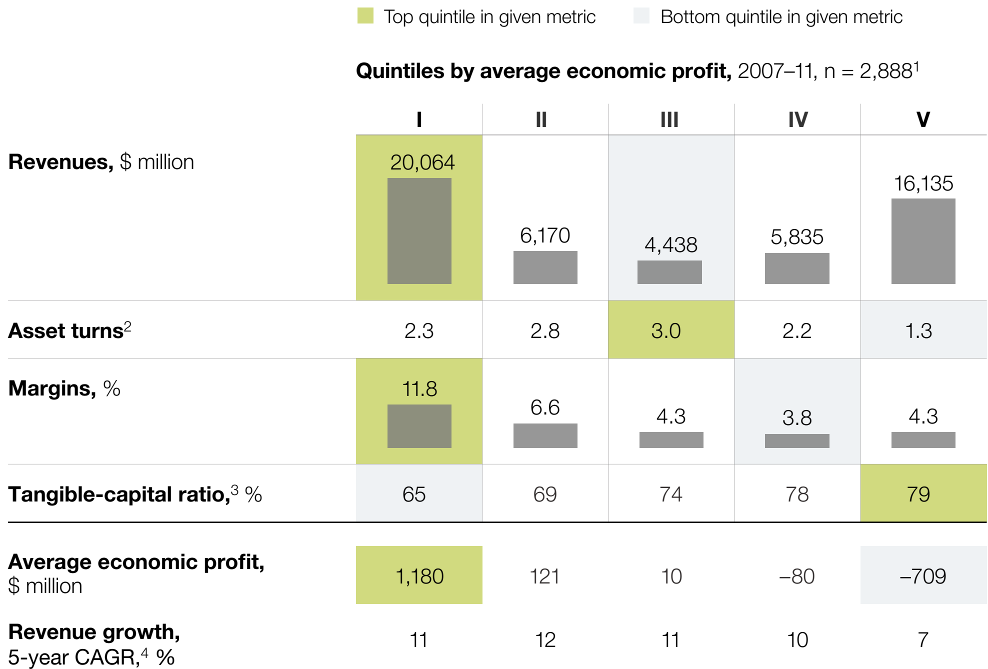
Size clearly matters: both the biggest creators and the biggest destroyers of economic profit are large. Low turns are the hallmark of the bottom quintile, which includes capital-intensive industries, such as airlines, electric utilities, and railroads. High margins clearly differentiate the top class of EP outperformers. Somewhat counterintuitively, however, the weakest EP performers have the best TCR and the strongest the worst. For top companies routinely engaged in M&A, the added cost of goodwill is apparently more than recouped in profitable scale.

Finally, it's worth noting that the average company in the first four quintiles grows by double-digit rates a year—a compelling fact in its own right. Bottom-quintile companies grow one-third more slowly. This compounds their asset-intensity problem, as higher revenues don't offset fixed investment.

[3]There is, mathematically, a fifth dimension of economic value: funding. But the weight of evidence suggests that companies cannot directly influence it. For the purposes of this analysis, we use a global average cost of capital of 9 percent.

Exhibit 2

**Drivers of economic profit by quintile**



Top quintile in given metric | Bottom quintile in given metric

**Quintiles by average economic profit,** 2007–11, n = 2,888[1]

| | I | II | III | IV | V |
|---|---|---|---|---|---|
| **Revenues,** $ million | 20,064 | 6,170 | 4,438 | 5,835 | 16,135 |
| **Asset turns**[2] | 2.3 | 2.8 | 3.0 | 2.2 | 1.3 |
| **Margins,** % | 11.8 | 6.6 | 4.3 | 3.8 | 4.3 |
| **Tangible-capital ratio,**[3] % | 65 | 69 | 74 | 78 | 79 |
| **Average economic profit,** $ million | 1,180 | 121 | 10 | –80 | –709 |
| **Revenue growth,** 5-year CAGR,[4] % | 11 | 12 | 11 | 10 | 7 |

[1]Top 3,000 companies by revenues in FY2011, minus companies with insufficient data to calculate average economic profit for given period.
[2]The capacity to extract revenue from a given quantity of assets.
[3]The ratio of physical to total capital, including goodwill.
[4]Compound annual growth rate.

## Wealth stays at the top

Markets are typically strong agents of mean reversion—but not when it comes to economic profit. We created cohorts based on the performance of companies from 1997 to 2001 and “followed” them to see how long the performance differential lasted (Exhibit 3).

The valuation multiple (enterprise value divided by earnings) converges rapidly and completely. Returns on invested capital (ROIC) partially converge, but the gap never fully closes. Both results reflect the impact of market forces: the strongest EP performers attract imitation, eroding their advantages, while the weakest reform. In the case of economic profit, though, a portion of the advantage persists: the rich stay rich and the poor stay poor. Why?

Exhibit 3

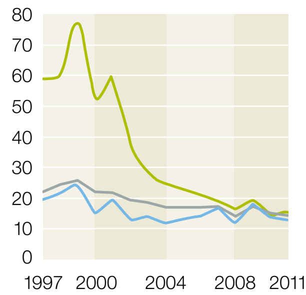
**Three speeds of reversion to the mean**

Cohort average based on companies' quintile in 1997–2001, n = 2,160[1]

Quintile I (top) — Quintiles II, III, IV — Quintile V (bottom)

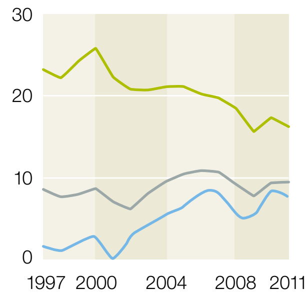
**Rapid and close convergence**

Valuation multiple,[2] times



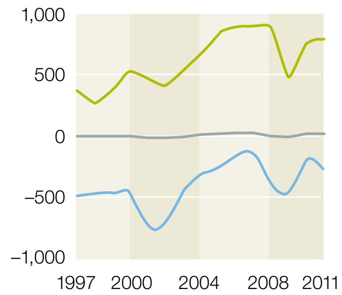

**Persistent gap after initial convergence**

Total return on invested capital, %




**Low indication of convergence**

Economic profit, $ million




[1]Top 3,000 companies by FY2011 revenues, minus companies with insufficient data to consistently calculate the 3 metrics for given period.
[2]Net enterprise value (NEV) divided by net operating profit minus adjusted taxes (NOPLAT).

## To the victors . . . the capital

How does the top cohort maintain its EP outperformance? An important clue lurks in Exhibit 4, which shows how top-quintile companies offset the impact of declining ROIC by attracting a disproportionate share of investment. Two opposing forces are at work here. ROIC convergence reduces the gap between the top and bottom quintiles by $409 million, while diverging capital flows increase the gap by $593 million. In fact, companies in the top quintile in 1997–2001 invested 2.6 times more fresh capital than bottom-quintile businesses did over the subsequent decade. So at least on average, companies in the elite class stay ahead, mostly because they get bigger.

## The economic mobility of companies

Exhibit 5 shows the likelihood that companies will change class over a subsequent decade. The force of gravity is particularly strong in the three middle quintiles: 79 percent of the companies that start

there remain ten years later. In the top and bottom classes, a small majority of companies stay at their station.

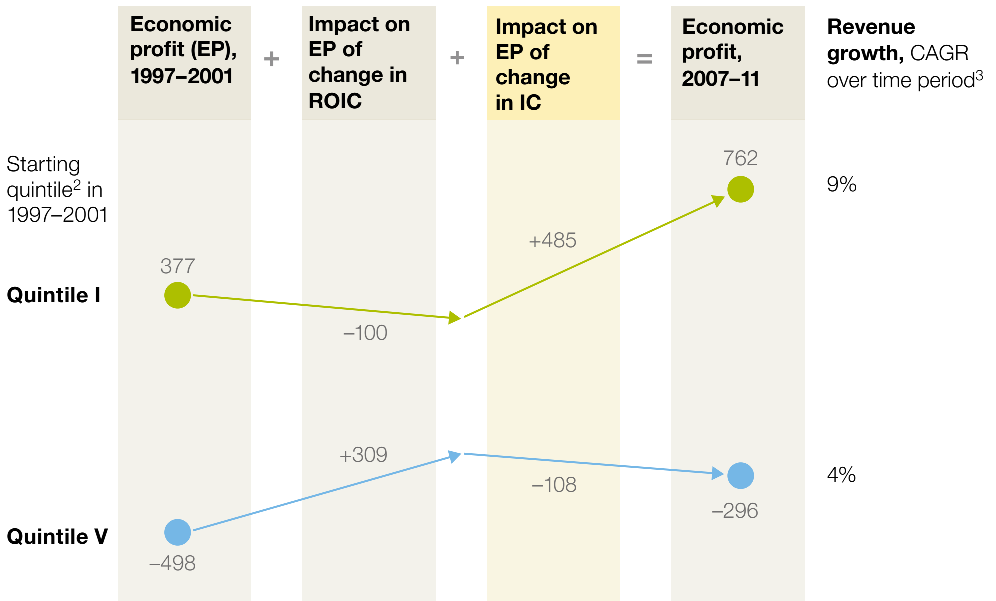
Most strikingly, only 11 percent of companies in the middle make the leap to the top league. But companies at the top cannot rest on their laurels, because almost half drop out, and one in eight slides all the way to the bottom.

To find out more about upward mobility, we looked closely at the 37 companies that started in the middle quintile in the 1997–2001 period but rose to the top over the subsequent one. This breakout group seemingly improved its performance miraculously, increasing revenues by 21 percent and adding 18 percentage points to ROIC.

Exhibit 4

## Why economic profit doesn't converge

Shift in economic profit caused by changes in return on invested capital (ROIC) and invested capital (IC), n = 864,[1] $ million




[1]Actual sample = 2,160; for each quintile = 432; based on top 3,000 companies by FY2011 revenues, minus companies with insufficient data for longitudinal analysis over given period. Figures may not sum to total, because of rounding.
[2]Middle 3 quintiles showed no significant movement. Quintiles based on rankings for economic-profit generation from 1997 to 2001, averaged and held as a fixed cohort. Economic profit and total invested capital provided as total of cohort (not average).
[3]Compound annual growth rate from earlier time period (1997–2001) to later one (2007–11).

Something very special is needed to achieve results like these and escape the middle. So what's the secret? Are these "social climbers" hauling themselves up the ladder primarily through their own efforts, or are wider industry forces at work?

## Riding the megatrends

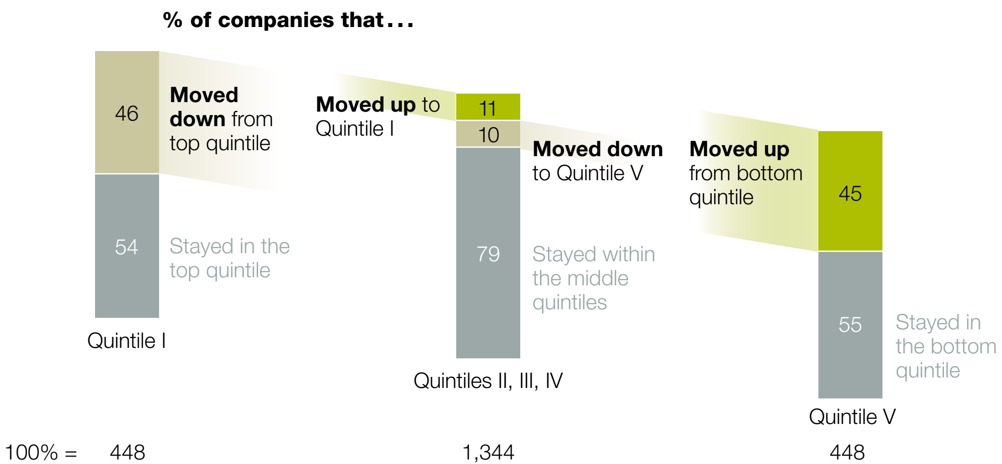
Of the 37 companies that started in the middle quintile and moved to the top, nearly 90 percent compete in industries that improved their economic-profit ranking (Exhibit 6). A rising tide helped lift these boats: the wireless-telecommunications-services industry, for example, pulled middling players to a conspicuously higher rank. Its average EP was 112th out of the 128 in our sample in 1997–2001, but by 2007–11 it had jumped up 102 spots, to 10th place. Two of our 37 big movers were wireless players.

On average, the 37 breakout companies were in industries that jumped up 39 places on the economic-profit league table. Only four came from industries with a flat or declining economic-profit rank. Overall, 75 percent of the increased economic profit of the

Exhibit 5

**Class mobility in economic profit**

Quintile ranking: 2007–11 compared with 1997–2001[1]

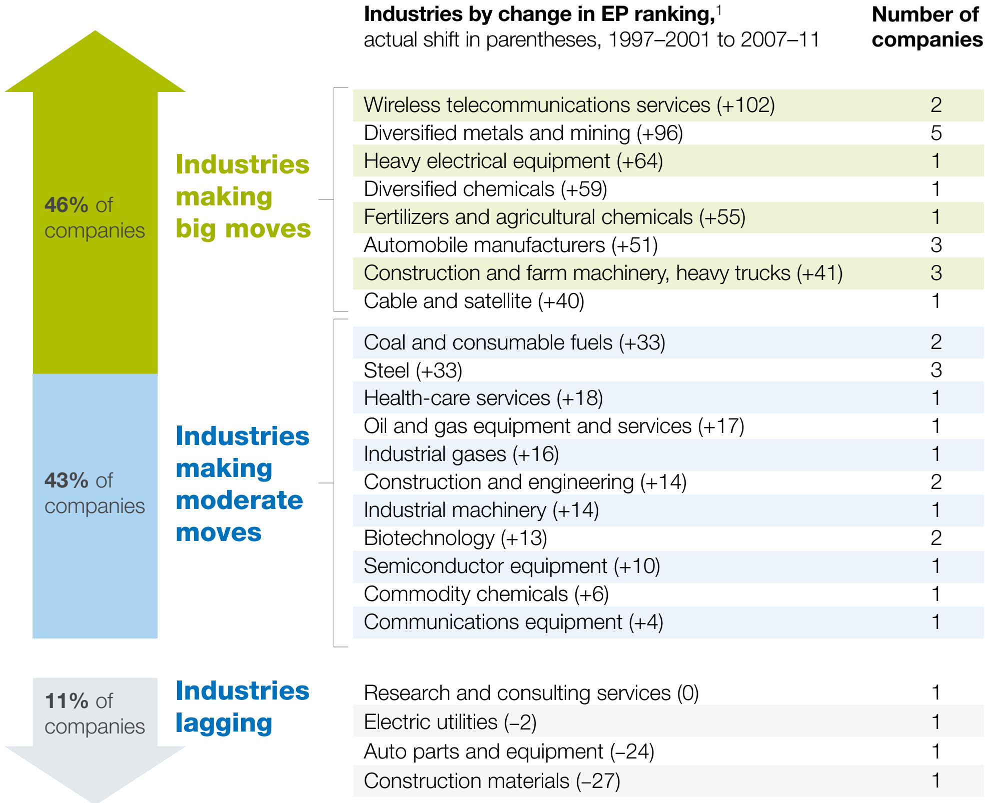



[1]Actual sample = 2,240; based on top 3,000 companies by FY2011 revenues, minus companies with insufficient data for mobility analysis over given period. Quintiles based on rankings for economic-profit generation for 1997–2001, averaged and held as a fixed cohort.

Exhibit 6

## Contribution of industry re-ranking to economic mobility

**Of the 37 companies that rose from Quintile III to Quintile I, nearly 90 percent were in industries that moved up in economic-profit (EP) ranking.**




| Group | Industries by change in EP ranking,[1] actual shift in parentheses, 1997–2001 to 2007–11 | Number of companies |
|---|---|---|
| Industries making big moves (46% of companies) | Wireless telecommunications services (+102) | 2 |
| | Diversified metals and mining (+96) | 5 |
| | Heavy electrical equipment (+64) | 1 |
| | Diversified chemicals (+59) | 1 |
| | Fertilizers and agricultural chemicals (+55) | 1 |
| | Automobile manufacturers (+51) | 3 |
| | Construction and farm machinery, heavy trucks (+41) | 3 |
| | Cable and satellite (+40) | 1 |
| Industries making moderate moves (43% of companies) | Coal and consumable fuels (+33) | 2 |
| | Steel (+33) | 3 |
| | Health-care services (+18) | 1 |
| | Oil and gas equipment and services (+17) | 1 |
| | Industrial gases (+16) | 1 |
| | Construction and engineering (+14) | 2 |
| | Industrial machinery (+14) | 1 |
| | Biotechnology (+13) | 2 |
| | Semiconductor equipment (+10) | 1 |
| | Commodity chemicals (+6) | 1 |
| | Communications equipment (+4) | 1 |
| Industries lagging (11% of companies) | Research and consulting services (0) | 1 |
| | Electric utilities (–2) | 1 |
| | Auto parts and equipment (–24) | 1 |
| | Construction materials (–27) | 1 |

[1] Ranking of 128 industries by average industry economic profit; industries with fewer than 10 breakout companies default to next level of industry classification.

37 companies came from improvements in their markets or industries. The lesson is clear: riding on the coattails of an industry-moving trend is almost essential to escaping the middle class.

## The more winners, the more losers

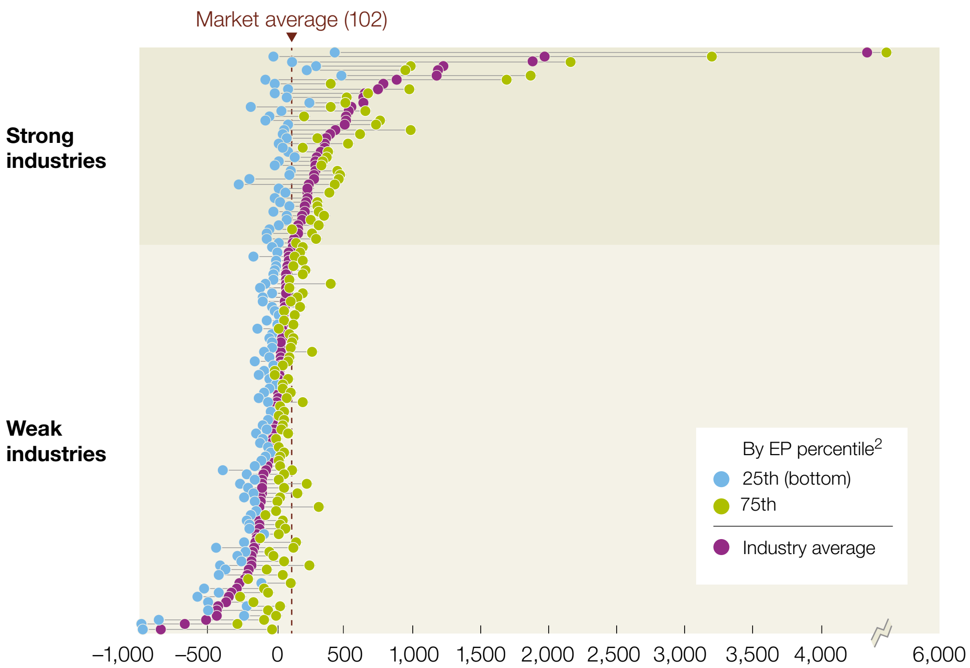
Much as we mapped companies by the economic value they create, so too we found that industries follow the same pattern of haves, have-nots, and a big, muddy middle (as shown by the *S* line in Exhibit 7).

Interestingly, though, the variation between companies is bigger at the top and the bottom, as indicated by the gap between the 25th- and 75th-percentile performers in the industry. In the best and worst industries, big winners and big losers have a big impact on total performance—so the graph looks like a tilted hourglass. The link between the performance of industries and companies, in other words, is more complex than meets the eye: besides facilitating

Exhibit 7

### Distribution of company economic profit within industry

Companies' average economic profit (EP), 2007–11, n = 2,888,[1] $ million




**Bottom 5 industries** (no. of companies)

- Electric utilities (102)
- Airlines (45)
- Multi-utilities[3] (42)
- Independent power producers and energy traders (30)
- Railroads (26)

**Top 5 industries** (no. of companies)

- Diversified metals and mining (46)
- Wireless telecom services (45)
- Pharmaceuticals (40)
- Integrated oil and gas (39)
- Communications equipment (18)

[1]Top 3,000 companies by revenues in FY2011, minus companies with insufficient data to calculate average economic profit for given period. 128 industries analyzed; those with fewer than 3 companies default to next level of industry classification.

[2]Analysis based on the bottom 25th and top 75th percentiles illustrates the dispersion of a highly skewed distribution (eg, in some cases, average economic profit is in the top quartile).

[3]Utilities offering more than 1 service—eg, telephony, cable television, and Internet services.

mobility, better performance by industries correlates with higher variance among the companies in them.

Of course, on average it is better to be in good industries, whose companies are three times more likely than others to generate a market-beating economic profit. But a below-average company in a good industry appears no more likely to win than an above-average company in a bad one. Warren Buffett once famously remarked, "With few exceptions, when a manager with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact." But our research suggests that he is only partly right.

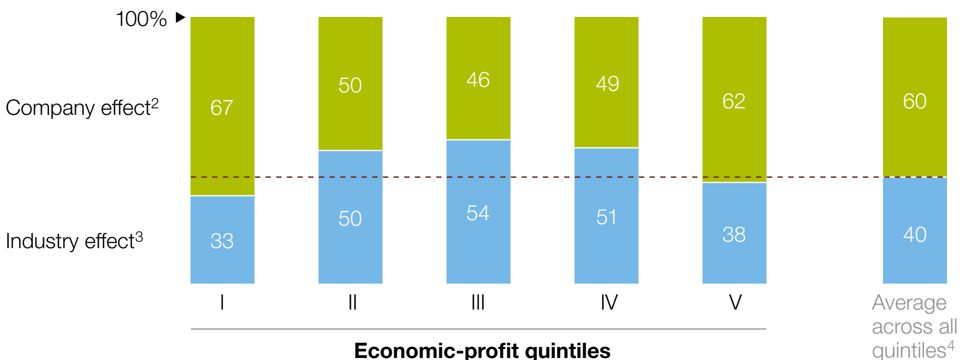
## Why do you make money?

So how do we untangle the forces of market selection versus company effects in explaining performance? How much does the neighborhood determine a company's economic fate? The question is fundamental because of the widespread confusion between performance

Exhibit 8

**Industry vs company effect by quintiles**

Share of contribution to company performance, 2007–11, n = 2,888[1]




[1]Top 3,000 companies by revenues in FY2011, minus companies with insufficient data to calculate average economic profit for given period. 128 industries analyzed; those with fewer than 3 companies default to next level of industry classification.
[2]Defined as difference between company's economic profit and its industry's average economic profit.
[3]Defined as difference between an industry's average economic profit and the market average.
[4]Weighted by absolute contribution to economic profit.

and capability (see "Mastering the building blocks of strategy," on page 36).

At a granularity level of 128 global industries, we can explain 40 percent of a company's economic profit by the industry in which it competes (Exhibit 8). We make this calculation from simple but powerful math by adding the three layers of the company's EP: the market's average EP, plus the difference between the average EP of the company's industry peers and the market average (the industry effect), plus the difference between the company's EP and the industry-average EP (the company effect). The industry's contribution is smaller in the top and bottom quintiles—idiosyncratic factors explain more of the performance differences here.

The remaining 60 percent (the company effect) represents other drivers of value. These could be attributable, first, to a company's more granular choices about market selection—not just broad industries, but subsegments and geographies too. After those are accounted for, there will be a gap representing a company's unique proprietary advantage, encapsulated in privileged assets and special capabilities. It takes real work to isolate these factors, but the payoff can be worthwhile: first, because market selection is in many ways a more practical lever of strategy than broad attempts to lift market share and, second, because it can clear up misconceptions about the (noisy) link between performance and capabilities.

So, what are the implications for CEOs and strategists?

- If you're in the elite, "use it or lose it." You have a privileged ability to mobilize capital. Really know the formula that got you there and vigilantly watch for signs of change. You can't rest on your laurels, as the odds are almost 50–50 that you will slide down into the middle class—or lower.

- If you're in the middle, you mostly face a battle of inches. A fortunate few companies will ride a favorable industry trend. But for the most part, it will take substantial strategic or operational shifts to escape the gravity of market forces. The odds are against you, which elevates the importance of looking at strategy with a high degree of rigor.

- If you're at the bottom, growth without better performance will be the equivalent of throwing good money after bad. You will probably need a new trend to get out of the basement, but in the meantime focus on improving ROIC, which often requires improving asset turns.

Our research offers a yardstick on the empirical reality of strategy and can help create better rules of thumb for considering and assessing it. Individual companies should start by measuring whether they beat the market and by digging into the timeless strategic question of why they make money. ○

*The authors would like to acknowledge the contributions of Alex Harper, Taichi Hoshino, Bin Jiang, Pia Mortensen, and the team at the McKinsey Strategy and Trends Analytics Centre (STAC) to the development of this article.*

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# Mastering the building blocks of strategy

**Chris Bradley, Angus Dawson, and Antoine Montard**

**Increase your likelihood of developing effective strategies through an approach that's thorough, action-oriented, and comfortable with debate and ambiguity.**

**Left unchecked,** market forces continually conspire to deplete profits. Powerful business strategies can counteract those tendencies, but good strategy is difficult to formulate.[1] Indeed, the latest McKinsey research (see "The strategic yardstick you can't afford to ignore," on page 24) finds that a very small number of companies create most economic profit.[2] The research also shows that a significant number of good companies outperform even in so-called bad industries, where the average economic profit is less than the market average.

How do they do it? In other words, where do powerful strategies come from? Sometimes it's luck, or good timing, or a stroke of inspiration. In our experience, it's also possible to load the dice in favor of developing good strategies by focusing on the core building blocks that often get overlooked. One is the need to gain agreement—before creating strategy—on the essential decisions and the criteria for making them. Another is to ensure that the company is prepared and willing to act on a strategy once it is adopted. Too much of what passes for strategy development, we find, consists of hurried efforts

[1] A 2011 McKinsey survey asked executives to evaluate their strategies against ten objective tests of business strategy. It found that 65 percent of companies passed just three or fewer tests. For more, see Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, 2011 Number 1, mckinsey.com.

[2] What's left over after subtracting the cost of capital from net operating profit.

that skip one or more of the essentials. The resulting strategies are often flawed from the start.

It's also easy, though, to go too far in the other direction and make the creation of strategy a rigid, box-checking exercise. Appealing as a formula-driven approach might be, it ignores the truth that strategy creation is a journey—and an inherently messy one at that. Proprietary insights are hard to come by. Shaping keen insights into good strategies requires deep interpersonal engagement and debate from senior executives, as well as the ability to deal with ambiguity in charged and often stressful circumstances. When would-be strategists overlook these dynamics, they cover the essentials in name only. Consequently, they miss opportunities and threats, or create great paper strategies that remain unfinished in practice.

In this article, we'll outline a middle path—an end-to-end way of thinking that views the creation of strategy as a journey, not a project. This method, developed through our work with some 900 global companies over the past five years, can help senior executives approach strategy in a rigorous and complete way. We'll also describe some principles that strategists should keep in mind as they use the method to ensure that their strategic-planning processes embody the spirit of debate and engagement, which, in turn, yields inspiration. By better understanding both the method and how to get the most out of it, companies can boost the odds that the strategies they create will beat the market.

## Do justice to strategy's building blocks

Most companies we're familiar with demonstrate a variety of good habits when they create strategies, and they get many things right. But what they miss can be critical. Consider these examples:

- a technology company that prided itself on analytical rigor but never accurately diagnosed how difficult it would be for a targeted customer group to provide reasonable returns

- a beer company that rightly focused on industry structure in its core business but made a losing bet on a related business—wine—after failing to forecast declining returns stemming from structural shifts there

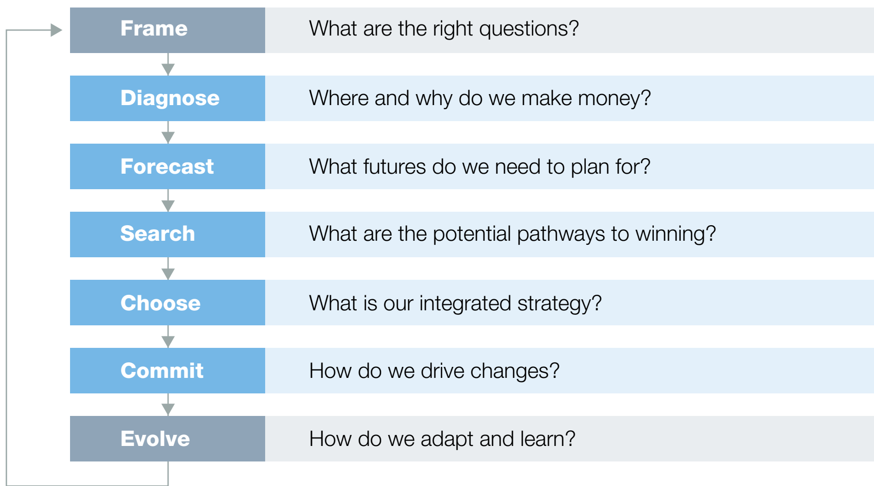
- a telecommunications company's strategy team, which recognized the importance of involving senior managers but ended up alienating them by holding a series of time-consuming workshops that focused on alignment around strategic choices, though the full set of choices hadn't yet been identified

These problems don't have to happen. We find that companies do better when they ground all their strategy-development efforts and processes in an understanding of the building blocks of strategy. These straightforward modes of activity (exhibit) track the progression of a strategy from its roots as an idea through its emergence as an operational reality.

One central building block is deep insight into the starting position of the company: where and why it creates—or destroys—value (diagnose). Executives also need a point of view on how the future may unfold (forecast). By combining insights into a company's starting position with a perspective on the future, the company can develop and explore alternative ways to win (search) and ultimately decide which alternative to pursue (choose). With the strategy selected, the company needs to create an action plan and reallocate resources to deliver it (commit).

Exhibit

**The building blocks of strategy help companies make strategic choices and carry them through to operational reality.**



These five core building blocks are book-ended by two others. One is an initial block (frame) to ensure that the team properly identifies and agrees to both the questions asked and the decisions made as the strategy is developed. The final block (evolve) is dedicated to the constant monitoring and refreshing of the strategy as conditions change and new information becomes available.

To some extent, the building blocks simply represent a thorough list of activities that all good strategists perform. And while all are important and should be included in the creation of strategy, slavishly following this or any other framework won't bring success. Depending on the situation, some blocks will be more critical than others and therefore require more attention (see sidebar, "Re-create, recommit, and refresh").

That's why taking some time to frame issues at the outset is so important. When strategists do so, they are better able to identify the real choices and constraints facing their organizations and to see which building blocks are likely to matter most given the situation at hand. Unfortunately, many executives feel that taking the time to frame strategy choices thoughtfully and to decide where to focus strategy-development efforts is a luxury they don't have.

We've seen evidence of this pressure firsthand and in the responses to an executive survey we've been conducting as part of an ongoing research project. Fully two-thirds of the 200 executives we've surveyed so far report that they feel rushed to provide outputs in their strategic-planning processes. This pressure is understandable in today's always-on, fast-changing environment, but it can be hazardous to a company's strategic health. That's especially true in the all-too-common situations when it's not immediately obvious what factors will determine the success or failure of a change to strategy.

A financial-services institution in the Asia–Pacific region, for example, was investigating a growth opportunity involving the creation of an online business. Changing the company's focus in this way would be a big undertaking, but the upside potential was large. Moreover, the members of the strategy team could already see that demonstrating the channel's significant potential to the top team would be straightforward. Before doing that, however, they stepped back to spend some

time thinking through the idea's broader strategic context—framing, in other words.

When they did, they saw a serious risk of cannibalization for one of the company's existing businesses. The new venture would also require substantial funding over the next three to five years before it contributed financially. This had important implications, and the team's members needed to convince themselves that the risk was worth taking. Moreover, if the company made the move, would it

## Re-create, recommit, and refresh

For a number of years, we, our colleagues, and many others who are engaged in the practice of strategy have been pointing out how ill-suited traditional strategic-planning processes are to the dynamism and pace of 21st-century business life. Less clear is what should happen to many organizations' well-oiled approaches. Shut them down? Morph them into budgeting and operational-planning processes? Use them to synthesize the valuable insights emerging from more frequent strategic dialogues involving larger numbers of executives?

The building blocks of strategy shed fresh light on what strategic planning should and shouldn't try to do. For starters, we'd emphasize that periodically—perhaps as often as every three to five years, if new competitors arrive or markets unexpectedly shift—companies must *re-create* their strategies. This cannot be accomplished through typical planning processes, as it requires broader skills, wider engagement, and more flexibility to make big strategic choices than they allow. So forget about strategic planning when you need to revamp your strategy; instead, take a more immersive strategy-development approach using all of the seven building blocks described in this article.

At the other end of the spectrum is what we would describe as the need to *recommit* organizations to established strategies. Traditional strategic planning is tailor-made for this purpose, and thinking about the task in these terms helps elevate it above the glorified budgeting exercise into which some processes lapse. Two of the building blocks we have described in this article—

stick with the effort when the time came to provide funding for people and technology?

Instead of steaming ahead with analytical work to prove the potential, the team recognized that it would be critical to invest a disproportionate amount of time and effort to the commit building block. The strategy team did this, in part, by developing a powerful multimedia concept prototype to capture the imaginations of the top team and the executives representing key support functions. The

commit and evolve—are useful reminders of what any such strategic-planning process should accomplish: the constant monitoring of strategy, the reallocation of resources, the alignment of management on strategic priorities, and the creation of targets, budgets, and operational plans.

Between these two extremes lies the strategic *refresh*, which is particularly relevant for organizations where a lot of valuable, ongoing strategy dialogue takes place among members of the top team. Such engagement can highlight nagging issues that might one day necessitate a strategic redo but certainly merit attention now. For example, if signs suggesting that one or more key assumptions have become less valid emerge from strategic dialogues at the business-unit level, it might be time to update the company's perspective on long-term trends. This exercise could be elevated in importance by making it a core theme of the upcoming strategic-planning process. In such situations, it's a good idea to check all seven building blocks quickly, with an emphasis on understanding the strategic implications of underlying changes. If they are big enough, that could be a red flag signaling the need to re-create the strategy and thus to elevate the discussion beyond strategic-planning parameters.

For a closer look at how to improve strategic planning, see "Managing the strategy journey" and "Dynamic management: Better decisions in uncertain times," on mckinsey.com.

team's focus on gaining commitment was prescient; the prototype and the communication around it helped convince the leaders that the concept was so compelling for consumers that if the company didn't cannibalize its existing business, a competitor would probably come up with the idea. The effort also helped motivate the leaders of the finance and IT functions to support the new offer. The company launched it in record time, to promising early results in both customer acquisition and levels of customer engagement.

In retrospect, the team credits the conversations and debates held during this framing period as necessary to identify and resolve the potential stumbling blocks related to the organization's strategic direction. Although messy at times, this activity helped build an organizational commitment to the strategy and its importance to the company.

## Myth-bust your story

A focus on strategic building blocks also can help companies develop penetrating insights. While "insight" conjures up visions of research, data crunching, and "aha" moments, real strategic insight also rests on a seemingly mundane and easy-to-overlook factor: a thorough understanding of how and why a company, its competitors, and others in the industry value chain make money. Absent dumb luck, a strategy that doesn't tap directly into such an understanding will underperform.

The difficulty, as professor Phil Rosenzweig of the International Institute for Management Development has explained so well,[3] is that a company's performance—good or bad—creates strong impressions that powerfully shape the way people perceive strategies, leaders, cultures, and organizational effectiveness. A commodity company, for instance, might falsely attribute its strong performance to the efficiency of its operations. Yet despite its efficiency, the economics of those operations could be swamped by market-structure changes that have significant pricing implications or by unexpectedly volatile demand.

[3] See Phil Rosenzweig, "The halo effect, and other managerial delusions," *McKinsey Quarterly*, 2007 Number 1, mckinsey.com.

One way senior executives can address the challenge, we find, is explicitly questioning received corporate wisdom—much as the popular US television show *MythBusters* does when it takes apparent axioms, urban legends, and popular assumptions and (in entertaining fashion) tries to prove or disprove them. In the creation of strategy, this approach means dispassionately identifying the elements that contribute to performance, while discounting any factor contaminated by perceptions of the company's supposed greatness. It also requires a curiosity that's woefully lacking in some strategic-planning processes. Nearly eight in ten executives we surveyed, for example, say that the processes of their companies are more geared to confirming existing hypotheses than to testing new ones.

To see how these dynamics play out in practice, consider the experience of a global retailer that was revisiting its strategy after the previous one had delivered five years of strong earnings. The positive results, most in the company believed, reflected good execution and the success of a recent initiative to refresh the store format. Still, the leader of the business felt there could be more to the story and worried that continuing along the same path might not produce the same results in the future. To determine what was actually driving performance, the leader met with the company's strategy team, as well as other executives.

This was time well spent. The resulting discussions sparked important insights—revealing, for example, that while overall performance was good, there were problems under the surface. On the positive side, the company was steadily improving its margins and winning customers from a higher-cost competitor. Nonetheless, the solid network growth at the top-line level appeared to be masking a

Nearly eight in ten executives say that the processes of their companies are more geared to confirming existing hypotheses than to testing new ones.

worrisome decline in the productivity of older stores. The big drag on performance, the team discovered, was the loss of mainstream customers to a cheaper competitor, which careful analysis showed to have an unassailable advantage on cost. Increasing promotional activity had so far seemed to stem the march of this aggressive rival, but the retailer was running out of steam and hitting practical limits. Significant changes would be necessary.

## Let them grapple

This realization was the product of more than just number crunching. The thoughtful argument and debate surrounding the analysis from day one played a vital part in generating the insights. In our experience, many companies forget this truth when they create strategy. Instead, they put too much emphasis on preparing documents and completing analyses and not enough on stimulating the productive debates that lead to better decisions.

Getting executives to grapple with the issues can be a messy process, and the debates may be quite personal. After all, formulating good strategies typically involves revisiting fundamental and deeply held beliefs about a company's past and future, and people tend not to shift their views without a fight.[4] But without the necessary fights, and without the use of carefully designed decision-making techniques, companies may end up with rubber-stamped strategies whose flaws are exposed during implementation—or afterward, by competitors.

When companies find ways to get executives grappling—throughout the strategy-development process—with the choices that matter, they make better, less biased decisions. They also improve the likelihood that the relevant stakeholders will be on board when the time comes to make and act on choices.[5]

[4] We also know that executives exhibit a number of biases that lead them to be overconfident about their beliefs and adept at finding facts to confirm them and reject challenges. To learn more about addressing this problem, see Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, 2010 Number 2, mckinsey.com.

[5] The importance of gaining social support for a strategy is often overlooked. Fully 62 percent of executives in our survey say that their strategy processes focus on the strategy itself, not on building a support base of influencers who will drive implementation.

To exemplify our point, let's look again at the retailer's strategy team as it engaged with the company's broader leadership group to share its observations. Most strategy teams interact with decision makers by presenting management with a summary report and recommendations. But this team understood that senior managers needed time to debate the issues themselves and reach their own conclusions—and that such collective discussions would improve the resulting strategy.

Because the senior managers had a very hands-on attitude, the strategy team designed a series of weekly meetings called think tanks to let them work through a profit-deconstruction exercise illuminating the company's past. In each session, the analysis was tabled after a certain point, and the management team's members took turns drawing out conclusions or identifying further questions that needed answering. The strategy team was prohibited from bringing any conclusions of the analysis to these meetings, much to its discomfort. This ensured that company leaders were invested in the decision-making process and could challenge the strategy team with new ideas.

Through a series of small-group meetings, the leadership team (with analytical help from the strategy team) debated the reasons for the company's past success and how to continue it. By unpacking these complex dynamics together, the leadership team arrived at an accurate, sharp diagnosis: the company needed to restore mainstream shoppers' trust in its prices. The result was a simple, focused strategy for delivering "value" products and reinforcing that market position with customers. Furthermore, because the management team was deeply involved in the diagnosis, its members had a strong incentive to drive implementation.

## Don't leave the strategy unfinished

In conversations with senior executives, we occasionally hear some version of this saying: "I'd rather have a good strategy and great execution than vice versa." We believe that this attitude reflects confusion about what great strategy is. Such a strategy creates a path for action and is inherently incomplete without it. Yet many companies fail to get the conditions for successful implementation right, and

fully two-thirds of the executives in our survey admit that their companies struggle with the issue.

It's a crucial struggle. No strategy, however brilliant, can be implemented successfully unless the people who have the most important jobs know what they need to do differently, understand how and why they should do it, and have the necessary resources. An added challenge, of course, is that strategic choices often involve big changes over long, three- to five-year time frames.

Finishing a strategy, therefore, requires creating tangible, proximate goals that connect to the longer-term strategy. It's easy to create a high-level list of next steps and things to do differently on Monday morning. It's much harder to roll back the future and connect it to the present so that people understand what they need to do differently and actually do it.

When companies fail to set proximate goals, the results can be disappointing. An Asian telecommunications company, for example, had landed on an intriguing and counterintuitive strategy involving two big shifts: it wanted to move its target customer base from big business to the midmarket and to standardize its products rather than provide customized service to large clients. Making the changes work, however, would require salespeople to start saying no to new business from large and complex clients so that the company could redirect its efforts to midmarket customers. The short-term pain (lower revenues and higher costs) would ultimately lead the company to a market-beating position.

The management team understood and encouraged the shift and was ready to act. But the strategy team did not do enough to prepare the organization for the moves, instead spending its time on detailed initiative-planning exercises. Absent any effort to translate the company's strategic desires into proximate goals for its employees, those employees balked at the changes.

Sales managers, for example, not only viewed saying no to larger customers as a short-term loss for the business but also were simply not as excited about pursuing midmarket customers with simpler needs. They understood the strategy intellectually and believed the analysis, but their skills, incentives, and ways of working and even

thinking had not changed. Without such changes, they couldn't connect the necessary steps to a longer-term goal and naturally reverted to their old ways, creating a backlash that inevitably undermined the strategy. Only afterward did the team recognize the kinds of activities that might have helped—for example, changing the salespeople's goals, resetting the overall budget to acknowledge the transition from one customer segment to another, and using the reallocated funding to generate a new product-development road map.

Creating strategy in today's environment of complexity, ever-changing priorities, and conflicting agendas is a daunting task. Yet when senior executives invest the time and effort to develop a more thorough, thoughtful approach to strategy, they not only increase the odds of building a winning business but also often enjoy a positive spin-off: the gifts of simplicity and focus, as well as the conviction to get things done.

*The authors wish to thank Matthew Chapman, Pia Mortensen, and Victoria Newman for their contributions to the development of this article.*

**Chris Bradley** is a principal in McKinsey's Sydney office, where **Angus Dawson** is a director and **Antoine Montard** is a senior expert.

# **Rethinking where to compete:** An interview with the CEO of Pentair

The US manufacturer has reinvented itself by switching out of power tools and into water and other resource-based businesses.

**Few large,** established companies anywhere in the world effectively reinvent themselves overnight. But Minneapolis-based Pentair did just that. A decade ago, the company sold its core power-tools businesses—42 percent of group sales—and reinvested the proceeds in Wicor Industries, the water-systems subsidiary of Wisconsin Energy. In March 2012, Pentair made another big bet, roughly doubling its size to $8 billion by acquiring Tyco International's flow-control business. Randall Hogan, chairman and chief executive officer and the man who led the transition, talked recently with McKinsey's Rik Kirkland about strategy, capital reallocation, the importance of getting the board's buy-in, and the vital art of thinking "right to left."

**The *Quarterly*:** *How do you approach strategy?*

**Randall Hogan:** Before joining Pentair, in 1998, I had worked for GE and United Technologies. Both companies were in a lot of different and seemingly unrelated businesses, but the experience taught me that successful conglomerates exist because they're good at moving capital, talent, and processes around. United Technologies, in particular, brought substantive operating discipline—using the Toyota Motor production system, for example—to its assets. That just threw a switch inside me; here, I thought, is a powerful way of running a diverse company. And it shaped my view that there had to be something more to Pentair than just a holding company—a set of common principles and common beliefs, for instance.

**The *Quarterly*:** *Was it a difficult decision to exit power tools?*

**Randall Hogan:** The power-tools group was our largest business when I became CEO, in 2001, but I don't think the board was surprised when I told them I thought it had the dimmest prospects. We didn't control our own destiny. Lowe's and Home Depot, the retail outlets which stocked our professional niche tools and helped drive growth in the 1990s, accounted for 55 percent of sales, and we were dependent upon them. Water, on the other hand, was looking interesting to a lot of people; its growth prospects were strong, its M&A potential was bright, and its industry dynamics—channel power, innovation, pricing fundamentals—seemed attractive. It was clear that we had to reduce our dependence on power tools and double down on at least one of our other businesses, maybe both.

**The *Quarterly*:** *So, was the timing of the water acquisition a coincidence?*

**Randall Hogan:** The purpose of the CEO, the leader of the company, is to create a brighter future. And that's why I often talk about thinking "right to left." Left is where you are now. The right-hand point is the goal—in our case, not just getting out of power tools but developing a water strategy. Even before we sold power tools and bought Wicor Industries, we were identifying interesting spaces and people in the water sector and making a number of small acquisitions. Our focus wasn't just on the sale, it was on the buy—with the commitment and understanding that we would do the sell. In February 2004, we announced the purchase of Wicor, and then we had an auction to sell the power-tools business. It was hairy at times, but for a net difference of $75 million, the result was that we upgraded our entire portfolio, the stock price jumped, and as investors saw the promise of it, we were rewarded with a better multiple.

**The *Quarterly*:** *How did the board react to the change of direction?*

**Randall Hogan:** It was very important that the board was in on the discussions early—they were fully aligned on the "right point" of our strategy. I'm sure that this was easier to do 10 or 15 years ago than it is today, when many boards are a bit more focused on governance. Yet engaging in strategy and resource allocation is really where boards can help the most to create value. That said, plenty of people in the know at the time argued that our move was too radical.

They pointed out that all our power-tools know-how was irrelevant to the water business and that there was a lot about the water business that we didn't know. The role of the CEO is not to let those little voices carry the day. Listen to them, by all means, and understand them, but keep that point to the right in mind. And stick to it.

**The *Quarterly*:** *Does the end goal of strategy have to be fully baked?*

**Randall Hogan:** It's really best to think of it as a destination with an infinite number of ways to get there. We knew we had to get out of power tools but initially we had no idea how. Most companies, in my experience, don't have a destination; they just want to keep doing what they're already doing, at an incremental pace.

**The *Quarterly*:** *Was the financial crisis of 2007–08 a big test of nerve?*

**Randall Hogan:** We actually got hit earlier than that, in 2006, because the water business we built was 50 percent residential and we had deliberately stayed small in municipal, where the margins are low. Between 2006 and 2008, Wall Street told us we were the dumbest people in the world. It was quite an education. The board wasn't always easy when things were going badly: miss a few quarters and you're going to hear about it. But luckily, I had enough of a relationship with them that we drew together a little tighter, and they stuck with us. Even then, we were still focused on that right-hand point—what is the long game?

**The *Quarterly*:** *What prompted the Tyco deal?*

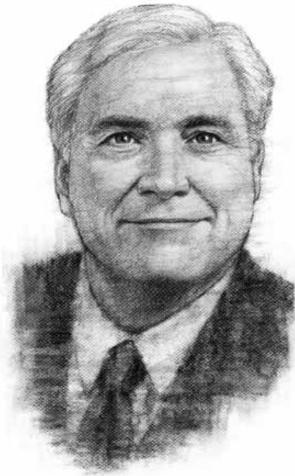
**Randall Hogan:** We had taken the actions to get us through the financial crisis, but after that the target was to become a $10 billion company. We knew that we had to be bigger to control our own destiny. And the opportunity was there in what we call the "new–new world," four billion middle-class people demanding energy, water, and food.

We first identified Tyco's flow-control business in 2009 as a way to gain scale, diversify beyond residential consumers, and gain greater global coverage. We had no idea if it would ever be an option,

but the point of thinking right to left is to imagine where you'd like the company to be, and then to be open to the opportunities as they present themselves. You create the future you imagine.

When Tyco decided to spin off its flow-control business, they recognized that it needed some common operating disciplines and that we already had a corporate office we could leverage. Secondly, we had a strategic road map of how the businesses would fit together. Thanks to those operating disciplines, we've been able to

## Randall Hogan



### Vital statistics

Born in 1955, in Framingham, Massachusetts

### Education

Attended the US Coast Guard Academy from 1973 to 1975

Graduated with a BS in civil engineering in 1977 from the Massachusetts Institute of Technology and an MBA in 1981 from the University of Texas at Austin

### Career highlights

**Pentair** (1998–present)

Chairman (2002–present)

CEO (2001–present)

President and COO (1999–2000)

Executive vice president and president of Electrical and Electronic Enclosures Group (1998–99)

**United Technologies** (1994–97)

President, Carrier Transicold Division (1995–97)

**GE** (1988–94)

Various executive positions

**McKinsey & Company** (1981–87)

Consultant

### Fast facts

Received Ernst & Young's Entrepreneur of the Year Lifetime Achievement Award (2013)

Serves as deputy chair of the board of the Federal Reserve Bank of Minneapolis

Sits on the board of trustees of American Public Media Group

Is a member of the board of directors for the Guthrie Theater, in Minneapolis

Is a member of the board of directors for Covidien

extract the necessary synergies to pay the bills. It was what we call a “Goldilocks” deal—the combination and price were just right.

**The *Quarterly*:** *How do you routinely allocate capital to the best businesses?*

**Randall Hogan:** Rarely do the business units have the altitude or the amplitude to think big. So it’s the job of the corporate center to say what’s next.

But the decisions on nurturing and pruning do happen inside the business units, and we try to encourage a dialogue around that. In the old days, we used to call the capital-allocation model “first pig to the trough,” and the biggest pig usually won. I’m not sure we’re totally weaned off that, but the process now starts with the 33 platforms we’ve identified across Pentair—platforms with a little *p* that could be anything from a $600 million product line to just an idea. We take a look at all the opportunities. Some are cash cows, and some need more resources put into them.

What we’re trying to do is to turn what’s been predominantly a budgeting process into a more strategic allocation of capital. My big focus right now is getting the business culturally ready for that. We have seven global business units run by really talented people who all want to run their own show. My challenge is to encourage the notion that they are part of Pentair, as opposed to running a Pentair division. In organizations, there is always deep inertia, a reluctance to change things. You have to introduce energy in a radical way to change the corporate gyro.

**The *Quarterly*:** *How have you tried to change people’s thinking?*

**Randall Hogan:** We’ve set questions at the outset of the planning process, listened to their ideas, provided feedback, and attempted to get them to think more nonlinearly—challenging them about markets that are not growing or ones where there is a clear mismatch of resources. How do you run a market with 25 percent of your sales but only 15 percent of your sales people? We’re not saying, “Do it.” We’re saying, “How would you do the thought exercise?” They may be big in the United States and Western Europe, but the opportunities are in Indonesia and Brazil.

For five years, I've been saying we need more talent in the fast-growth markets and our best talent against our best opportunities. At our global leadership meeting, one or two global business units sent 30 people, but only one of them came from Asia, despite the region's representing 50 percent of their opportunities for growth. That doesn't make sense.

**The *Quarterly*:** *What's next for Pentair?*

**Randall Hogan:** We have been through a huge shift in the last few years, from 20 percent to 60 percent of our sales outside North America, and from $1 billion to more than $12 billion in market cap; from being the largest unknown company in Minnesota to one with a much higher, global profile. In the future, we're going to be even bigger outside North America, because growth rates elsewhere will be higher. Our aim will be to grow faster organically in these markets. Although that doesn't mean that we won't do more acquisitions, we now really have to develop our organic-growth genes. Strategically, we're interested in the food space and we're really interested in energy.

A language of performance is important—our lean enterprise, process improvement, and talent-management principles are all about that. But we're also working hard to clarify the underlying purpose of the company—improving the quality of life for people around the world—and to be the next great industrial company. Our values are about "winning right," and we're going through a process right now to tie that philosophy to our operating principles. I want to get 30,000 people all heading in the same direction, or, as Lee Walton, an old McKinsey mentor with Texas roots, said to me, "You know, management is about getting everyone roughly heading west." And I would modify that with these words: "as long as west is the direction you want to go." o

This interview was conducted by **Rik Kirkland,** senior managing editor of McKinsey Publishing, based in McKinsey's New York office.

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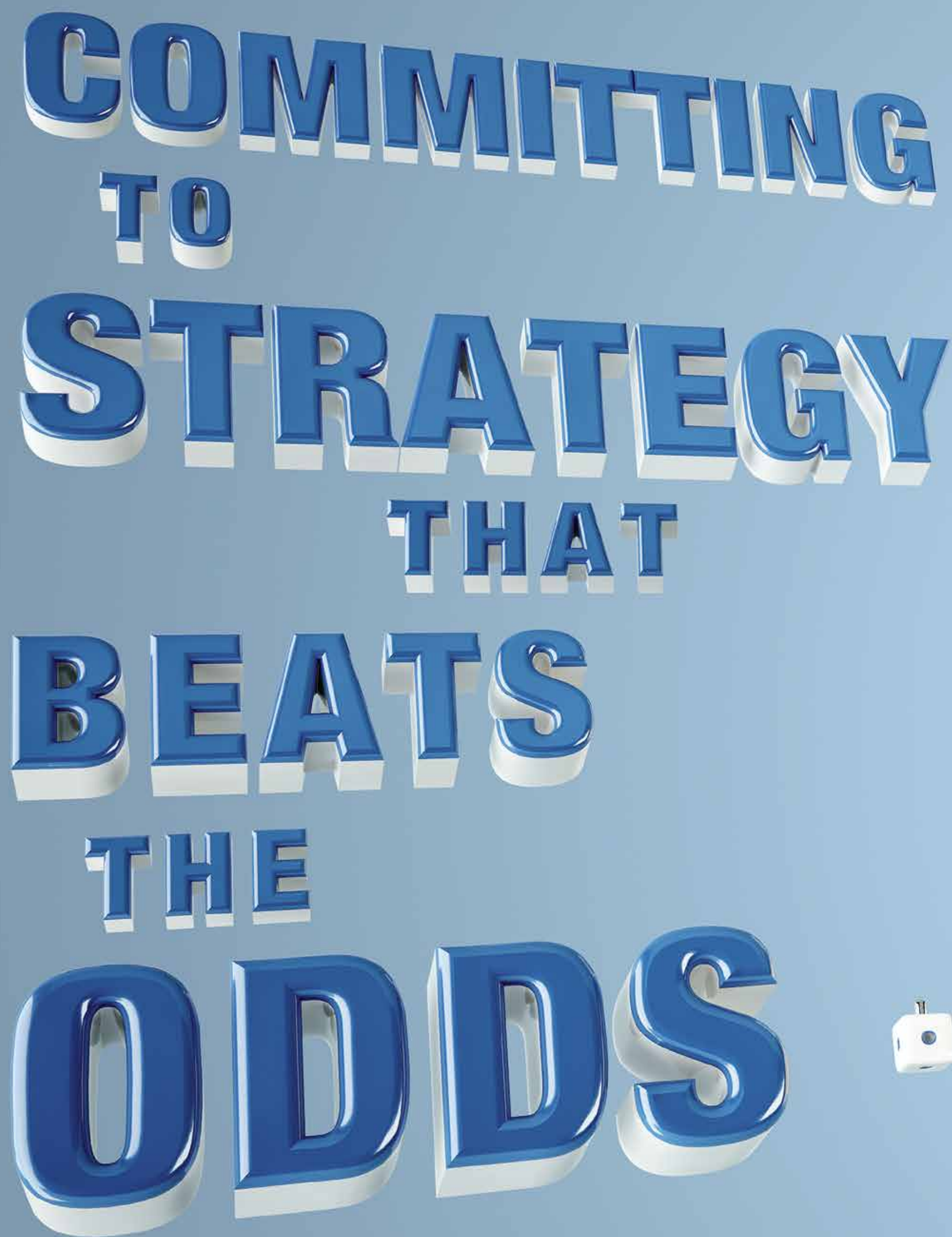


**56**
**Never let a good crisis go to waste**
Mladen Fruk, Stephen Hall, and Devesh Mittal

Illustration by FOREAL™

Great strategic thinking goes for naught when corporate resources aren't reallocated as strategies shift. This sounds like a truism, yet McKinsey research has repeatedly shown that inertia is the rule, not the exception. The financial and economic crisis didn't change that equation, according to new research, which also highlights the value of decisive moves by new CEOs. Rounding out this package are ten techniques for overcoming inertia and ideas from a CEO who has boldly led the way.

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# Never let a good crisis go to waste

**Mladen Fruk, Stephen Hall, and Devesh Mittal**

New research shows that actively reallocating corporate resources is even more important in a downturn than it is in good times.

**The vast majority** of organizations are surprisingly slow to reshuffle their resources. When we conducted a large-scale analysis of the reallocation patterns of multibusiness companies, for instance, we found that most of them awarded each business in their portfolio an unchanging percentage of total corporate capital year after year between 1990 and 2005. Yet the returns were higher and the volatility lower at organizations that reallocated more actively.

When we present these findings (which we highlighted in a previous *McKinsey Quarterly* article[1]) to senior executives, they often ask us about the impact of the financial crisis and the downturn that followed. Surely, they argue, a tougher economic environment has led to more pronounced changes in resource-allocation patterns as companies were forced to look for new sources of value.

In fact, this proves not to be true. When we extended our analysis through 2010, thereby covering a full 20 years of performance by 1,500 companies, we found that the downturn had virtually zero impact on patterns of reallocation.[2] There was apparently no

[1] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, 2012 Number 2, mckinsey.com.

[2] Resource allocation is measured as 1 minus the minimum percentage of capital expenditure received by distinct business units over the 20-year period from 1990 to 2010. We used Compustat data on 1,508 US-listed companies that reported capital expenditure in a minimum of two distinct four-digit Standard Industrial Classification (SIC) codes.

greater aggregate corporate appetite for it in the tough recent years than there had been in the previous 15.

Yet the executives' instincts are right: dynamic resource allocation became more critical than ever during the downturn. Compare the performance of companies in the top third of our pool (high reallocators) with the performance of those in the bottom third (low reallocators). As Exhibit 1 shows, the gap between the total returns to shareholders (TRS) of the high reallocators, on the one hand, and of the low reallocators, which evolved their allocations only modestly over the 20 years, on the other, increased from 2.4 percentage points to 3.9 percentage points as a result of the extra five years. That may not sound like such a big gap, but 3.9 percentage points of annual incremental returns to shareholders implies that an investor's stake in our sample's typical high reallocator was worth more than twice as much as a stake in an average low reallocator by the end of the 20-year period (assuming all dividends were reinvested).

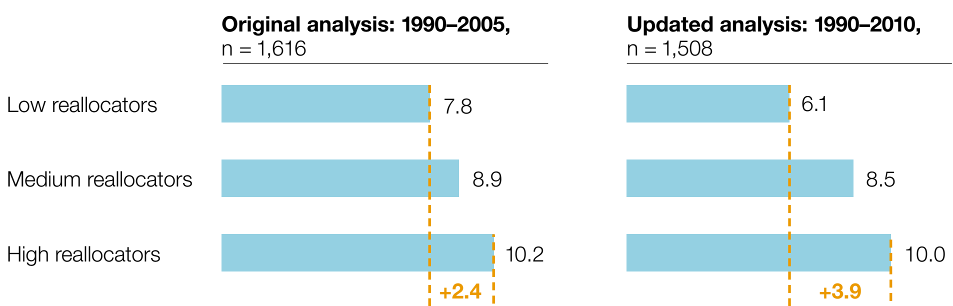
When we looked at companies sector by sector, the same broad pattern emerged: whether in basic materials, energy and utilities, information technology, or consumer products and retailing, the median TRS was consistently greater for the high reallocators than for the low ones.

A similar story is apparent in the corporate-survival statistics. Over the new, longer period of our study, the survival gap between

Exhibit 1

**Companies that actively reallocated their resources continued to perform better through the 2007–10 economic downturn.**

Median TRS CAGR for US companies, by degree of reallocation,[1] %




[1]TRS = total returns to shareholders; CAGR = compound annual growth rate. Degree of reallocation measures share of capital expenditure shifted between business units over given period; low reallocators = bottom third by reallocation activity, medium = middle third, and high = top third.

Source: Standard & Poor's Compustat; McKinsey analysis

high and low reallocators increased to 22 percent, up from 13 percent in the original period.

In addition, since our data now cover both of the major global economic downturns of the past 20 years (for our purposes, 1999 to 2002 and 2007 to 2010), we can divide companies into those slow to respond by reallocating resources in the two crises, those that actively reallocated in only one, and those that did so in both. The results speak for themselves (Exhibit 2). On average, a company that was a high reallocator during both downturns had a TRS 3 percent greater than a company that was a high reallocator in only one and 4.5 percent greater than a company that wasn't in either.

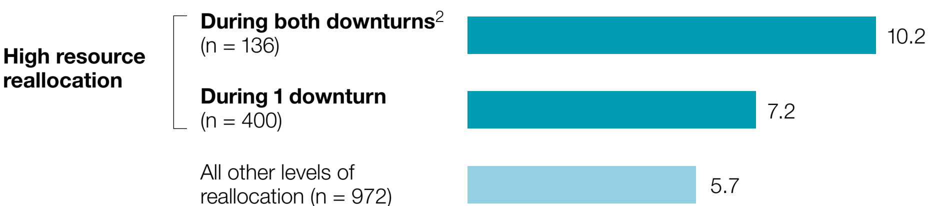
Realizing the benefits of resource reallocation during a downturn often requires shifting capital and other resources from one existing business to another: when times are tough, there is generally less new capital around, either in the form of growth in retained earnings or of new debt and equity capital. From 2007 to 2010, for example, the volume of new capital available to corporate-management teams in our sample declined by over 15 percent.

In these circumstances, it is more incumbent than ever on companies to make difficult trade-offs between the funding of promising growth opportunities (which require nurturing with more capital) and of mature or underperforming ones (which may need pruning). We found that high reallocators in our sample tended to reallocate existing and new resources equally; low reallocators, by contrast, had a much harder time taking resources away from existing lines of

Exhibit 2

**Companies that reallocated their resources during tough times enjoyed significantly higher returns.**

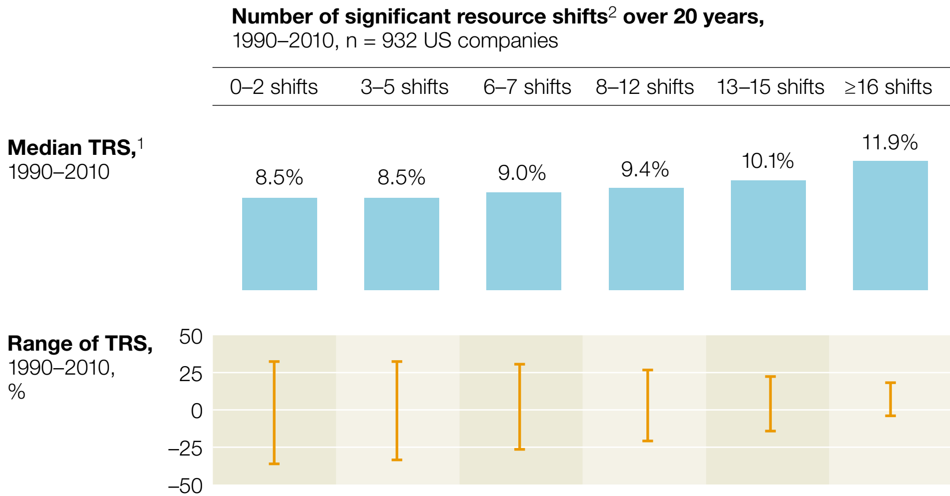
Average TRS for US companies, 1990–2010,[1] %




[1]TRS = total returns to shareholders; low reallocators = bottom third by reallocation activity, medium = middle third, and high = top third.
[2]Downturn periods defined as 1999–2002 and 2007–10.

Exhibit 3

**Companies that consistently reallocated their resources experienced higher and less variable returns.**




[1]TRS = total returns to shareholders.
[2]A significant shift is one that moves >5% of total capital-expenditure allotment.

business and tended predominantly to reallocate new resources. The willingness to rob Peter to pay Paul is one of the hallmarks of a dynamic top team.

This is not to say, however, that sharp, one-time swings of focus in response to a changing external environment generally make sense. Rather, our new data suggest that markets most reward companies that do not overreact to short-term signals by making large, abrupt changes in business focus but instead pursue multiple, stepwise shifts in resources, year after year, in pursuit of a clear strategy. That approach tends to produce better returns and lower volatility than one or two Herculean changes to a corporate portfolio (Exhibit 3).

These results suggest to us that resource reallocation is a muscle that requires exercising in good times and even more in bad times. Companies should be on their guard against inertia at all stages of the cycle—and may need to be particularly ruthless in a downturn, especially when new sources of capital dry up. ○

The authors would like to thank Reinier Musters for his contribution to the development of this article.

**Mladen Fruk** is a consultant in McKinsey's Bucharest office, **Stephen Hall** is a director in the London office, and **Devesh Mittal** is a specialist in the McKinsey Knowledge Center in Gurgaon.

# Avoiding the quicksand: Ten techniques for more agile corporate resource allocation

**Michael Birshan, Marja Engel, and Olivier Sibony**

**These tested ideas can help organizations overcome inertia and implement their strategies more effectively.**

**Insanity has been** defined as doing the same thing over and over again and expecting different results. Many senior executives face exactly this situation in allocating critical corporate resources. Every year, they turn the handle on the same strategy-development, capital-planning, talent-management, and budgeting processes, and every year the outcome is only marginally different from the one they reached in the previous year and the year before that. Business leaders readily accept that strong corporate performance demands bolder shifts in resources over time; most even agree that this is one of the most important roles of a CEO and top team. Yet they remain prisoners of management processes that have evolved to deliver the exact opposite of what they are looking for.

Refocusing those processes can deliver different results. We do not yet have an exhaustive list, but we've been collecting, refining, and adapting a rich menu of ideas for shaking up the corporate status quo. Here are ten proven techniques for putting better information on the table, encouraging boldness, cutting through corporate politics, and improving accountability in this critical area.

1. **Create a corporate-resource map.** Some companies now choose to allocate resources at the level of literally hundreds of product and market "cells," such as product or geography categories. While that's too detailed for others, the key, in any case, is to go beyond the big divisions and develop a map that's granular enough to see where resources are currently deployed. Make sure it goes beyond capital spending, to include marketing expenditures, R&D funds, and top talent. Such maps—which one company we know brings to life on a tablet app highlighting resource requirements, returns, and growth options—give corporate decision makers the visibility they need for trade-offs between activities and initiatives a level or two below the business-unit level. This detailed transparency is typically required to change the allocation of resources in organizations that have powerful divisional leaders.

2. **Benchmark your "resource inertia."** A number of companies have begun to measure the correlation between the percentage of resources each cell in their portfolios received in the most recent year and what it received in previous years. We encourage you to do the same—like them, you'll be surprised by how often the answer is well above 90 percent. This provides a good measure for tracking whether a company really reallocates its main resources.

3. **Reframe budget meetings as reallocation sessions, and run them accordingly.** This may mean introducing unorthodox approaches, such as giving investment-committee participants a small pile of poker chips and asking them to "place bets" on projects they think deserve funding. Such an approach concentrates minds on the big picture, not individual silos, and makes all of the people in the room aware that a company has other priorities besides their own pet projects. Also useful is the technique of "stage gating," the common practice—in R&D- or capital-intensive organizations—of setting performance milestones and releasing additional resources only when intermediate targets are hit. This forces periodic debate when new tranches of resources must be released.

4. **Develop a formal "counteranchor."** One common cognitive bias, known as "anchoring," is to base next year's allocation uncritically on the previous year's. Leaders can encourage debate by, for example, circulating independent analysts' reports on the growth outlook for their different markets. One consumer-goods company uses external growth and profit-potential data, down to the level of individual cities, to create a hypothetical allocation of advertising expenditures. Often, it is so different from the company's current allocation that it shifts debate from whether spending should be 110 percent or 90 percent of last year's figure to whether it should be 200 percent or 50 percent.

5 **Change your strategy-setting rhythm.** While companies rightly want their deliberations on strategy to influence resource shifts, too few allow sufficient time between the conclusion of the strategic direction setting and the locking down of resource-allocation decisions. This approach leads to allocations that are very similar to the previous ones, because the planners then say, "Our bottom-up planning process has spoken, and it's too late to change now." Better to share unrefined strategic direction with the wider organization early on rather than wait to issue a more complete one that arrives too late to make a difference.

6 **Build flexibility into the process.** Opportunities—whether to nurture existing businesses with additional capital or to acquire new assets at knockdown prices—often pop up once annual allocations have been locked down. One large natural-resources group allows its CEO to allocate 5 percent (in practice, usually well over $1 billion) of its capital expenditures at his own discretion. A biotech company creates two budgets, red and blue: one based on business as usual, the other ready to be implemented quickly if a pending major clinical trial has a positive outcome. It's also worth considering the creation of a separate "rolling" budget: a discretionary pool that can be allocated over the year rather than at a single point in the calendar. This flexibility is particularly important for volatile emerging markets and cyclical industries, where the benefits of moving resources quickly are often high.

7 **Learn to let go.** One of the most difficult parts of allocating resources is getting out of businesses that have served a company well in the past but are now stagnant or worse. One useful approach is for the investment committee, once a year, to conduct a formal exercise imagining that the company isn't in any of its businesses and then to ask whether the market fundamentals would make investments in each of them compelling. As a matter of policy, one large energy group makes sure that it disposes of at least 2 to 3 percent of its portfolio every year.

8 **Make it easier to move the top 100 to 300 people.** Much management talent works in the business units, and rightly so—that's where companies create value. But many business-unit heads tend to hang on to their star executives, which complicates the people side of resource reallocation. Fighting these natural instincts requires action at the top. Several global CEOs think of their companies' top ranks as a corporate asset to be applied to opportunities that offer the highest returns. Tactics that facilitate this approach include a corporate review of all top talent, as well as standardizing job titles and role descriptions across the top 200 or so executives and compensating them on the same basis regardless of geographic location. Such ground rules make it easier for the top team to mix, match, and move top talent.

9 **Don't forget about time.** Even without moving capital or people, companies can shift management's emphasis dramatically by taking a clean-sheet approach to the way the top team spends its time. Some companies set a time "budget" for the top team to clarify how much leadership capacity exists to "finance" initiatives and whether management is really focused on the highest strategic priorities. Time can also feature on the resource map.

10 **Look back and learn.** Reviewing earlier investment decisions helps companies refine the resource-allocation process. One company responded to such a postmortem review by insisting that no future investment proposal come forward for discussion unless independent technical- and business-evaluation teams had formally signed off on it. The company also required each individual executive on the investment committee to cast a formal vote for or against every specific investment and recorded such votes for posterity.

We don't pretend that each of these ideas for refocusing resource-allocation processes is relevant to every business. Rather, we hope that they will inspire management teams to talk through what adjustments they need to make within their own organizations to deliver better resource outcomes. Ultimately, it is the CEO's job to adjust a company's processes so that they truly allocate resources strategically.

*The authors would like to acknowledge the contribution of Blair Warner to the development of this article.*

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# How quickly should a new CEO shift corporate resources?

**Stephen Hall and Conor Kehoe**

Moving early to reconfigure the business portfolio and top-management team improves corporate performance and the odds for a lengthy tenure.

**New CEOs** face a critical strategic choice. Should they settle into the job, spend a year or more getting to know their businesses, and then start shifting the portfolio? Or is it better to act quickly and boldly early on to divert resources from mature activities to a new generation of corporate opportunities?

We observe CEOs following both approaches, but one appears to deliver superior results: between 1990 and 2010, chief executives who reallocated corporate resources early in their tenures generated materially stronger returns for shareholders than those who waited. In the process, these active CEOs also seem to have prolonged their own time at the top. What's more, a similar decisiveness in changing the composition of the top team also brought disproportionate longer-term rewards.

In our database of more than 1,500 multibusiness public companies in the United States, we identified a subset that reported changing their CEOs. We then divided the 365 "new" CEOs in our database into two roughly equal groups: those who were slow to reallocate capital across the business portfolio during their first three years and those who were fast to reallocate it.[1] When we correlated these results

[1] For the first three years of a CEO's tenure, we used flow-reallocation measurements calculated as 1 minus the minimum percentage of capital expenditure received by distinct business units. The CEOs of bottom-half companies were classified as slow reallocators and the top half as fast ones.

with a CEO's individual tenure, we discovered that just over one-third of the relatively inactive CEOs had moved on by year six, but only a quarter of the fast leaders had.

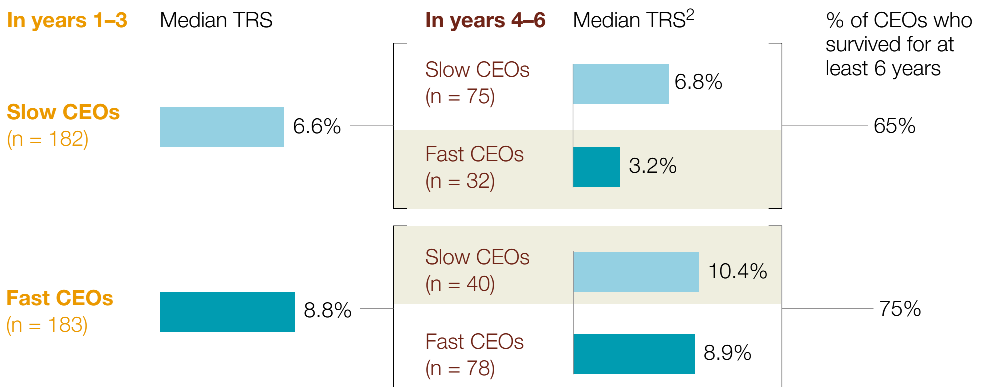
The best results were achieved by CEOs who moved swiftly early on and then throttled back the rate of resource-allocation change to allow the market to understand and value their early actions. By contrast, late starters—those who were slow to reallocate capital during the first three years of their mandate but then picked up the pace of change—did not find themselves as well rewarded by the market. Exhibit 1 compares the total returns generated by companies with "fast–slow" versus "slow–fast" CEOs.

As we have argued in our companion article focused on the downturn, (see "Never let a good crisis go to waste," on page 56), the key to allocating resources actively lies not just in acquisitions and disposals but also in the undoubtedly more difficult challenge of taking capital away from mature, often well-performing businesses and reinvesting it in faster-growing alternatives. Fast CEOs are much

Exhibit 1

**CEOs who initiated resource reallocations early in their tenures—but slowed down the pace later—generated superior returns.**

**Speed of resource reallocation and 6-year median TRS,** based on 365 US-listed companies[1]




[1]Includes companies with a change in CEO, subsequent CEO tenure of at least 3 years, and reallocation data available for the first 3 years of tenure; slow reallocators = bottom half by reallocation activity; fast = top half; TRS = total returns to shareholders.
[2]Deflated to account for survivor bias; excludes companies whose resource-reallocation data were not available for the 4–6 year period.

more inclined to do so than their slow counterparts are (Exhibit 2). Interestingly, CEOs recruited from outside a company appear to find it easier to undertake such nurturing and pruning of existing portfolio businesses than do those appointed from the inside.[2] Internal candidates, notwithstanding their more intimate knowledge of the company, may be more reluctant than outsiders to prune businesses overseen by their former peers. New inside CEOs, moreover, may have a bias in favor of the existing portfolio. After all, it is always hard to be objective about children you yourself have raised.

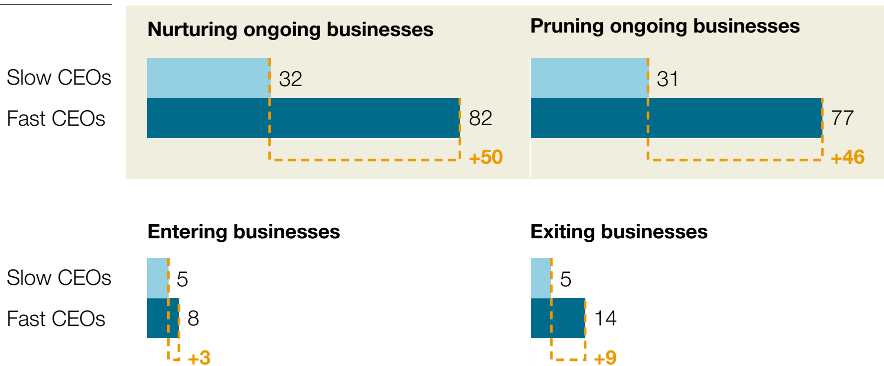
The value to CEOs of making swift and meaningful changes in the allocation of resources applies not only to capital but also to top talent. Our data show that CEOs who add or subtract members of their executive committees within the first year of their tenure are likely to survive longer and to achieve higher total returns to shareholders (TRS) in their first three years as chief executive. Our analysis shows that the greatest impact comes from moving swiftly to change the top team rather than from the actual

[2]The CEO is considered an external one if the date when the executive assumed that office was not more than one year from the date when he or she joined the company.

Exhibit 2

**The difference between fast and slow CEOs appears to be most pronounced with respect to nurturing and pruning.**

% of companies executing given activities, based on 365 US-listed companies[1]

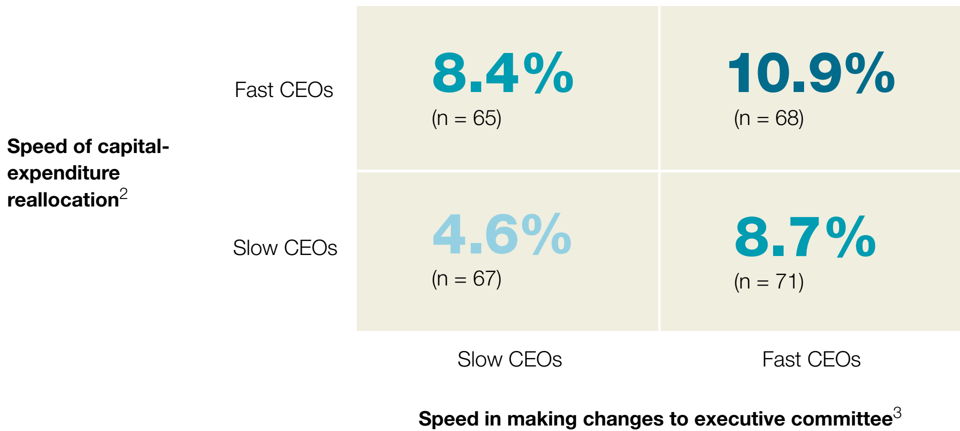



[1]Includes companies with a change in CEO, subsequent CEO tenure of at least 3 years, and reallocation data available for the first 3 years of tenure.
[2]Slow reallocators = bottom half by reallocation activity; fast = top half. Nurturing = increasing an ongoing business's share of company's overall capital-expenditure budget; pruning = decreasing that share.

Exhibit 3

**CEOs who were quick to make top-management changes and reallocated more in their first three years in office generated superior returns.**

**CEOs as fast and/or slow reallocators in first 3 years of tenure, TRS CAGR,**
n = 271 companies[1]




[1]Excludes 2 companies with CEOs who did not add or remove any member during that period. TRS = total returns to shareholders; CAGR = compound annual growth rate.
[2]Slow reallocators = bottom half by reallocation activity; fast = top half.
[3]Fast and slow categories based on percentage of executive-committee members added or removed over the first 3 years of CEO tenure.

Source: Annual reports; Standard & Poor's ExecuComp; McKinsey analysis

number of changes. If CEOs combine this decisive approach to top talent with a rapidly implemented capital-reallocation strategy, the results are even more dramatically positive (Exhibit 3).

CEOs, it appears, should consciously exploit the "honeymoon" period during the early part of their tenure to make the difficult decisions about capital and people. Markets are sluggish to recognize the rewards of reallocation—they usually mark down the shares at first. It takes approximately one to two years for the cumulative TRS effect to turn positive. But the message of our research is that over time, markets will be less forgiving toward CEOs who adopt a prolonged "steady as she goes" policy, as it produces lower long-term TRS.

Our research also suggests some additional rules of the road for new CEOs and members of their senior teams:

- Explain the reallocation strategy clearly. Investors may react badly to any plan that hits near-term earnings, but they will be more

understanding if they know what's happening, the reasons behind it, and the projected time frame for the results. As far as possible, nurture long-term investors—and do not pander to "short-termists."

- Be bold. Don't worry about reallocating too much. We imagined we would find some companies that had reallocated so much that TRS declined as a result. No such example existed in our database covering US multibusiness companies over 20 years. Managers seem strongly biased to do much less than is needed to optimize TRS.

- 'Own' the careers of senior corporate talent. CEOs must ensure that they are free to deploy good people to manage new or expanded activities across the corporate portfolio. The ability to exert a strong influence over the career moves of a company's top 100 to 300 executives is vital for successful corporate reallocators.

- Enlist board support. The most effective board directors, according to a recent McKinsey survey,[3] focus on overseeing the execution of strategy (making sure that people, processes, and resources are in place to carry it out) and on holding management accountable. CEOs should use their boards to reinforce and oversee the changes required to increase the pace and scale of resource reallocation by engaging board members to become challenging but supportive "coaches." ○

[3] See "Improving board governance: McKinsey Global Survey results," August 2013, mckinsey.com.

*The authors would like to thank Mladen Fruk, Martin Hirt, Devesh Mittal, Reinier Musters, and Kurt Strovink.*

**Stephen Hall** and **Conor Kehoe** are directors in McKinsey's London office.

# **Tilting the global balance:** An interview with the CEO of Solvay

The Belgian company is reshaping its portfolio to focus harder on fast-growing markets.

**Many companies** talk about placing a greater emphasis on emerging economies. Solvay, with headquarters in Brussels, has acted decisively in this respect—first by freeing up resources through the €5.2 billion sale of its core pharmaceutical business in 2010, then in 2011 by acquiring Rhodia, a French rival with an enterprise value of €6.6 billion. Rhodia complemented Solvay's chemical portfolio and added a substantial Chinese business.

Responsibility for directing Solvay's latest international expansion lay initially with Christian Jourquin (CEO, 2006–12) and, more recently, with Jean-Pierre Clamadieu, who had been Rhodia's chairman (2008–11) and CEO (2003–11) and became head of the enlarged group in May 2012. Mr. Clamadieu won many plaudits in his native France a decade ago for leading a radical restructuring at Rhodia, and the task ahead is more complex and no less challenging. He recently talked with McKinsey's Hervé de Barbeyrac and Ruben Verhoeven about the importance of strategic agility, radical plans for the group's top talent, the dangers of "sequential" thinking, and the appropriate role for a global CEO seeking to build a fresh culture.

**The *Quarterly*:** *Can you summarize the rationale for the Rhodia acquisition?*

**Jean-Pierre Clamadieu:** I think it was very unusual for a group like Solvay to sell its pharma business without having a specific target in mind for how to spend the proceeds. There was a clear

understanding in 2009 that Solvay did not have the scale or the innovative potential to grow in pharma—and an equally firm belief that the group had the fundamentals to succeed in chemicals with the right acquisition. But there was nothing more than an agreement in principle to reinvest in that sector. In my view, that could only have happened because of the controlling shareholding of the Solvay families. Over the past 150 years, these shareholders have demonstrated their commitment to a long-term strategy for the business. In most companies, investors would have wanted their money back and asked for a special dividend.

**The *Quarterly*:** *How important was it for Solvay to increase its exposure to emerging markets?*

**Jean-Pierre Clamadieu:** Solvay was too much tilted toward Europe, so this was a significant factor in the choice of Rhodia. If things go according to plan, by the end of the year we will end up with one-third of our sales in Europe, one-third in Asia, and one-third in the Americas. That will be a unique position in the global chemical industry. Asia gets a lot of attention these days, of course, but we shouldn't forget that North America is also a very attractive market because of the very favorable energy scenario which has developed there over the last three to four years. Energy is the key input factor for a large number of our chemical products.

**The *Quarterly*:** *How do you ensure that Solvay stays focused on these high-growth opportunities?*

**Jean-Pierre Clamadieu:** The fact that our headquarters is in Brussels and that our top team is still largely European in origin and culture means it is a challenge. We're organized into global business units, or GBUs, not regions, so it is up to each GBU separately to make sure that it has a clear strategy for what Asia and Latin and North America can offer. The job of the corporate team, meanwhile, is to give GBUs the right amount of resources and make sure we exploit our group synergies.

Twelve of our 17 GBUs already operate in Asia—an example is our specialty-polymers business, for which the region is a particular priority. That global business unit has grown historically out of Europe and North America, but it's likely that 40 percent of its sales

will soon be in Asia. So the business is scrambling to develop its Asian teams, something that is certainly much easier thanks to the fact that Solvay, as a group, already has around 5,000 people in Asia, of whom about 3,000 are in China. We also have assets, like our large R&D lab in Shanghai. We have some excellent Chinese executives in the other businesses who are helping with the recruitment.

**The *Quarterly*:** *Is talent a constraint in these markets?*

**Jean-Pierre Clamadieu:** Solvay has been in Brazil for more than 90 years, China for about 30, and South Korea for 35. In all these countries, we have mostly locals in the key jobs. We bring Westerners in for short, very specific assignments, but the days of sending expatriates in large numbers are largely past. The challenge is that whereas 30 years ago there were few Western companies in a country like China, today most multinationals are there, Chinese companies are developing very fast, and the job market is very competitive. We have to work harder than ever to demonstrate that we can offer local talents a rewarding and exciting career path and opportunities to develop their skills.

**The *Quarterly*:** *How do you get the best people in the Solvay group as a whole matched with the most exciting opportunities in the business units?*

**Jean-Pierre Clamadieu:** In some ways, capital is easier to reallocate than people—you can sit in Brussels, look at the annual capital flows of the different businesses, and act accordingly. With people, there is always a tendency to manage in geographic or business "silos." That's why we have recently established a new principle: that the top 300 people in the group are corporate assets. That means we will take a corporate view, obviously in discussion with the GBUs, about the best role for these key individuals. The tendency up to now has been for each business to want to hang on to the good ones. In my view, though, it's important that we offer our top people the chance to contribute to different businesses and acquire different know-how. I am still rather amazed when I travel around and someone says, "This guy started his career in chemicals; now he is in plastics. That's incredible!" This should be the rule, not the exception.

**The *Quarterly*:** *How do you actually manage the capital-reallocation process?*

**Jean-Pierre Clamadieu:** Following the acquisition of Rhodia by Solvay, we ended up with a large and diverse set of activities, so it was important to establish at the outset the strategic intent for each one. Which ones would be growth engines? Which ones sustainable cash generators? And which ones were struggling?

This exercise led to the development of what we call a five-year strategic road map, which we will update each year. In some cases, that update is simple because things have worked out much as we expected; in other cases, it calls for a brand-new road map because the industry environment has changed. The annual review allows us to see where the units are allocating their resources, which ones

## Jean-Pierre Clamadieu

**Vital statistics**

Born August 15, 1958, in Chambéry, France

**Education**

Graduated with a degree in engineering in 1983 from the *Ecole Nationale Supérieure des Mines de Paris*

**Career highlights**

**Solvay** (2011–present)

CEO (2012–present)

Vice chairman of the executive committee (2011–2012)

**Rhodia** (2003–11)

Chairman (2008–11)

CEO (2003–11)

**Fast facts**

Awarded the title of *Chevalier* of the *Légion d'honneur* in 2005

Serves as chairman of the *Mouvement des Entreprises de France's* (MEDEF) Sustainable Development Commission

Serves as a vice president on the board and executive committee of the European Chemical Industry Council

Sits on the board of directors for Faurecia and AXA

are generating cash, which ones consuming cash, and whether the overall financial equation makes sense for the group. Out of this, we are able to see where the capital is flowing and what capital expenditure is required for the individual GBUs.

These annual discussions are intended to send a clear signal to the different management teams: if we agree that you are going to grow, tell us what resources are needed; if we agree that you are there to generate cash and maintain your industry position, you equally know what's expected. Where businesses are struggling—which inevitably they are in the economic environment of mid-2013—you have to make midterm strategic adjustments. An example of this is that by the end of the year, we hope to have constituted a 50–50 joint venture in polyvinyl chloride with INEOS, a leading industry player.

**The *Quarterly*:** *Do you think managing this sort of change is more difficult in Europe than in North America?*

**Jean-Pierre Clamadieu:** It is true we have certain regulations, particularly social ones, which make movement and change more complex. But this is just the way everyone in Europe has to operate. Europe has its place, and exciting things are happening here too. A significant number of our R&D facilities are located in this region, we have excellent relationships with universities here, and innovations continue to flow from our European labs. Even though automotive-industry volumes are suffering in Europe, it is still by far the global leader in technology and innovation. When our businesses come up with innovations linked to automotive, the first markets to respond are in Europe. The reality of Solvay is that we are based in Europe and we have a European culture. There is no reason to fight that reality. We have to fight to maintain the competitiveness of our operations here, and we can't and don't want to put chemical assets on a boat and ship them to Asia or North America.

**The *Quarterly*:** *How do you manage your own time to keep that global perspective?*

**Jean-Pierre Clamadieu:** I obviously travel around the group. But I am starting to wonder if the classic two- to three-day business

trip is still the right way to get this sort of global exposure. For the moment, the priority for Solvay's executive committee is probably to spend time together and to learn to work as a team. The next step, though, could be for members of the top team to spend more significant amounts of time in different geographies. Two to three weeks in a place like Shanghai or Singapore, for example, allows you not only to sit down with local managers but to get to know key suppliers and customers.

I find it quite frustrating when I look at my calendar and see so many dates for next year that are "must do." It's good to organize ahead, of course, but doing so sometimes inhibits flexibility. I am sure it's going to make more sense in the future to take longer trips, and I am now starting to prepare for 2014 with this mind-set. A couple of months ago, I met the global COO of a large Europe-based consumer-goods group who is based permanently in Singapore. After a couple of hours with him, I realized how being based in the European headquarters of a global company gives you a completely different outlook. I am not planning to move to Singapore, but with the benefit of high-quality video and other technology, these days I think we need to spend less time at HQ and longer periods in different regions of the world.

**The *Quarterly*:** *How do you think about your own role in the transformation?*

**Jean-Pierre Clamadieu:** Broadly speaking, there are two types of things that I can do as CEO of a global group like Solvay, and it's very important to keep a balance between them. The first is what I would describe as conceptual work: developing strategies with colleagues, preparing plans for better operations and processes, thinking about the appropriate interventions to change the culture. The second role is to be an active change agent in aligning people's energy with the group's priorities: meeting employees, meeting customers, meeting public officials. There's an important loop here—what I get out of an interaction with stakeholders informs the next conceptual exercise and vice versa. It's what makes the job fascinating and rewarding. One day you are thinking about high-level strategy, the next day you are at a plant explaining to people why they should follow you.

In the 18 months since the integration of Solvay and Rhodia got under way, we have pushed ahead simultaneously on developing a common culture for the enlarged group, on devising a new strategic direction for the businesses, and on driving operational improvements. It would have been easier for us to have moved sequentially—to spend the first two years on integration, the next two on operational excellence, and then get around to thinking about strategy and portfolio management in years five and six. Our markets are changing quickly, and there is no alternative but to move forward in parallel. The destination is probably changing as fast as we are moving.

**The *Quarterly*:** *Solvay celebrates its 150th anniversary this year. Has this prompted any reflections?*

**Jean-Pierre Clamadieu:** There is a saying that nice trees have strong roots—and I think that's a good image. It's interesting that in the same year, we can both celebrate our 150th birthday and make important changes. The history makes me more confident that the transformation will be successful. Looking back, the group has taken many different turns and made many breakthroughs.

Some people think that for the first 150 years of Solvay's existence life was nice and simple and that now everything is changing. That's just not the reality. Before World War I, we were already very international—indeed, we were the largest multinational in the world—but over the years we have faced a lot of challenges and entered and exited many businesses. The one constant is that we have been supported by long-term-minded family shareholders. My mandate is very clear: to carry out the necessary actions so that in 20, 30, and 50 years Solvay remains a leader in the global chemical industry, an industry that is likely to be very different from what it is today. ○

This interview was conducted by **Hervé de Barbeyrac,** an associate principal in McKinsey's Paris office, and **Ruben Verhoeven,** a director in the Antwerp office.

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Artwork by Jacopo Rosatti

# Mobilizing your C-suite for big-data analytics

**Brad Brown, David Court, and Paul Willmott**

Leadership-capacity constraints are undermining many companies' efforts. New management structures, roles, and divisions of labor can all be part of the solution.

**The problem**
As data and analytics transform the business landscape, they place a range of new demands on top teams, which often lack the management capacity to respond.

**Why it matters**
Without sufficient senior leadership, it's difficult to catalyze the widespread organizational change needed to capture data-analytics opportunities.

**What to do about it**
The biggest leadership gaps span six areas. Decide how to fill them by assessing the importance of centralized databases and analytics resources, as well as the ability of business-unit leaders to drive front-line change. Then take action by enhancing the mandates of existing functional or business-unit leaders, adding new roles to provide support for them, or creating new top-management capacity such as a chief data or analytics officer.

**Over the past 30 years,** most companies have added new C-level roles in response to changing business environments. The chief financial officer (CFO) role, which didn't exist at a majority of companies in the mid-1980s, rose to prominence as pressures for value management and more transparent investor relations gained traction.[1] Adding a chief marketing officer (CMO) became crucial as new channels and media raised the complexity of brand building and customer engagement. Chief strategy officers (CSOs) joined top teams to help companies address increasingly complex and fast-changing global markets.

Today, the power of data and analytics is profoundly altering the business landscape, and once again companies may need more top-management muscle. Capturing data-related opportunities to improve revenues, boost productivity, and, sometimes, create entirely new businesses puts new demands on companies—requiring not only new talent and investments in information infrastructure but also significant changes in mind-sets and frontline training.[2] It's becoming apparent that without extra executive horsepower, stoking the momentum of data analytics will be difficult for many organizations.

Because the new horizons available to companies typically span a wide range of functions, including marketing, risk, and operations, the C-suite can evolve in a variety of ways. In some cases, the solution will be to enhance the mandate of the chief information, marketing, strategy, or risk officer. Other companies may need new roles, such as a chief data officer, chief technical officer, or chief analytics officer, to head up centers of analytics excellence. This article seeks to clarify the most important tasks for executives playing those roles and then sets out some critical questions whose answers will inform any reconfiguration of the C-suite. Daunting as it may seem to rethink top-management roles and responsibilities, failing to do so, given the cross-cutting nature of many data-related opportunities, could well mean jeopardizing top- or bottom-line growth and opening the door to new competitors.

[1] For more on the rise of the CFO role, see Dirk Zorn, "Here a chief, there a chief: The rise of the CFO in the American firm," *American Sociological Review*, 2004, Volume 69, Number 3, pp. 345–64.

[2] See Dominic Barton and David Court, "Making advanced analytics work for you," *Harvard Business Review*, 2012, Volume 90, Number 10, pp. 79–83; and David Court, interview with Frank Comes, "Putting big data and analytics to work," September 2012, mckinsey.com.

## Six top-team tasks behind data analytics

Crafting and implementing a big-data and advanced-analytics strategy demands much more than serving up data to an external provider to mine for hidden trends. Rather, it's about effecting widespread change in the way a company does its day-to-day business. The often-transformative nature of that change places serious demands on the top team. There's no substitute for experienced hands who can apply institutional knowledge, navigate organizational hazards, make tough trade-offs, provide authority when decision rights conflict, and signal that the leadership is committed to a new analytics culture. In our experience, the concerted action that's required falls into six categories. Leaders should take full measure of them before assigning responsibilities or creating roles.

### Establishing new mind-sets

Senior teams embarking on this journey need both to acquire a knowledge of data analytics so they can understand what's rapidly becoming feasible and to embrace the idea that data should be core to their business. Only when that top-level perspective is in place can durable behavioral changes radiate through the organization. An important question to ask at the outset is "Where could data analytics deliver quantum leaps in performance?" This exercise should take place within each significant business unit and functional organization and be led by a senior executive with the influence and authority to inspire action.

Leaders at one large transportation company asked its chief strategy officer to take charge of data analytics. To stretch the thinking and boost the knowledge of top managers, the CSO arranged visits to big data-savvy companies. Then he asked each business unit to build data-analytics priorities into its strategic plan for the coming year. That process created a high-profile milestone related to setting real business goals and captured the attention of the business units' executives. Before long, they were openly sharing and exploring ideas and probing for new analytics opportunities—all of which helped energize their organizations.

### Defining a data-analytics strategy

Like any new business opportunity, data analytics will underdeliver on its potential without a clear strategy and well-articulated initiatives and benchmarks for success. Many companies falter in

this area, either because no one on the top team is explicitly charged with drafting a plan or because there isn't enough discussion or time devoted to getting alignment on priorities. At one telecommunications company, the CEO was keen to move ahead with data analytics, particularly to improve insights into customer retention and pricing. Although the company moved with alacrity to hire a senior analytics leader, the effort stalled just as quickly. To be sure, the analytics team did its part, diving into modeling and analysis. However, business-unit colleagues were slow to train their midlevel managers in how to use the new models: they didn't see the potential, which, frankly, wasn't part of "their" strategic priorities.

As we have argued previously,[3] capturing the potential of data analytics requires a clear plan that establishes priorities and well-defined pathways to business results, much as the familiar strategic-planning process does. Developing that plan requires leadership. At a North American consumer company, the CEO asked the head of online and digital operations, an executive with deep data knowledge, to create the company's plan. The CEO further insisted that it be created in partnership with a business-unit leader who was not familiar with big data. This partnership—combining a data and analytics expert and an experienced frontline change operator—ensured that the analytics goals outlined in the plan were focused on actual, high-impact business decisions. Moreover, after these executives shared their progress with top-team counterparts, their collaborative model became a blueprint for the planning efforts of other business units.

## Determining what to build, purchase, borrow, or rent

Another cluster of decisions that call for the authority and experience of a senior leader involves the assembly of data and the construction of advanced-analytics models and tools designed to improve performance. The resource demands often are considerable. With multitudes of external vendors now able to provide core data, models, and tools, top-management experience is needed to work through "build versus buy" trade-offs. Do strategic imperatives and expected performance improvements justify the in-house development and ownership of fully customized intellectual property in analytics? Or is reaching scale quickly so important that the experience and

[3] See Stefan Biesdorf, David Court, and Paul Willmott, "Big data: What's your plan?," *McKinsey Quarterly*, 2013 Number 2, mckinsey.com.

talent of vendors should be brought to bear? The creation of powerful data assets also can require the participation of senior leadership. Locking in access to valuable external data, for instance, may depend on forging high-level partnerships with customers, suppliers, or other players along the value chain.

The radically diverging paths different retailers have chosen underscore the range of options leaders must weigh. Several retailers and analytics firms have established long-term contracts covering a broad sweep of analytics needs. Other large players, both brick-and-mortar and online, have invested in deep internal data and analytics expertise. Each of these choices reflects a dynamic set of strategic, financial, and organizational requirements that shouldn't be left to middle management.

## Securing analytics expertise

Under almost any strategic scenario, organizations will need more analytics experts who can thrive amid rapid change. The data-analytics game today is played on an open and (frequently) cloud-based infrastructure that makes it possible to combine new external and internal data readily and in user-friendly fashion. The new environment also requires management skills to engage growing numbers of deep statistical experts who create the predictive or optimization models that will underwrite growth.

The hunt for such talent is taking place in what has become the world's hottest market for advanced skills. Retaining these valued employees and then getting them to connect with business leaders to make a real difference is a true top-management task—one that often demands creative solutions. The leader of a big-data campaign at a major consumer company, for instance, decided to invest in an analytics unit distant from company headquarters. This other locale had abundant talent and a cultural environment preferred by data scientists and engineers. The leader then closed the loop, ensuring that each unit of the analytics team had a direct connection to a business-unit team at the company.

## Mobilizing resources

Companies often are surprised by the arduous management effort involved in mobilizing human and capital resources across many functions and businesses to create new decision-support tools and

help frontline managers exploit advanced analytics models. An empowered senior player is vital to breaking down the institutional barriers that frequently hamper efforts to supercharge decisions through data analytics. Success requires getting a diverse group of managers to coalesce around change—encouraging alignment across a wide phalanx of IT, business-lines, analytics, and training experts. The possibility of failure is high when companies don't commit leadership.

Take the example of a second transportation company, where middle managers across product areas were tasked with identifying data-analytics opportunities and then pushing them forward. The analytics managers were routinely frustrated when data teams failed to deliver data on schedule or in usable formats. When it came time to embed the resulting analytics into customized tools, managers faced additional frustrations as urgent requests worked their way through routine budgeting and planning processes. The company gave the task of stepping up the pace of its analytics agenda to a top marketing and sales executive, who assembled cross-functional teams including database managers, analysts, and software programmers. The teams rotated across analytics opportunities, steering them from launch to implementation in six- to eight-week bursts. Through this rapid mobilization, the company checked off several analytics priorities only months after the marketing leader took charge.

## Building frontline capabilities

The sophisticated analytics solutions that statisticians and scientists devise must be embedded in frontline tools so simple and engaging that managers and frontline employees will be eager to use them daily. The scale and scope of this adoption effort—which must also involve formal training, on-the-job coaching, and metrics that clearly define progress—shouldn't be downplayed. In our experience, many companies spend 90 percent of their investment on building models and only 10 percent on frontline usage, when, in fact, closer to half of the analytics investment should go to the front lines.

Here, again, we have seen plenty of cases where no one on the top team assumed responsibility for sustained ground-level change. Lacking senior accountability and engagement, one financial-services company weathered several waves of analytics investment and interest only to have efforts fizzle when training and adoption fell short. Dismayed, business-unit leaders then took charge, investing

in ongoing training sessions for managers and end users, pushing for the constant refinement of analytics tools, and tracking tool usage with new metrics. Over time, thanks to the consistent application of analytics, the transformation effort gained the hoped-for momentum.

## Putting leadership capacity where it's needed

As companies size up these challenges, most will concede that they need to add executive capacity. But that leaves unanswered important decisions about where, exactly, new roles will be located and how new lines of authority will be drawn. As we'll outline below, our experience shows that companies can make a strong case for leading their data-analytics strategies and talent centrally or even for establishing a formal data-analytics center of excellence. However, frontline activities (mobilizing resources, building capabilities) will need to take place at the business-unit or functional level, for two reasons. First, the priorities for using data analytics to increase revenues and productivity will differ by business. Second, and just as important, companies best catalyze frontline change when they connect it with core operations and management priorities and reinforce it with clear metrics and targets.

Beyond this bias for pushing frontline mobilization responsibility to business units, there is no single prescription for where and how a company should add leadership capacity. Given the relative immaturity of data-analytics applications, that shouldn't be surprising. Yet as leaders review their options, they needn't fly blind. Pushing for answers to three key questions, in our experience, brings strategic clarity to the needed organizational changes:

1. Will a central customer or operational database be used across business units?

2. Is there a compelling need to build substantial analytics resources internally to retain talent and build proprietary assets and advantages?

3. Within each business unit, can the current functional executives handle the change-management challenge or should the company dedicate new executive capacity specifically for the data-analytics change effort?

We'll illustrate the importance of these issues through examples of companies that have addressed them in different ways.

## When central data assets are key

At many consumer-services businesses, exploiting analytics involves combining transaction data across a number of businesses or channels. That approach allows these companies to shape insights such as how consumers engage with Web sites or decide between shopping online or in stores. These companies often have (or are building) new central data warehouses or data environments, as well as related data-management capabilities. In addition, they often are working through new rules of the road on issues such as how they can access data while protecting consumer privacy or ensure that key customers aren't hassled by unnecessary contacts.

In such cases, an enhanced role for the CIO—spearheading the development of the data-analytics strategy and talent building—is a popular path. Operationally, the CIO takes charge of efforts to develop the data and analytics infrastructure while letting the business units mobilize change aimed at exploiting it.

At one multibusiness consumer-services company, for instance, the board and senior-leadership team recognized that a significant step-up in performance could be achieved if it fully exploited analytics opportunities across business lines by harnessing its multichannel databases. Recognizing the overarching role that the central databases play in the company's agenda, the leadership designated the chief information officer to direct the effort and to define the data and analytics strategy.

The leaders realized that each business unit, by necessity, would have its own targeted analytic priorities, such as strengthening promotional offers or optimizing inventory levels. Moreover, a different group of managers would be applying the insights across business units. The leadership concluded that under these circumstances, managing analysis and frontline training from the center would be a mistake and decided instead that the CIO should partner with business-unit leaders, sharing with them a tiered set of responsibilities.

At present, the CIO is immersed in two key projects. The first is creating a new infrastructure that unites the company's multichannel

transaction data with external social-media and competitive information and delivers the result to business units through an intuitive interface. The second involves building up analytics expertise that can be assigned to different business units but managed centrally, at least for the next couple of years as the effort gains critical mass. The analytics team is led by a deeply experienced executive who reports to the CIO and provides a crucial injection of top-management capacity. In parallel, business-unit leaders are hammering out analytics priorities and building the skills of frontline managers who will use new models to, for example, redirect spending across media channels.

## When substantial internal analytics expertise is core to performance

We are also seeing a second approach, which shares some of the centralized aspects we touched on above but specifically involves companies that decide to build rather than outsource a critical body of advanced analytics expertise. That decision often leads organizations to locate the expertise centrally, where it serves as a common platform for creating value across business units.

At one consumer-facing company, analytics expertise and leadership were concentrated in the finance and risk-management team, which historically had accounted for significant data-related value creation. When the company began pursuing a more aggressive analytics strategy, the CFO took responsibility for several tasks, including defining the basic strategy, overseeing make-versus-buy decisions for the core risk-management analytics tools, mobilizing resources within the function's analytics team, and building expertise.

However, having made these primary decisions about analytics, the CEO and CFO soon realized that significant complementary efforts were needed to secure better data for the analytics team and to reinforce change efforts and revamp several processes across the business units. To lead these initiatives, they established a new position—chief data officer—within the CFO's organization. This CDO proactively manages information, working with business managers to identify both internal and external data they may not even realize exists. Delivered ready for analysis, the data can be applied rapidly to needed tasks by modeling experts and, just as important, continually refreshed for new experiments and broader application. Many companies may find they need this type of

leadership to support business leaders as they identify sources of data-driven advantages, work through analytics priorities, and try to accelerate frontline adoption.

## When managing scale and complexity within business units is paramount

Whether elements of the effort are managed centrally or not, much of the data-analytics heavy lifting will fall on business or functional leaders within individual business units. A core question at the business-unit level is whether to add a new role or ask a key functional leader (such as the CMO or the head of operations) to add new responsibilities to what in all likelihood is already a pretty full plate.

When the senior leaders of a large financial-services company took a wide-ranging look at its strategy, they decided that one business unit could gain a significant competitive edge if it doubled down on data analytics. To push the strategy ahead decisively, the company recruited a chief analytics officer, who reports to the business-line president and oversees a new center of excellence drawing on internal consultants, analytics modelers, and software programmers.

This approach, which represents a significant organizational change, is accelerating the business unit's data-transformation effort. As a top-team member, the CAO can drive a broad range of decisions, from setting analytics strategy to defining the responsibilities of frontline managers. Since the center of excellence spans multiple disciplines, the CAO can mobilize analytics and software-programming resources swiftly, which has sped up the creation of frontline tools. Meantime, operating from within the business unit has given him a deeper understanding of what makes it tick—its priorities, patterns of working, and ongoing challenges. This has paid off in sharper decisions about which tools to develop and a keener sense of the skills that training programs need to foster. The fact that the business unit's leaders are engaged with the CAO on a day-to-day basis helps keep them focused on their analytics and adoption agendas.

Building on this success, the company has recently taken the further step of adding another new role, a chief data officer, who reports to

the CIO but works daily with the chief analytics officer to help knit together data and new analytics tools and to speed frontline change.

For companies pursuing the potential of data analytics, a decision about leadership capacity looms—regardless of where in the end they decide to place it. For some, such as the consumer-facing companies described earlier, current top-team members will be asked to step up and assume broader leadership responsibilities, often with additional support from new, senior lieutenants. For others, such as the financial-services company we explored, establishing one or more new senior posts to drive the analytics agenda will be the best solution.

At all companies, top teams, and probably board members as well, need a better understanding of the scale of what's needed to ensure data-analytics success. Then they must notch these responsibilities against their existing management capacity in a way that's sensitive to the organization's core sources of value and that meshes with existing structures. None of this is easy, but it's the only serious way to pursue data analytics as a new frontier for growth. ○

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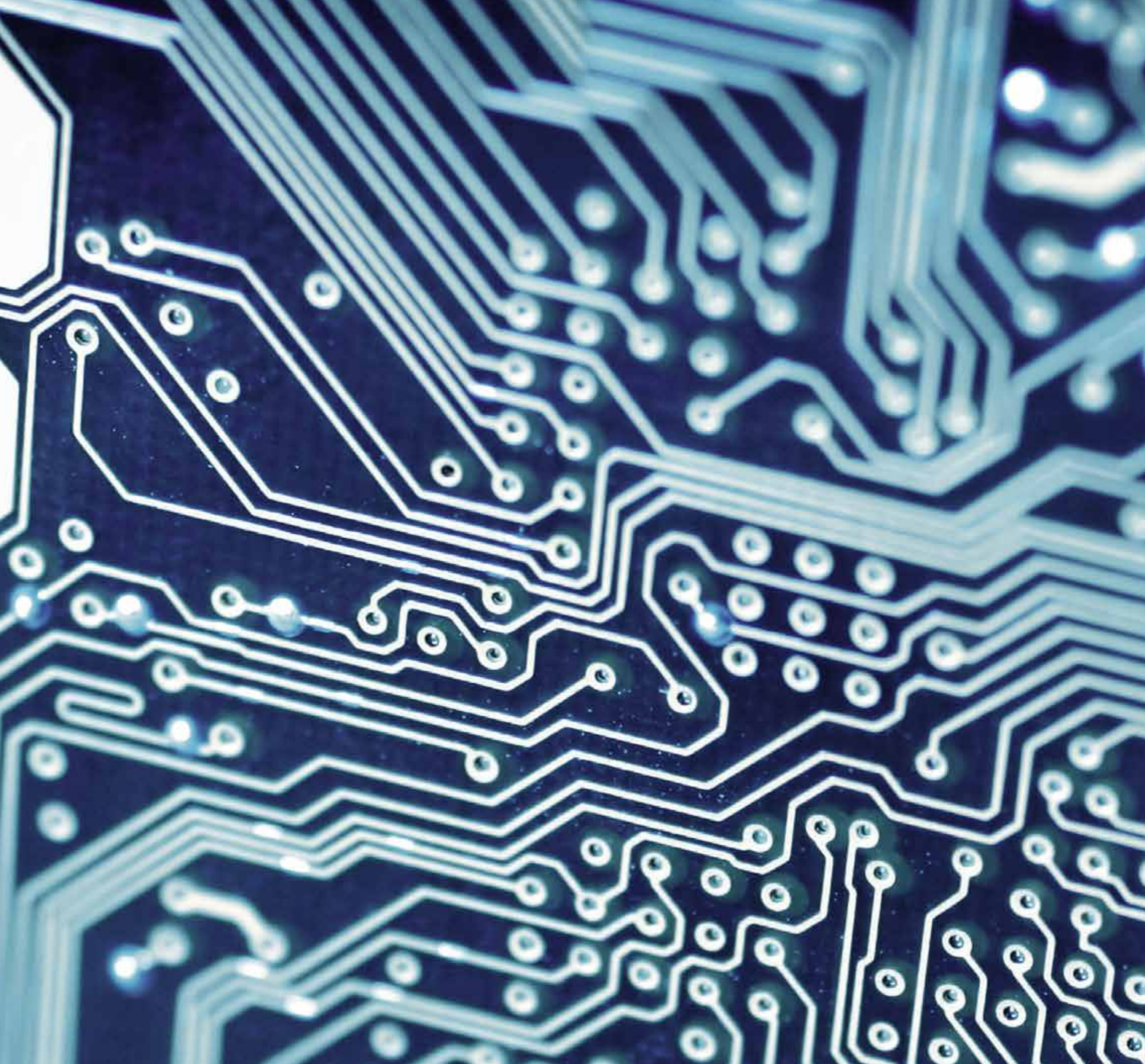

# Measuring the full impact of digital capital

**Jacques Bughin and James Manyika**

Although largely uncounted, intangible digital assets may hold an important key to understanding competition and growth in the Internet era.

**On July 31, 2013,** the US Bureau of Economic Analysis released, for the first time, GDP figures categorizing research and development as fixed investment. It joined software in a new category called intellectual-property products.

In our knowledge-based economy, this is a sensible move that brings GDP accounting closer to economic reality. And while that may seem like an arcane shift relevant only to a small number of economists, the need for the change reflects a broader mismatch between our digital economy and the way we account for it. This problem has serious top-management implications.

To understand the mismatch, you need to understand what we call digital capital—the resources behind the processes key to developing new products and services for the digital economy. Digital capital takes two forms. The first is traditionally counted tangible assets, such as servers, routers, online-purchasing platforms, and basic Internet

software. They appear as capital investment on company books. Yet a large and growing portion of what's powering today's digital economy consists of a second type of digital capital—intangible assets.

They are manifold: the unique designs that engage large numbers of users and improve their digital experiences; the digital capture of user behavior, contributions, and social profiles; the environments that encourage consumers to access products and services; and the intense big-data and analytics capabilities that can guide operations and business growth. They also include a growing range of new business models for monetizing digital activity, such as patents and processes that can be licensed for royalty income, and the brand equity that companies like Google or Amazon.com create through digital engagement.

Conventional accounting treats these capabilities not as company investments but as expenses, which means that their funding isn't reflected as capital. Since the amounts spent aren't amortized, they take a large bite out of reported income. Spending on those capabilities sometimes *should* be treated as capital, though, since they can be long-lived. Amazon.com's development of an internal search process that promotes recurring sales or the efforts of Netflix to fine-tune personal recommendations to increase video viewing and retain customers are certainly more than expenses. Such capabilities, which are complex to build and replicate, can often help companies create enduring competitive strengths.

We're acutely aware of misguided efforts to justify sky-high valuations during the late-1990s Internet bubble by claiming that finance and accounting fundamentals were no longer relevant. We also recognize that we're far from the first to note the relationship among intangibles, company-level growth and productivity, and overall economic growth.[1] What we want to suggest here is that those relationships, which once represented a small minority of business activities, are becoming the rule in the digital economy. In fact, much of today's digital spending could pay for long-lived intangible assets that will

[1]See, for example, Lowell L. Bryan, "The new metrics of corporate performance: Profit per employee," *McKinsey Quarterly*, 2007 Number 1, mckinsey.com. At a country level, see Carol Corrado and Charles Hulten, "How do you measure a 'technological revolution'?," *American Economic Review*, 2010, Volume 100, Number 5, pp. 99–104.

define the competitive landscape going forward.[2] The rising stakes are seen in the copyright battles between Internet and consumer-electronics companies and in major spending on patent portfolios.

Above all, we want to emphasize the importance, for many business leaders, of making the mind-set shift required to embrace the importance of digital capital fully. The disruptive nature of digital assets is intensifying in markets such as search, e-commerce, and social media (where attackers can build business models with near-limitless scale). Disruptive digital assets are also important in segments where behavioral data and user participation can be monetized, by defining entirely new business opportunities or fostering breakthroughs in collaborative innovation. As the mobile-payments start-up Square is demonstrating in the credit-card arena, increasingly, companies that deploy these assets have the potential to threaten large existing profit pools thanks to the challengers' vastly different economics or radically new ways of doing things.

## The big picture

There are parallels between what's occurring today and during the period, 100 years ago, when electric motors gained widespread adoption. Early in that cycle, companies invested in physical motors, which like today's servers and routers provided a new growth platform. But the more important kind of value appeared after companies began to understand how motors could change almost every process, improve productivity, and stimulate innovation. Companies that captured these benefits were more successful and more valuable than others.

Today, the market valuations of many Internet-based companies are higher than those of their counterparts in other sectors, including high tech. Many Internet leaders earn lower returns on equity than established technology companies do, yet there's no reason to

[2] It's noteworthy that today's valuations coincide with the equity markets' slow recovery from their financial-crisis doldrums. In the late 1990s, when the relative importance of intangibles seemed to be on a continuous upward trajectory, market conditions were quite different.

*(continued on page 94)*

# Valuation and intangibles:
## Viewing the numbers differently

The valuation premium investors place on digitized companies becomes clearer when intangible assets are counted as investments rather than expenses. To illustrate this point, we'll define three pro-forma companies. The first, Company A, represents a baseline: a publicly quoted enterprise that mirrors the US economy across several business variables as compiled by researchers at NYU's Stern School of Business.[1] These variables include total value added,[2] employee costs, investments, depreciation, debt levels, the cost of capital, five-year earnings-growth rates, and taxation.

By early 2013, this pro-forma company was generating a return above its cost of capital in the range of 4 percent. Recently, earnings had grown by 3.8 percent a year. Although the market valued the company at 2.1 times its book capital, historical accounting data suggest that the computed ratio of equity value to book capital should be more like 1.5. Why the gap? Our thesis is that intangible capital is now creating both additional capital and greater marginal returns on it. Highly efficient financial markets recognize this and therefore credit the company with improved growth prospects.

We explore this hypothesis through Company B, which matches our first pro-forma one except that we assume a different stock of and growth rate for invested intangible capital. Here we use estimates by Carol Corrado and Charles Hulten.[3] As the exhibit shows, recognizing the intangible capital at work bridges much of the valuation gap. That's true even though the return on total equity remains flat—intangible-capital returns for Company B are roughly the same as those for tangible capital—and intangible capital depreciates at an accelerated rate, over 7 rather than 20 years. Implicit in the multiple that helps to close the valuation gap is a higher prospective growth rate: 4.3 percent a year.

Finally, we push the analysis to a strong digital player, Company C. Its digital-capital investment, calculated using estimates from our own research, is one-third of its total capital; two-thirds of that digital capital is intangible. As a consequence of fast-changing digital competition, assets are depreciated even more quickly, so Company C's total net capital will be smaller than Company B's. Yet even with a smaller capital base, the valuation gap is closed, since the shift in the asset mix toward digital capital boosts the company's earnings-growth rate to 5.5 percent. A large part of the premium results from the higher returns (and growth prospects) flowing from digital capital.

Of course, this result, like all of the preceding analysis, simply confirms

**Treating intangible investments as assets rather than expenses acknowledges the value added by digital capital and helps explain typical market valuations.**

| | Pro-forma analysis of a public enterprise that mirrors the US economy across several business variables[1] yields: | Yet, analysis based on historical data and traditional accounting assumptions for tangible capital suggests: | Adding either intangibles or digital capital to the valuation restates equity and implied growth rates, explaining the difference. | |
|---|---|---|---|---|
| | **Company $A_1$** | **Company $A_2$** | **Company B** | **Company C** |
| Book value of capital | 59 (tangible) | 59 (tangible) | 82 (tangible + intangible) | 71 (tangible + digital) |
| Price-to-book ratio | x 2.1 | x 1.5 | x 1.5 | x 1.7 |
| **Market value** | **124** | **89** | **123** | **121** |
| | | | Mix of tangible and intangible capital[3] | Mix of tangible and digital capital (2/3 of which is intangible) |

Differences in the price-to-book ratio for different mixes of tangible and intangible capital reflect growth assumptions assoicated with those capital forms.[2]

[1]Based on research by Aswath Damodaran.
[2]Numbers are approximated for simplicity of communication.
[3]Based on US estimates.

Source: Aswath Damodaran, "Valuing companies with intangible assets," New York University Stern School of Business, September 2009; Carol Corrado and Charles Hulten, "How do you measure a 'technological revolution'?," *American Economic Review*, 2010, Volume 100, Number 5, pp. 99–104; McKinsey analysis

the core principle of corporate finance: value creation is a function of returns on capital and rates of growth.[4] The scenarios and assumptions that we've described here in accounting terms (to illustrate the implications of thinking about digital capital in different ways) also reflect the bedrock reality that, ultimately, only improving cash flows can create value.

[1]Aswath Damodaran, "Valuing companies with intangible assets," New York University Stern School of Business, September 2009. The author has also compiled a large data set, which we used subsequently in this analysis. See "The Data Page," on stern.nyu.edu.
[2]Value added in this case is defined as revenue minus all cost of goods sold.
[3]Carol Corrado and Charles Hulten, "How do you measure a 'technological revolution'?," *American Economic Review*, 2010, Volume 100, Number 5, pp. 99–104.
[4]See Richard Dobbs, Bill Huyett, and Tim Koller, "The CEO's guide to corporate finance," *McKinsey Quarterly*, 2010 Number 4, mckinsey.com.

believe that markets are making irrational bets on the growth potential of digitally adept companies. As the sidebar "Valuation and intangibles: Viewing the numbers differently" illustrates, treating digital intangibles as assets rather than expenses clarifies the logic behind valuations. (We based these pro-forma valuation calculations on data compiled by academic researchers, as well as assumptions about rates of intangible and digital investment from our own and outside research.)

Macroeconomic studies we have done suggest that digital capital is growing rapidly.[3] We examined the national-accounts data of 40 countries, assigning values to tangible and intangible assets. In 2005, digital-capital investment represented barely 0.8 percent of GDP for those countries. This year, it will exceed 3.1 percent of GDP. Likewise, the accumulating global value of digital-capital investments has reached more than $6 trillion, about 8.5 percent of nominal world GDP. Globally, levels of digital intangible investment are more than half those of digital tangible investment. In more highly digitized economies, such as Israel, Japan, Sweden, the United Kingdom, and the United States, spending on intangibles represents two-thirds of digital capital's total value.

This activity is also starting to become a major contributing factor in global economic growth. We estimate that digital capital is the source of more than one percentage point of global GDP growth (roughly one-third of total growth). Intangible capital already accounts for two-thirds of that slice, tangible investment for the rest. This growth flows from not only capital deepening but also increased labor productivity—a remarkable thing, since the digital economy has emerged in the relatively brief space of 15 years. By contrast, it took 80 years for steam engines to increase labor productivity to the same extent, about 40 for electricity, and more than 20 for conventional information and communications technologies.[4] (For more on the relationship between capital

[3] See the McKinsey Global Institute report *Internet matters: The Net's sweeping impact on growth, jobs, and prosperity*, May 2011, mckinsey.com.

[4] For more details on the estimated impact of global technologies on growth, see Nicholas Crafts, "Fifty years of economic growth in Western Europe: No longer catching up but falling behind?," *World Economics*, 2004, Volume 5, Number 2, pp. 131–45; and Nicholas Bloom, Mirko Draca, Tobias Kretschmer, John Van Reenen, and Raffaella Sadun, *The Economic Impact of ICT*, Centre for Economic Performance, London School of Economics and Political Science, 2010.

formation and productivity, see sidebar "Innovation, capital, and productivity growth.")

## Navigating the new terrain

Intangible digital capital's role in economic growth gives policy makers one more reason to favor investments in broadband and other forms of Internet infrastructure. Such investments correlate strongly with overall digital-capital levels. In our experience, though, the implications are even greater for executives, who often are not tuned into their organizations' digital strengths or weakness. Few companies have gone through the internal exercise of reclassifying expenditures or segregating benefits from spending on intangibles. And of course, companies can boast a high ROE thanks to strong legacy-product margins but may nonetheless have muted growth prospects as a result of underinvesting in digital capital. To set a more effective digital course, leaders should consider the following ideas.

### Take stock of your assets

Since identifying intangible assets is difficult, companies may be missing growth opportunities. Many have realized only recently that they can use social-media interactions with their best customers to leverage innovation efforts or that they may have unused data they could restructure into valuable big-data assets to sharpen business strategy. Similarly, companies should take stock of how digital capital they don't own may be relevant to the business. A retailer that doesn't have access to digital behavioral data on consumers, for example, may be at a disadvantage. So could a bank whose customers access products through a third-party platform that limits the bank's ability to capture information.

Conversely, companies may wrongly assume that their growth results from conventional capital spending and therefore compromise growth by underinvesting in digital competencies. One online company, for example, stuck to a subscriber pay model in hopes of boosting returns on tangible investments such as server farms. It wound up missing a massive social-networking opportunity that would have yielded far greater returns on advertising revenues.

Our global research shows that the stock of intangible assets varies considerably by region. Some markets have larger numbers of strong digital contenders, others fewer. Companies could make those differences a factor in deciding which markets to enter and where to place digital bets.

## Face up to looming threats

Assume that digital leaders in your competitive zone are relentlessly expanding their intangible assets both to attack existing markets and to create new ones. Amazon.com, for instance, won share from brick-and-mortar retailers with its ease-of-purchase model and its ability to reach long-tail customers. Now it's launching new business models (such as Amazon Prime) to further leverage its user base and logistics capabilities. It's also using tangible server assets to offer cloud-based labor services (Mechanical Turk) that match freelance workers with demand for their labor.

A good first step is to identify which areas of your value chain are most vulnerable—for example, service delivery or weak digital brands. Competitors can slide vertically or horizontally into large gaps, so you'll need to build digital assets quickly as a counterweight. Even companies that have a considerable stock of digital assets should understand that capturing value from them isn't a given. Instead, such companies must define (and relentlessly innovate with) business models that can be scaled up to match those assets.

One clue suggesting that a company might face emerging digital challenges is the existence of businesses that have unusually high levels of revenue per employee in adjacent market spaces. Amazon.com's employee productivity, for example, is double that of traditional retailers. Netflix, similarly, generates more revenue per employee than traditional cable operators do, by leveraging intangibles such as its highly evolved recommendation algorithms. Unusual financial profiles are another warning sign. Since digital funding is counted as operating expenditure, digital leaders often have small capital-investment levels relative to their size and growth potential. They also borrow less, both because they may not need to (some reap sizable market rents from, for example, search licensing fees or patent income) and because banks may be less likely to lend against intangible assets.

## Partner with care

Most companies rely on digital agencies for things like optimizing search marketing. In such cases, they may be ceding digital capital, since they never develop a full understanding of consumer segments or what inspires a customer who searches for their products. Seeing such capability building as an investment may change the logic of using third parties. Similarly, when companies look to established tech players for partnerships shoring up weaknesses, they should be cautious: some seemingly high performers may be on the wrong path and could burden you with outmoded standards and platforms. Alternatively, if you deal with strong players, you may be leaving yourself vulnerable by letting them lead.

The need for growth and competitiveness will force companies to build strong digital capabilities. Viewing them as assets rather than additional areas of spending requires a new set of management and financial lenses. Embracing them is a major shift—but one worth making for companies striving to master a still-evolving landscape.

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# Innovation, capital, and productivity growth

Eric Hazan, Nathan Marston, and Tamara Rajah

Digital capital is an important and growing contributor to many forms of innovation, but other factors are at work, as well. To better understand the range and value of innovation-related assets that contribute to productivity and economic growth, we developed a measure of innovation capital. The metric has three components:

Physical capital refers to investments in information and communication equipment. Across the 16 economies we analyzed,[1] physical capital represents 16 percent of innovation capital. These "hard" assets are counted as investments and thus elements of national GDP.

Knowledge capital arises from investments that build a company's intellectual property and brand equity. This form of innovation capital—including investments in computerized information, R&D and marketing investments, and relevant research spending in universities—represents 60 percent of the total and embodies significant amounts of digital capital.

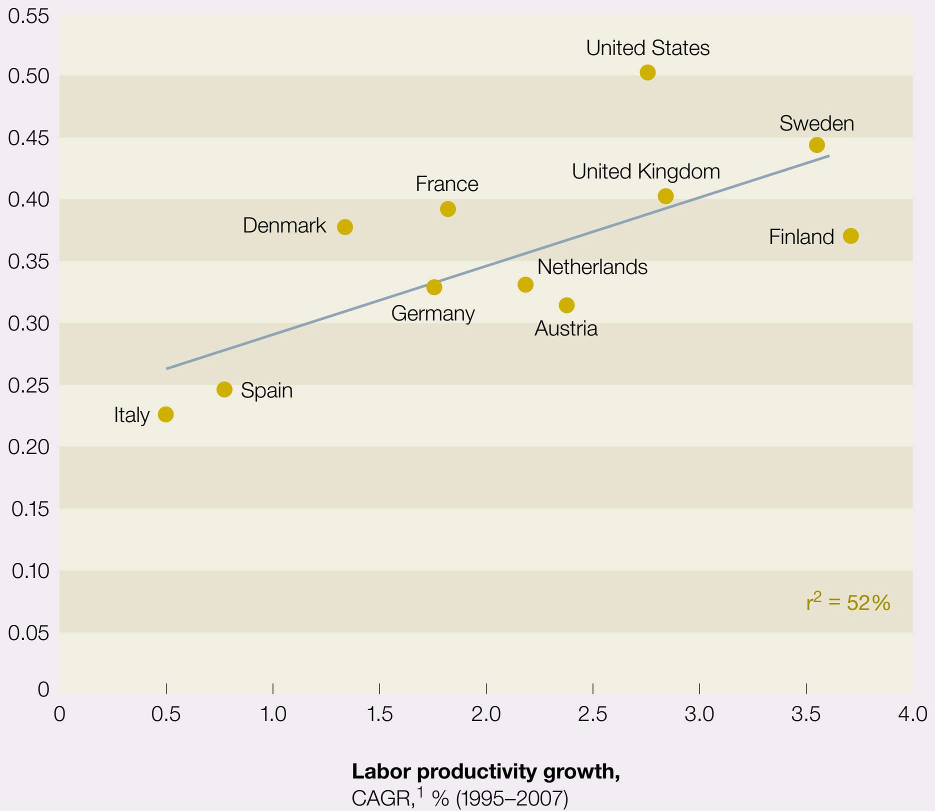
Human capital is formed by investments to build individual or organizational skills that drive productivity growth. It includes public and private investments in tertiary STEM[2] education, employee-based training programs, and investments to develop organizational efficiencies—for example, the redesign of business processes or the adoption of new business models. Human capital represents 24 percent of innovation capital.

The stock of innovation capital is substantial, totaling $14 trillion, or more than 40 percent of the GDP of the 16 nations in our study. (Our colleagues—the authors of the accompanying article—estimate that digital capital represents just under 30 percent of innovation capital.) Over the period we studied (1995–2008), innovation capital grew at an annual rate of 4.6 percent. We also found a strong correlation between levels of innovation capital as a proportion of gross domestic product and labor-productivity growth (exhibit).

[1] Austria, Canada, the Czech Republic, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Russia, Slovenia, Spain, Sweden, the United Kingdom, and the United States.

[2] Science, technology, engineering, and mathematics.

**Innovation stock has a strong correlation with productivity growth.**




$r^2$ is the proportion of variance that is explained by a regression.
[1] 2005 real prices; CAGR = compound annual growth rate.

Source: Carol Corrado, Jonathan Haskel, Massimiliano Iommi, and Cecilia Jona-Lasinio, "Intangible capital and growth in advanced economies: Measurement and comparative results," Centre for Economic Policy Research working paper, Number DP9061, July 2012; McKinsey analysis

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# Doing well by doing good:

## A leader's guide

**Mary Brainerd, Jim Campbell, and Richard Davis**

Addressing community problems increasingly requires cooperation among the private, public, and not-for-profit sectors. Here, three executives explain how a civic alliance in America's Minneapolis–Saint Paul region may point toward an operating model.

**The vitality of our communities** has always required the involvement of the private sector, not just governments or not-for-profit organizations. Unfortunately, despite business leaders' best intentions, these collaborative efforts often founder, fueling skepticism about the private sector's ability to contribute meaningfully to civic advancement.

Changing this equation is in the interest of corporate leaders, for whom the ability to work across sectors is becoming a business necessity.[1] It's in the interest of their companies, which require talented employees attracted to vibrant communities. And it's in the interest of the world's cities, which are confronting unprecedented challenges at a time when many national governments' resources and support mechanisms are wobbling.

[1]Dominic Barton, Andrew Grant, and Michelle Horn, "Leading in the 21st century," *McKinsey Quarterly*, 2012 Number 3, mckinsey.com.

Our group, the Itasca Project, has been experimenting for more than a decade with fresh collaborative approaches aimed at boosting the economic and social health of the Minneapolis–Saint Paul region of the United States, America's 16th-largest metropolitan area, with about 3.4 million people. If you've been to any meeting of your local Chamber of Commerce or Growth Association, you may think you know what a civic alliance such as Itasca does. Ten years ago, we would have thought so, too, because we and our companies had long been trying to work productively with governments and not-for-profit groups in the Twin Cities. But we would have been wrong. Although other organizations play a critical role in communities, Itasca is different. It's an employer-led civic alliance with no individual members, no office, and no full-time staff. We are quite prepared to end Itasca the minute we feel it is no longer adding value. In fact, we debated that very issue—*should we continue?*—at our fifth birthday and again this year, at our tenth.

We keep going because of the opportunities we see to make a difference. In the past decade, Itasca has forged links between the business community and our region's biggest university. It has improved the financial fitness of the region through educational programs and cast a national spotlight on growing socioeconomic disparities. Today, Itasca is working to improve higher education and generating quality-job growth, as well as advancing efforts to address transportation issues comprehensively.

We don't claim to have cracked the code to successful trisector partnerships. But we do think our approach—how we've organized, focused our efforts, relied on hard facts, and involved, personally, our region's key leaders—is different enough to spark useful ideas for corporate leaders in other communities. This article outlines that approach, which has not only made a difference in Minneapolis and Saint Paul but also been extraordinarily rewarding for us as individuals.

## Who we are

Understanding Itasca requires understanding its origins. After World War II, the state of Minnesota enjoyed dramatic economic growth, driven by locally based Fortune 500 companies such as General Mills, Minnesota Mining and Manufacturing (3M), and Northwest Airlines,

as well as private, family-owned empires, including Cargill, Dayton, and Pillsbury. That lineup's not bad for a region that is, for many, flyover country. We don't enjoy sunshine 300 days a year. We don't have beautiful mountains or gorgeous seashore. But for the four decades from the 1950s onward, our focus on those factors we could control—such as the quality of life, education, and the arts—made our state incredibly special and a place where people wanted to live.

As the new century approached, though, our competitive edge dulled. Between 1990 and 1999, Minnesota's share of the nation's initial public offerings and venture-capital investment fell. We began losing the battle for emerging high-technology businesses and slipped as a hub for research and development. By March 2000, David Kidwell, then the dean of the University of Minnesota's Carlson School of Management, delivered a speech titled "Has the Twin Cities economy lost its blue chip status?" Deep down, we all knew the answer. The question was what could be done about it.

Later that year, Mark Yudof, at the time the president of the University of Minnesota, convened 1,200 civic and business leaders to discuss regional competitiveness, and a task force of around 50 local leaders from all sectors was formed. It was a disaster. A group of that many people, representing diverging constituencies and priorities, barely agreed on the shape of the table let alone a path to revitalize our competitiveness.

Yet a fuse had been lit. Rip Rapson, then the president of the McKnight Foundation,[2] organized a breakfast meeting with a small group of business leaders who by now were convinced that something had to be done. Itasca eventually emerged from this, though its creation was far from a foregone conclusion in a region awash with groups ostensibly promoting economic growth and competitiveness.

To decide whether we could do anything worthwhile, we got in touch with leaders throughout the region and conducted interviews aimed at examining the Twin Cities' strengths and weaknesses and the degree to which those issues could be addressed collectively. What we found was room for a different kind of organization: one that was

[2]The Minnesota-based McKnight Foundation, created in 1953 by 3M president and CEO William McKnight and his wife, Maude, provided seed money for Itasca and continues to be a financial supporter.

If the day comes when we find there are no issues to address, we will walk away and Itasca will be no more.

business led while demanding all other perspectives as well and that took a long-term view, peering decades into the future rather than just to the next legislative session. Such an organization should prioritize regional vitality over business self-interest and be willing to take on issues that are inherently difficult to solve.

On September 12, 2003, Minnesota's governor, the mayors of both Minneapolis and Saint Paul, and about 30 other business and civic leaders attended the first organizational meeting. Ten minutes had been set aside for introductions; this stretched to nearly half an hour as participants expressed their passion for the Twin Cities and their hope that the new organization could make a difference. We all believed that a group driven by private enterprises but including a broad set of stakeholders could play a constructive role in reviving the economic competitiveness of Minneapolis and Saint Paul.

When it came to a name, we were inspired by what many regard as the Twin Cities' golden era of business-leader civic engagement. In the 1950s and 1960s, regional business leaders would assemble annually at a state park to discuss critical issues, setting aside rivalries between their companies to contribute to the state's prosperity. The park's name was Itasca.

## Our different approach

All regions are unique. All have strengths and weaknesses. And all have organizations that see their role as promoting economic vitality, business growth, and community well-being. On this basis, you could consider Itasca and the Minneapolis–Saint Paul region as entirely ordinary. Yet we like to think that our results have been extraordinary—and that they are a direct result of the conscious, deliberate ways we sought to think differently about how a civic alliance should operate.

## Organize for action

In the case of Itasca, "organization" refers to how we operate, not what we are. We're not an *organization*. We work virtually, without a formal office. There's no full-time staff, but we have been fortunate to receive support[3] with operations and logistics—such as preparing agendas and documents for meetings—as well as some of the fact-gathering, which is so critical to our work. We leverage personal relationships rather than sell memberships. We have no public-relations people or thirst for recognition. And our budget process comprises a single annual meeting where the total estimated expenses for the year ahead are presented. Invoices are then sent to member companies, with payment optional. We collectively spend some two hours each year worrying about funding.

We do have some external financial supporters.[4] However, we believe other civic alliances have the ability to adopt our overarching approach—all communities have smart people, companies, and institutions that can provide support—especially when the benefits of being freed from traditional organizational structures are so obvious. Being a virtual organization frees us to focus entirely on picking issues and driving for results. It's a collective effort; while working groups are responsible for individual issues, none of us will hesitate to pitch in if we believe we can make a difference. We don't expend time or energy perpetuating an organization for an organization's sake, and if the day comes when we find there are no issues to address, we will walk away and Itasca will be no more.

## Focus on specifics

Everyone learns from mistakes, and Itasca is no exception. When we first tried to determine which issues we wanted to be involved in, we wrote all of them on a white board, voted, and chose six. A shorter list would have been better.

It's difficult to overstate the importance of carefully selecting issues where you believe you actually *can* make a difference, rather

[3] Our support comes in the form of pro bono service from McKinsey & Company. However, potential sources of support include partnerships with universities, rotating personnel from member organizations serving in a full-time capacity for fixed periods, or both.

[4] Itasca receives funding from the Bush Foundation, the Greater Twin Cities United Way, the McKnight Foundation, the Minneapolis Foundation, and the Saint Paul Foundation.

than those where you would like to. The key is to select the pressure points of issues on which a group such as Itasca—driven by the private sector but working collaboratively with all—can have an impact. When we targeted higher education in 2011, for example, our principal task was to narrow down potential action areas. Our task-force, led by Cargill chairman and CEO Greg Page, included executives from major employers, such as Andersen Corporation, General Mills, Target, and Wells Fargo. It recommended four priority areas: training students to meet the needs of employers, fostering a private–public ecosystem of research and innovation, forming new collaborations among higher-education institutions to improve efficiency, and helping to increase the number of students who graduate.

We immediately decided not to address the final priority—that's the responsibility of institutions themselves, with little role for the business community. But we knew Itasca could have an impact on the other three, and implementation teams have worked on each since late last year. Although the work is ongoing, early results are encouraging. To give just two examples: our state's conversation around the issue of higher education has shifted from cutting spending to increasing investment. In fact, Minnesota's 2013 legislative session was dubbed "the education session" for the way it prioritized investment. And the Minnesota State Colleges and Universities (MnSCU) system and Associated Colleges of the Twin Cities (ACTC) have been working in parallel on efficiencies. In fact, by adopting modern procurement practices, MnSCU has saved more than 30 percent on copier paper, and ACTC's board is determining the business case for shared services.

The effort to bridge the gap between education and employment fits neatly with Itasca's broader priorities. We view education, jobs, and transportation as a triangle, with socioeconomic disparities in the center, influenced by the other three. These centerpieces of *our* work have a critical factor in common: they are *local*. Education involves *our* children and students of all ages, as well as teachers. Jobs relate directly to *our* community and what we can do to increase opportunities and the region's attractiveness. Transportation includes *our* roads, bridges, and infrastructure. And the degree of disparity among *our* residents is influenced by all three factors. The

bottom line is that these are challenges where we believe Itasca can make a difference.

## Take a fact-based approach

Gathering the facts is critical to our success. While our working groups may be hypothesis driven, before any recommendation is contemplated they spend weeks or even months examining best practices in the United States and around the world, gathering data via interviews, surveys, and other approaches. Because every recommendation is firmly grounded in fact, this approach underpins our credibility with partners and the broader community. They know that Itasca is—to the greatest extent possible—objective, nonpartisan, and driven only by the desire to improve our community.

Consider the issue that is central to all that we do: disparities. While the issue of socioeconomic inequality has taken center stage nationally in the past five years, Itasca prioritized it from our first formal meeting, in 2003. Even at that point, it was evident anecdotally that the Twin Cities were increasingly dividing into haves and have-nots, with all manner of deleterious effects on our community. Yet we weren't aware of any organization in our region tackling this issue, and, frankly, we were concerned that it couldn't be tackled—it was simply too big to be addressed, especially by a small, fledgling civic alliance.

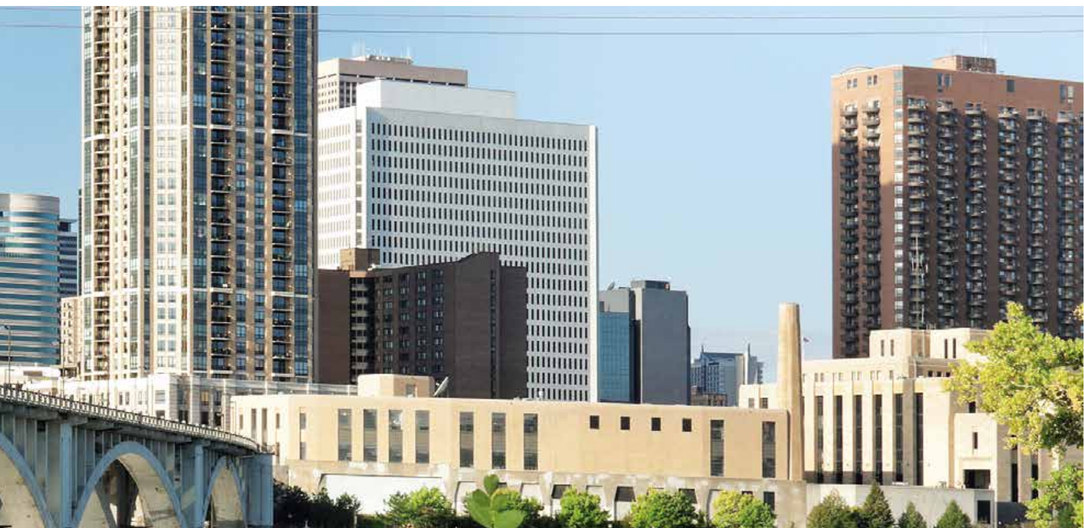
Then we got lucky. We discovered that one of our primary supporters, the McKnight Foundation, was already working with the Brookings Institution's Metropolitan Policy Program to examine publicly available census data on several US cities and determine the types and impact of disparities. We immediately saw an opportunity to become involved, and the eventual report, *Mind the Gap*,[5] was sobering. Although our region is generally regarded as highly educated, with relatively low rates of poverty and unemployment, the report showed worrisome trends emerging. In particular, it showed that fewer people of color attended college, their household incomes were lower, and they tended to live farther from areas where jobs were.

[5]For more, download the full report, *Mind the Gap: Reducing Disparities to Improve Regional Competitiveness in the Twin Cities*, Brookings Institution, October 2005, on brookings.edu.

What made the report, released in 2005, so powerful was that it was grounded in facts—in this case, publicly available data—and that the recommendations based on our analysis came from a unique business perspective. Because all of our member companies are major employers, the fact that we were expressing concern about growing socioeconomic disparities and their potential impact on the future vitality of our region carried significant weight. Some eight years later, we can't claim to have solved the disparities issue. But it is now squarely at the center of all conversations about what kind of community people want the Twin Cities to be and the initiatives that should be pursued to achieve this goal. That would never have happened without the credibility of Itasca as a messenger and the rigor of our approach to understanding and analyzing issues.

## Get leaders involved

When it comes to getting things done, there's no substitute for the direct involvement of those with authority. The members of Itasca who make up our working groups are private-sector chairmen and chief executives, the mayors of Minneapolis and Saint Paul, the governor of Minnesota, and presidents of universities and other institutions. There's no concern about miscommunication or making false promises that require the approval of others. We are all principals with decision-making authority, sitting in meetings as equal participants with equal voices.



Although this practice sounds like common sense, many civic alliances devolve into endless rounds of meetings attended by designated representatives who report back to others, adding layers of complexity and delays. Having principals at the table—principals whose time is precious and who are accustomed not only to making decisions but also to seeing tangible results—ensures our relevance and focuses our attention on what really matters. We all know that the work we do must be worth our time.

At one of our first meetings, for example, we discussed research and development undertaken by companies and public institutions in the Twin Cities. A vast amount of groundbreaking work was being done, yet there was little cooperation—research organizations worked in isolation and had done so for as long as anyone could remember. We all agreed this made little sense, and the then chairman and chief executive of 3M, Jim McNerney (who now holds the same roles at Boeing), immediately volunteered to chair a task force on the issue. Within seconds, another attendee, the president of the University of Minnesota, Bob Bruininks, piped up: "I'll co-chair." Six months later, the working group chaired by Jim and Bob had studied best practices, developed a deep fact base, formed recommendations, and pushed for changes that have transformed private–public sector collaboration across the state.

## Finding deeper meaning

The effort Jim and Bob spearheaded had obvious direct benefits for both of their organizations. Yet not all Itasca initiatives do, which raises the question: why bother? Why do so many leaders of companies, organizations, and institutions devote so much time and effort—our core working group typically meets weekly—to do work that, in many cases, may not bear fruit for years or perhaps decades? If you ask these leaders, the answer is universal and simple: it's incredibly meaningful. The personal return on investment from their Itasca involvement exceeds that of pretty much anything else they've done, including their corporate careers. It's that significant.

Itasca provides a couple of rare opportunities at a personal level. Members interact in a noncompetitive environment with fellow leaders, and they exercise different parts of their brains. While we like to

think that managing a major corporation is all about influence, the fact is that it's often just management: leaders make decisions, and others fall into line. At Itasca, it's all about influence. Ideas survive and thrive on the ability of members to bring their colleagues along with them. It's also creative. Our members have risen to their current positions by being very skilled at specific tasks in specific industries. Yet at Itasca, they may be examining a problem they have little expertise in, which is itself exhilarating. Not only that, they also have permission to try more things and make more mistakes—a luxury that quickly disappears in their day jobs. Don't get us wrong; we are determined to reach the right answer to a given problem as quickly as possible. But there is leeway for experimentation and learning.

At a broader level, there's no doubting the significance and satisfaction from the altruistic element of civic work, as any executive involved in community groups can attest. We like to imagine it's more intense for participants in Itasca, who are at the front line of efforts to reinvigorate a region that is responsible for the livelihoods of millions of people, not to mention the well-being of the participants' companies. While the percentage of revenue that these companies derive from the Minneapolis–Saint Paul area has certainly declined in recent decades, the happiness and prosperity of our employees is linked as tightly as ever to the region's vitality. Knowing we are working to improve it is incredibly gratifying, even if the full benefits may not be realized in our time at Itasca or even our lifetimes.

Finally, Itasca provides lessons that can be applied day-to-day. Some members learn from observing their peers, gaining insight into the way other chief executives think, solve problems, or interact. Others directly implement changes based on findings from our work; for example, our deep understanding of socioeconomic disparities has resulted in formal goals at HealthPartners—to reduce health-care disparities and increase the leadership team's diversity— as well as changes to the company's incentive plan to drive results. All members grow personally as a result of their involvement and relish the opportunity to be involved. We've never had to recruit participants; they welcome the opportunity to be part of something bigger than they could be elsewhere.

We're obviously proud of our work at Itasca and believe the approach we've adopted can be implemented elsewhere. Yet we know none of this is easy. We have false starts when it comes to selecting issues. Some of our initiatives struggle to gain traction. And we have our share of executives who become consumed by their day jobs, letting Itasca fall by the wayside. However, while we are sometimes discouraged, we are never dissuaded. We know personally how meaningful it has been to try to improve the community in which we live and work. The way we see it, leaders spend decades acquiring influence that typically peaks when they reach the very top of their organizations. Wouldn't it be wonderful to have the opportunity, at that point in your life, to engage with others in the same position and do something bigger than all of you?

*The authors wish to thank Tim Welsh, a director in McKinsey's Minneapolis office, and colleagues Allison Barmann, Beth Kessler, Jennifer Ford Reedy, and Julia Silvis, for their collective contributions to the Itasca Project since 2003.*

**Mary Brainerd,** president and CEO of HealthPartners, was chair of Itasca from 2008 to 2012. **Jim Campbell,** a retired chairman and CEO of Wells Fargo Bank Minnesota, was chair of Itasca from 2003 to 2008. **Richard Davis** is chairman, president, and CEO of US Bancorp and Itasca's current chair.

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For more on the Itasca Project, see the online version of this article, on mckinsey.com, for a video interview with current Itasca chair Richard Davis and former chairs Jim Campbell and Mary Brainerd.

# Breaking the US growth impasse

**Susan Lund, James Manyika, and Scott Nyquist**

Business leaders can give the US economy a shot in the arm by stepping out of their comfort zones, pursuing innovative partnerships, and creating industry standards.

**As the weak recovery drags on,** a hard reality has become clear: the US growth engine isn't what it was in decades past. For domestic and international companies alike, this painful realization has been heightened by the slow emergence of Europe from its long recession and the serious speed bumps that emerging economies are now hitting.

Earlier this year, we spent several months investigating catalysts with the potential to revitalize the US economy. Five game changers emerged, with particular promise for adding momentum to the recovery and setting the nation on a higher long-term trajectory.[1] These five are increasing shale-energy production, which could provide a competitive edge for the next 10 to 15 years; reversing the US trade deficit in knowledge-intensive goods, such as automobiles and aerospace products; harnessing big-data analytics to make broad areas of the economy more efficient; investing in infrastructure while transforming the selection, operation, and delivery of projects; and, finally, fully developing US human capital through better education and workforce training. We estimate these

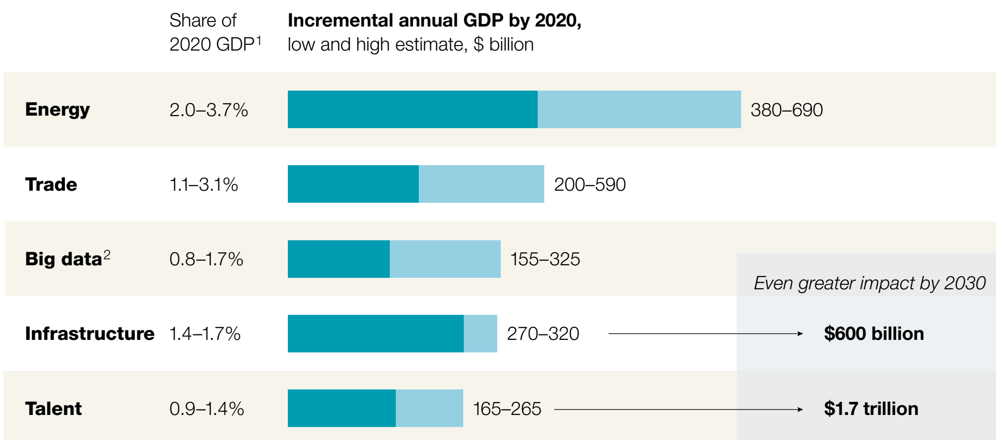
[1] See the full report, *Game changers: Five opportunities for US growth and renewal*, McKinsey Global Institute, July 2013, mckinsey.com.

opportunities could raise US productivity and boost GDP by hundreds of billions of dollars over the next seven years (Exhibit 1). Three of them—energy, trade, and infrastructure—could create more than 1.5 million jobs each by 2020.

Market forces and simple self-interest are already prodding companies to move in some of these areas, such as developing shale energy or adopting big data in sectors like retailing and financial services. But others will need a concerted push from business leaders and policy makers, and grasping their full economic potential is far from assured. New standards and partnerships, as well as a focus on local innovation, can jump-start momentum. Above all, progress will require a willingness to stretch for new opportunities rather than wait for the old economy to bounce back—and a fresh mind-set that looks beyond this quarter's results or the next election cycle. For business leaders in particular, four priorities loom large.

Exhibit 1

**Five economic catalysts could dramatically boost US GDP by 2020.**




[1]Based on a partial-equilibrium analysis that estimates first-order effects only; cannot be summed together to calculate full economic impact.
[2]Data are for retail and manufacturing sectors only. Big data may also yield cost savings in government services and health care ($135 billion–285 billion), but these do not directly translate into additional GDP.

Source: Economist Intelligence Unit; IHS Global Insight; McKinsey Global Institute analysis

## 1. Cooperate in developing industry standards

Lingering uncertainties are slowing progress in a number of areas, but business leaders can move these issues forward without waiting for legislative or regulatory action. In big data, for example, standards for sharing consumer information and protecting privacy need to be resolved. Some companies already are working with universities and nonprofits to find technical and legal solutions for assuring privacy and cybersecurity.

In shale energy, oil and gas players can help mitigate environmental risks by pursuing standards for all producers to follow in fracking—and by continuing to improve drilling and well technologies to reduce its environmental impact. Some energy companies are joining with environmental groups, academic researchers, and foundations to monitor the risks and create operational standards. The Center for Sustainable Shale Development, for example, is a coalition of environmental groups (including the Clean Air Task Force and the Environmental Defense Fund) and energy firms (including Chevron and Shell). Mitigating these risks is crucial to protecting the air and groundwater while allowing the economy as a whole to reap the full benefits of shale development.

## 2. Build new types of partnerships

As the cybersecurity and shale examples suggest, companies hoping to stay in the vanguard of the new economy must look beyond their own boundaries and find new forms of collaboration. Big data, for example, is tailor-made for partnerships, such as a joint effort by Google and the US Patent and Trademark Office to create a new searchable database of intellectual property. Biotech and pharmaceutical companies are entering new multidisciplinary research partnerships to analyze enormous open databases of clinical and genetic information and collaboratively develop new drugs and diagnostics.

Or take the challenge of building a more competitive workforce. Some employers, facing mounting skill shortages, are forming industry associations to develop joint training programs, with agreements to

protect participants from talent poaching. In one instance, AMTEC,[2] a consortium of automotive manufacturers, has successfully teamed up with community and technical colleges to train skilled workers. Individual companies can work directly with educational institutions, as PG&E has done with California community colleges to create a training curriculum for future utility technicians. Competitors can also collaborate to develop industry-wide competency standards that enable educational institutions and private training providers to tailor individual programs.

Educational partnerships may be most important in STEM[3] fields, for the United States has one of the lowest shares of college degrees awarded in science and technology. Relatively few incoming freshmen choose these subjects, and only half complete their degrees. Industry participation could help close the gap, with corporate internships, mentoring, and real-world research projects to keep students engaged. And companies can prime the talent pipeline even earlier, at the K–12 level. One intriguing experiment is P-TECH, a six-year New York City high school recently created through a partnership with IBM. Its STEM-intensive curriculum prepares students for entry-level IT jobs, offers one-on-one interaction with IBM mentors, and ultimately provides students with an associate's degree.

Finally, innovative public–private partnerships (PPPs) may offer cash-strapped local and state governments the means to tap private expertise and capital for infrastructure projects. Such partnerships have, for example, built new high-occupancy toll lanes for the Capital Beltway, outside Washington, DC; a major light-rail expansion in Denver; and multiple toll roads in Texas. There is a new willingness to experiment with different types of financial vehicles and operating arrangements that can make public-works projects more efficient while creating more attractive opportunities for private-sector firms.

## 3. Drive local change

Local innovation is the key to realizing the game changers on a national level. Efforts to revitalize advanced manufacturing and US

[2] Automotive Manufacturing Technical Education Collaborative.

[3] Science, technology, engineering, and mathematics.

exports, for example, will naturally revolve around the industry-specific regional clusters that help fuel US economic vitality. Local business leaders not only set the direction for these innovation hubs but also sustain them through start-up incubators, coordinating organizations, venture capital, and collaboration with research universities. While Silicon Valley is the most compelling example, the United States has hundreds of innovative clusters, such as the Gulf Coast (chemicals), Ohio (polymers and advanced materials), South Carolina (automotive manufacturing), and Wichita, Kansas (aerospace).

Industry leaders can work with city and state officials to build on these local capabilities. The New Orleans Business Alliance, for example, recently unveiled a new five-year economic-development plan that focuses on supporting strategic industries. In Minneapolis, the Itasca project, a business-led economic-development task force, has made major contributions for more than a decade. (For a perspective on Itasca from three of its corporate leaders, see "Doing well by doing good: A leader's guide," on page 100.) These types of organizations should move the opportunities presented by the game changers to the top of the local agenda by expanding vocational training, developing infrastructure, promoting export industries, supporting the use of big data, and assessing the role a region can play in the shale-energy revolution.

## 4. Step out of your comfort zone

Fully exploiting the opportunities we have outlined so far will also require business leaders to stretch their thinking and their capabilities. For instance, the energy sector's huge needs for new pipelines, drilling rigs, and related infrastructure equipment offers manufacturers a fast-growing market for existing and retooled offerings. In infrastructure, public–private partnerships are creating opportunities for not only engineering and construction firms but also insurance companies, pension funds, and other providers of long-term capital. In education, technology companies are seizing on the adoption by 45 states of Common Core standards—guidelines that create a much larger and less fragmented market for new digital learning tools.

The potential in energy, big data, and knowledge-intensive industries is large enough to spark the development of whole new supply chains.

That could stimulate growth among a wide range of B2B goods, from fabricated metals to electronic controls, as well as among service providers in areas such as logistics and data storage. What's more, the big-data revolution is forging large new markets at the intersection of information technology and traditional economic sectors, such as health care, manufacturing, and retailing. Exploiting these opportunities could spur new zones of business activity as data aggregators and service providers analyze millions of medical records to lower costs and improve patient outcomes or comb through volumes of social-media data to glean insights for consumer-goods companies.

A number of multinationals headquartered outside the United States have been making bold bets in pursuit of these opportunities. Consider the recent surge of foreign direct investment into the United States from well-known international firms such as Airbus, Sasol, Shell, and Volkswagen. Domestic companies can similarly take advantage of changing factor costs and new technologies to expand—or even reimagine—their US footprints.

None of this is to suggest that business leaders can do everything themselves. Policy makers have a role to play, as well, but they need to take a nuanced approach. For game changers such as shale energy and the private sector's use of big data, the government's role will largely be laying the groundwork by setting legal and regulatory frameworks, often in conjunction with businesses.

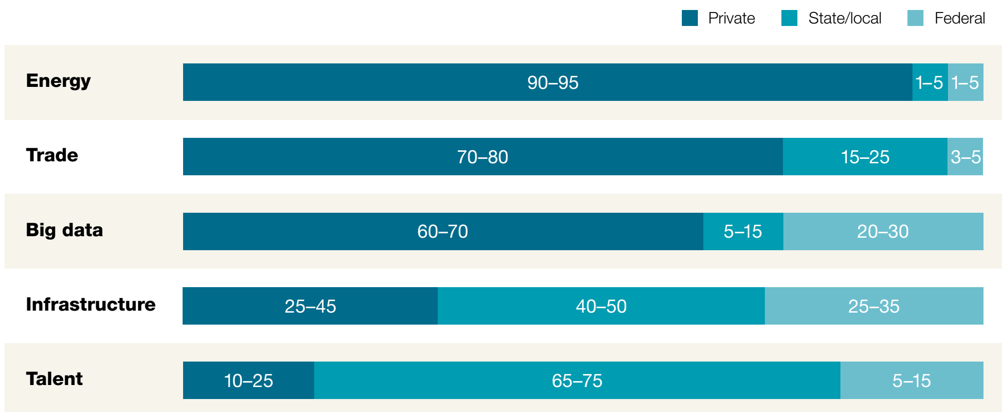
In other areas, the main roles of the government will be to create an attractive business environment and to streamline the entire permitting process (which ranges from applications to inspection, disclosure, certifications, and, finally, the issuance of permits)—and then to get out of the way. To improve trade competitiveness, for example, national policy plays an important role in leveling the global playing field on taxes, foreign investment, and export promotion. Other countries, such as Ireland and Singapore, provide examples of how government agencies can coordinate their actions to create an attractive environment for investment and take these efforts to the next level.

For several game changers, government can accelerate change. To realize the enormous potential of big data to cut costs in health care

Exhibit 2

**A majority of the investment needed to realize each catalyst will come from the private sector and from state and local governments.**

Estimated share of investment, by source, %




Source: McKinsey Global Institute analysis

and government services, for example, policy makers will have to take a more active role in speeding its adoption and creating the right incentives. For infrastructure and talent, state and local governments will need to provide around half to three-quarters of the necessary investment (Exhibit 2).

Yet the private sector can create considerable momentum—and realize large opportunities—even if gridlock in Washington persists. It will take vision to recognize new markets, invest early, and create unconventional partnerships, but companies that act now may be able to seize first-mover advantages. They can also help to close out a period of sluggish US growth that has become nothing less than a slow-motion crisis for the unemployed, the underemployed, and future generations. ○

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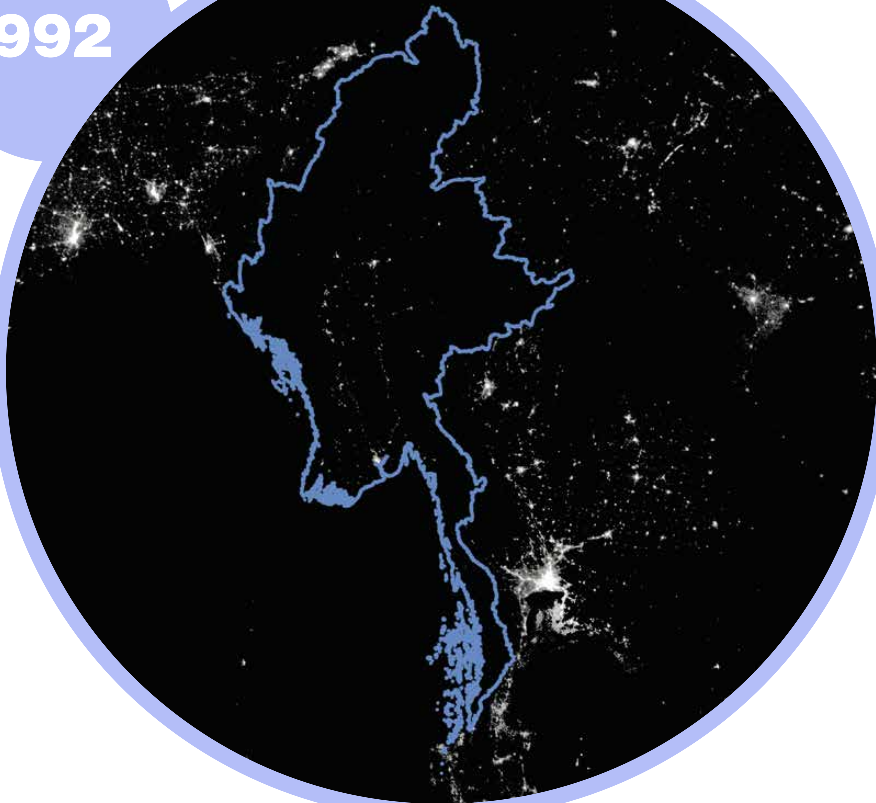
## Picture This

# Lighting up the last frontier

**Heang Chhor, Richard Dobbs, and Doan Nguyen Hansen**

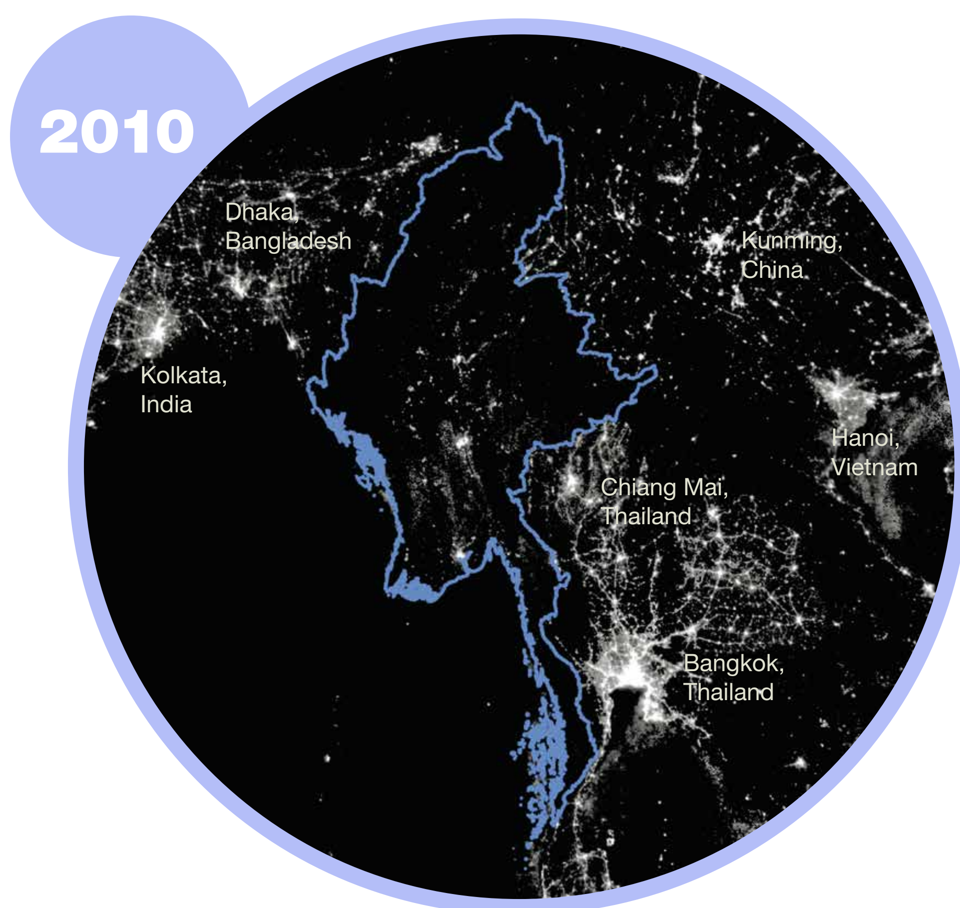
Seen from outer space at night, Myanmar is dimmer than its neighbors. It has changed remarkably little over the past two decades: the vast majority of its citizens still live in the countryside, and only the cities of Yangon and Mandalay approach the size of urban areas in neighboring countries. Low rates of labor productivity and a heavy reliance on agriculture help account for this picture—which could change significantly in the years ahead. McKinsey Global Institute (MGI) research suggests that dramatic improvements in labor-productivity growth to 7 percent a year, from today's 2.7 percent,




Source: National Geophysical Data Center; National Oceanic and Atmospheric Administration; US Air Force Weather Agency; McKinsey Global Institute analysis

For more on Myanmar's growth prospects, see the full MGI report *Myanmar's moment: Unique opportunities, major challenges*, on mckinsey.com.

are possible, though challenging. If achieved, and if the country diversifies its economy, Myanmar's GDP could more than quadruple, to more than $200 billion in 2030. Consumption and output would still be considerably lower than they are in some large Chinese city clusters. Yet the potential for rapid growth, not to mention the excitement of breaching one of global capitalism's final frontiers, has begun attracting a wide range of multinational corporations.

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# Applied Insight

Tools, techniques, and frameworks for managers


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Illustration by Brian Stauffer

# Managing the people side of risk

**Alexis Krivkovich and Cindy Levy**

*Companies can create a powerful risk culture without turning the organization upside down.*

Most executives take managing risk quite seriously, the better to avoid the kinds of crises that can destroy value, ruin reputations, and even bring a company down. Especially in the wake of the global financial crisis, many have strived to put in place more thorough risk-related processes and oversight structures in order to detect and correct fraud, safety breaches, operational errors, and overleveraging long before they become full-blown disasters.

Yet processes and oversight structures, albeit essential, are only part of the story. Some organizations have found that crises can continue to emerge when they neglect to manage the frontline attitudes and behaviors that are their first line of defense against risk. This so-called risk culture[1] is the milieu within which the human decisions that govern the day-to-day activities of every organization are made; even decisions that are small and seemingly innocuous can be critical. Having a strong risk culture does not necessarily mean taking less risk. Companies with the most effective risk cultures might, in fact, take a lot of risk, acquiring new businesses, entering new markets, and investing in organic growth. Those with an ineffective risk culture might be taking too little.

Of course, it is unlikely that any program will completely safeguard a company against unforeseen events or bad actors. But we believe it is possible to create a culture that makes it harder for an outlier, be it an event or an offender, to put the company at risk. In our risk-culture-profiling work with 30 global companies, supported by 20 detailed case studies, we have found that the most effective managers of risk exhibit certain traits—which enable them to respond quickly, whether by avoiding risks or taking advantage of them. We have also observed companies that take concrete steps to begin building an effective risk culture—often starting with data they already have.

## Traits of strong risk cultures

The most effective risk managers we have observed act quickly to move risk issues up the chain of command as they emerge, breaking through rigid governance mechanisms to get the right experts involved whether or not, for example, they sit on a formal risk-management committee. They can respond to risk adroitly because they have fostered a culture that acknowledges risks for what they are, for better or for worse; they have encouraged transparency, making early signs of unexpected events more visible; and they have reinforced respect for internal controls, both in designing them and in adhering to them.

### Acknowledging risk

It takes a certain confidence among managers to acknowledge risks. Doing so—especially to the point of discussing them internally, as well as with shareholders or even regulators—requires that managers rely on their own policies and procedures to work through issues that could lead to crisis, embarrassment, or loss.

The cultural differences between companies that acknowledge risk and those that do not are quite stark. Consider, for example, two global financial institutions that take similar risks and share a similar appetite for risk. The first has built a culture, at all levels of the organization, that prizes staying ahead of the trend. This might mean convening a group of executive peers to discuss issues faced by the entire industry or responding to regulatory trends early—for example, on capital and liquidity requirements or compensation practices. The stance it takes is, "If we see it, identify it, and size it, then even if it's horrible, we'll be able to manage it." Where risks cannot be sized, they are at least discussed in qualitative terms. The institution's candor and its plans to rectify cultural issues in response to a number of risk incidents has won it the respect of regulators and built credibility with investors.

The second institution, in contrast, has a reactive and back-footed culture—one focused more on staying out of trouble, ensuring regulatory compliance, and making sure all the boxes are ticked. Its managers are generally content to move with the pack on risk issues, preferring to wait for regulatory criticism or reprimand before upgrading sub-par practices. They are afraid of knowing what they don't know, and they fear the reaction of the board, regulators, and investors. Many would rather ignore undesirable behaviors because they don't know how to manage them and because managing them would demand time and might affect their cost base. This organization's stance is, "Let's wait until we really need to deal with these unpleasant things, because they're anomalies that may turn out to be nothing at all."

A separate institution had such a mind-set during the mortgage crisis. Managers did not trust their own models, which accurately predicted the severity of the issues to come. They knew that if the models were correct, they would be in more trouble than they knew how to

handle, and so they found it easier to assume that the models were wrong—or to hope that the risk would crest and fall before the model's estimates came true. Whether from fear or hubris, managers convinced themselves that they were safer than they really were. Even as the crisis developed, they were confident that they would not experience the mishaps befalling similar companies. In the end, the company's refusal to acknowledge and address risk left it far more vulnerable than managers expected, and it was hit particularly hard.

### Encouraging transparency

Managers who are confident that their organizational policies and controls can handle—and even benefit from—openness about risk are more likely to share the kinds of information that signal risk events and allow the institution to resolve emerging issues long before they become crises. This means they spot a risk issue developing and mobilize the organization to analyze and remedy it—at the board level if needed, and often within a few working days. In one situation, a division of an energy-services company was operating a contract in an emerging country in which it had not previously worked. There, the division discovered employment practices among subcontractors that ran counter to its own policies and practices. The operating leadership swiftly escalated the issue to the company's global management board to decide whether specific contractors were acceptable. It was able to reallocate project tasks among contractors, manage timeline slippage and the budget, and consequently reduce the company's employment-practices risk and safeguard project returns.

Companies with a culture that discourages such discussions—as well as those in which overconfidence leads to denial—are prone to ignoring or failing to recognize risks. In some cases, employees fear telling the boss bad news because they worry about the financial downside of slowing commercial progress, they know the boss doesn't want to hear it, or they fear being blamed. As a result, they alert managers to risks only when further delay is impossible.

In other cases, companies promote practices that unintentionally reduce transparency regarding risk. For example, at one global pharmaceutical company, the culture thrives on competitive teams. Competitiveness is so strong that product-development teams use subtly different risk classifications so that their respective projects can't be directly compared. To the teams, it can feel like good management to deal with issues close to home rather than raise them to higher levels—especially since revealing their true risks might place them at a disadvantage in the next planning round. For the company, though, this practice has obscured risks that were identified by one unit but went unnoticed by others, which continued to make errors that had been resolved elsewhere.

The best cultures actively seek information about and insight into risk by making it everyone's responsibility to flag potential issues. For example, managers at one global oil-exploration company explicitly begin every meeting

and interaction with a discussion about safety. Participants know they must be able to make an observation or raise a concern if called on randomly, which keeps them on the lookout for safety issues at all times. Most of the issues they raise are minor and easily addressed. But bigger questions often lead to longer conversations and inquiries from leadership, which clarify the problem and identify by name those responsible for resolving the issue.

### Ensuring respect for risk

Most executives understand the need for controls that alert them to trends and behaviors they should monitor, the better to mobilize in response to an evolving risk situation. And while managers are unlikely to approve of skirting the very guidelines and controls they have put in place, some unintentionally promote situations and behaviors that undermine them. For example, while too few controls can obviously leave companies in the dark as a situation builds, too many can be even more problematic. Managers in such cases mistake more controls for tighter management of risk, though they may be inadvertently encouraging undesired behaviors. In one large hospital system, managers had implemented so many guidelines and controls for ward procedures that the staff saw them as impractical. As a result, they routinely circumvented them, and the culture became increasingly dismissive of all guidelines—not just the less practical ones—to the detriment of patients.

Even companies with the right number of controls in place encounter difficulty if managers do not monitor related trends and behaviors. Companies often unconsciously celebrate a "beat the system" mind-set, rewarding people who create new businesses, launch projects, or obtain approvals for things others cannot—even if it means working around control functions in order to get credit lines or capital allocations, for example.

In the best of cases, respect for rules can be a powerful source of competitive advantage. A global investment company had a comprehensive due-diligence process and sign-off requirements for investments. Once these requirements were fulfilled, however, the board was prepared to make large, early investments in asset classes or companies with the collective support of the senior-executive team, which was ultimately accountable for performance. Company-wide confidence in proceeding resulted from an exhaustive risk debate that reduced fear of failure and encouraged greater boldness relative to competitors. Confidence also stemmed from an appropriately gauged set of risk controls and an understanding that if these controls were followed, failure would not be regarded as a matter of poor decision making.

## Building an effective risk culture

Companies that want to reshape their risk culture should be aware that patience and tenacity are crucial. Changing the operating environment of a large organization takes at least two to three years, as individuals come up against specific processes—such as policy decisions, project approvals,

or even personnel reviews—that have changed in line with new risk-culture principles. In our observation, companies wrestle with two challenges: building consensus among senior executives and sustaining vigilance over time.

### Finding consensus on culture

Improving a company's risk culture is a group exercise. No one executive—or even a dozen—can sufficiently address the challenge. In most global organizations, CEOs and CFOs who want to initiate the process must build a broad consensus among the company's top 50 or 60 leaders about the current culture's weaknesses. Then they must agree on and clearly define the kind of culture they want to build. This is no small task, typically requiring agreement on four or five core statements of values about the desired culture that imply clear process changes. For example, in one organization, managers often adopted new products or took on new customers without considering whether the company's infrastructure could support them. Often, it could not; this ran up costs and created huge operational risks. When leaders gathered to define the risk culture they wanted to see, one of their statements was, "We will always understand the infrastructure implications of the risk decisions we make."

The consequence of committing to such statements is that the company will need to change the way it approves activities, whether those are transactions at banks, capital projects in heavy industry, or even surgical procedures at hospitals. It cannot let them proceed if the risk infrastructure does not support them—and business-unit COOs must be held accountable for risk events related to infrastructure in their areas. To make aspirations for the culture operational, managers must translate them into as many as 20 specific process changes around the organization, deliberately intervening where it will make a difference in order to signal the right behavior. In some companies, this has meant changing the way governance committees function or modifying people processes, such as training, compensation, and accountability. And while fine-tuning some of these areas may take a fair number of cycles, even a few symbolic changes in the first cycle can have a profound impact on the culture.

For example, in one global organization, a simple announcement that certain risk-related data would be incorporated into one round of promotions radiated through the organization almost overnight, encouraging some behaviors and discouraging others. In the next round of promotions, managers created reports using the data so that every staff member had tangible risk indicators next to his or her name. At that point, the new approach to risk started to become part of the infrastructure—sending loud signals to the organization about what would be celebrated and what would not. Although these were big changes, they were accomplished without turning the organization upside down.

### Sustaining vigilance

Since cultures are dynamic by definition, sustaining the right attitudes and behaviors over time requires continuing effort. An ongoing risk committee

might start off by keeping on top of key issues but become stale and mechanical as people lose energy over time. Or a discontinuity—new leadership or a new set of market pressures, for instance—could send the culture in a different direction. To monitor for such shifts and make sure things continue moving in the right direction, managers at one pharmaceutical company conduct spot-checks every year on employee attitudes and minor risk infractions.

The responsibility for maintaining the new risk culture extends to boards of directors, which should demand periodic reviews of the overall company and individual businesses to identify areas that merit a deeper look. This need not be complicated. Indeed, most companies can aggregate existing data: a people survey, which most companies conduct, can provide one set of indicators; a summary of operational incidents, information on financial performance, and even customer complaints can also be useful. Combined, these data could be displayed in a dashboard of indicators relevant to the company's desired risk culture and values. Such a review process should become part of the annual risk strategy on which the board signs off.

Obviously, a shortage of risk consciousness will lead to trouble. But it is all too easy to assume that a thorough set of risk-related processes and oversight structures is sufficient to avert a crisis. Companies cannot assume that a healthy risk culture will be a natural result. Rather, leadership teams must tackle risk culture just as thoroughly as any business problem, demanding evidence about the underlying attitudes that pervade day-to-day risk decisions.

[1] The concept of risk culture featured prominently in a 2008 report by the Institute of International Finance on the failings that led to the credit and liquidity crisis among global banks and the consequent bank collapses and losses. See *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*, Institute of International Finance, July 2008, on iif.com.

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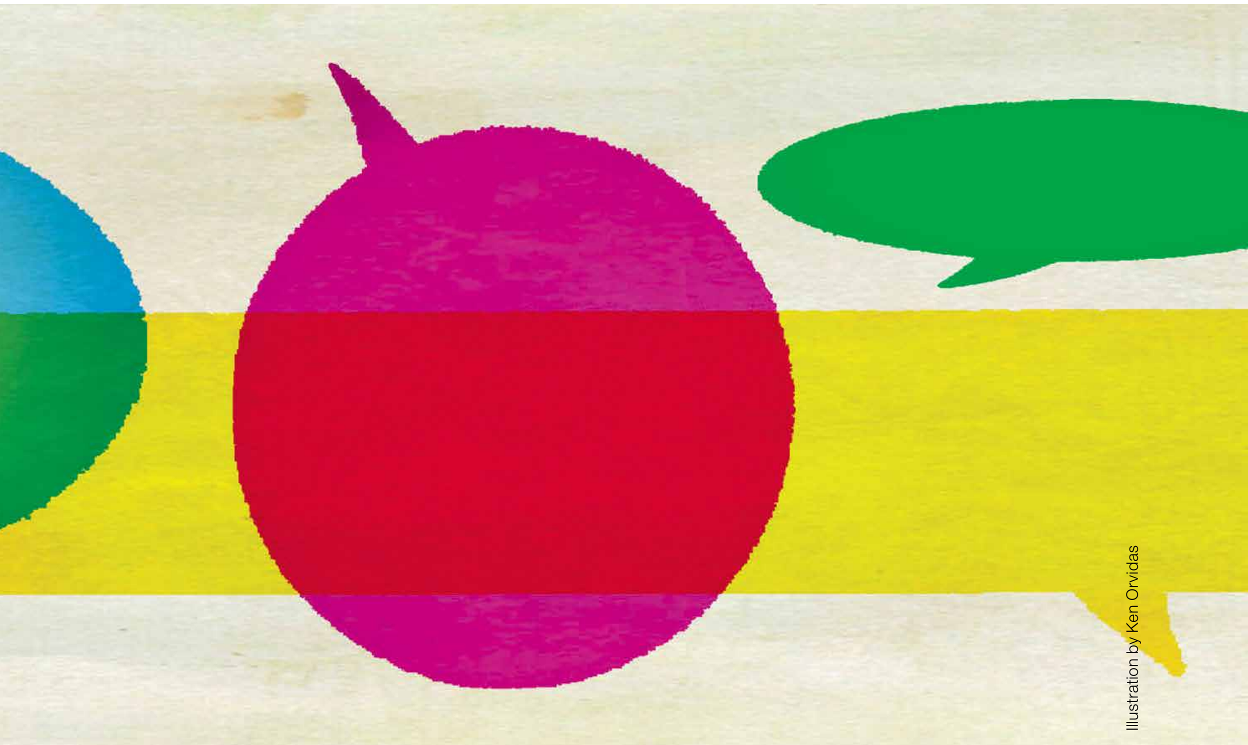

Illustration by Ken Orvidas

# Three steps to a more productive earnings call

Werner Rehm

*Traditional earnings calls are painfully unhelpful. Here's how companies and investors alike can get more out of them.*

As every earnings season comes to an end, it is striking how often executives and investors alike complain that earnings calls are a colossal waste of time. It's no wonder. Even a determined listener would be tested by an executive reading highly scripted texts of revenue, margin, and earnings data that would be better presented in tables. And few analysts or investors work up much enthusiasm for earnings-per-share (EPS)[1] data that heed the generally accepted accounting principles (GAAP)—data that say little about value creation. Clearly, the quarterly earnings call needs an overhaul.

Short of eliminating them entirely—a step many managers are unwilling to contemplate—what's a senior executive to do? There's plenty of room for experimentation with more insightful formats. Beyond the formal and legally required 10-K forms, managers are free to innovate their quarterly (or semi-annual) interactions—around both the

format and the content of their calls. Most stakeholders would likely be delighted. Three ideas could greatly improve the dialogue.

## 1 Ditch the prepared text—and allow more time for thinking

Today, very little time passes between a written announcement of earnings and the earnings call. Most companies send around a press release minutes before the call or, at best, the evening before, after the markets close. The call itself often starts with a prerecorded and legalistic review, most often a senior executive reading data from a script, followed by a mundane question-and-answer session in which the company usually selects who asks the questions.

The value of this setup is questionable. Nobody has time to analyze the data before the Q&A session, and the remarks are often a more convoluted way to convey data than simple tables. To improve the dialogue, companies should eliminate the prepared remarks and give investors more time to digest and analyze the data. For example, they could release—a few days in advance of the call—detailed tables and exhibits, as well as a targeted overview in text and perhaps even full quarterly filings.

If investors and analysts have enough time to review the prereleased data prior to the call, companies could likely eliminate the usual prepared remarks and go right to a Q&A session. The advantage of such an approach is obvious—questions are better when the data are clear and understood by the participants. And while executives might worry about volatility in stock price between the release of the data and the earnings call, they should not be. What matters is the longer-term value appreciation, not the day-to-day volatility—and in any case, volatility can be avoided if data are presented clearly in the release and the state of the company is described in a consistent and meaningful way.

## 2 Be creative in the way the Q&A is structured

Most Q&A discussions are broken. Sell-side analysts often ask questions—“even bad ones,” as one analyst told us—just so clients can hear their voice on the call or see their name in the transcript. Managers using sophisticated call-management software often invite questions only from the sell-side analysts they know and like. And buy-side analysts, arguably the most important participants on the call, are reluctant to reveal their thinking, and so are primarily just listening. The result is mediocre at best, routinely requiring numerous follow-up calls, and many questions remain unasked.

We need to start experimenting with systems where more investors can ask more pertinent questions, and perhaps a different way of selecting which ones get answered. New technologies make this fairly easy. If a company sends out data several days in advance of a call, it could, for instance, encourage investors and analysts to submit questions online and then have an online vote on which are the most important. The questions

could be posted with the names of the people who sent them in, or perhaps even anonymously, to reduce bias in the vote.

Google, for example, experimented with such an approach in 2009, albeit without sending advanced data.[2] Real-estate company Zillow took another tack to encourage real-time questions during its last earnings call. Anybody could ask a question via Twitter, encouraging analysts and investors in “listen only” mode to speak up. While this doesn’t make the poster anonymous, the company “now has less control over who can ask questions and what people can ask, and . . . everyone can see which questions management chose to ignore.”[3]

Some companies might even choose to go further. Expeditors International of Washington, a global logistics company, has a long-standing policy not to have earnings calls at all. Instead, managers respond to written questions in writing in a Securities and Exchange Commission filing. A 2000 disclosure form explains, “We do not currently plan to host a conference call. . . . We . . . believe that investors will benefit from real written answers to thoughtful questions. It’s a little more work for us, but we feel that the quality of the information disclosed will be better with a more formal process.”[4]

## 3 Stop talking so much about EPS

Given how little investors care about EPS and how far GAAP is away from true operating metrics in many cases, there is still too much emphasis on both in earnings calls, press releases, and announcements, at least with US companies. Managers should leave those numbers to the accountants and lawyers and focus instead on more operating-oriented numbers that make sense for their business. In the simplest form, these would be true pre- or posttax operating-earnings numbers, adjusted for amortization of intangibles, other nonoperating charges like the nonoperating portion of pension costs, and nonrecurring charges. Investors are likely to react positively to such a shift, and some large companies are indeed already reporting a non-GAAP operating margin.

In extreme cases, however, managers should be even more creative, especially those with business models where GAAP rules significantly distort economics. For example, capital expenditures, operating income, and other consolidated GAAP data do not reflect the underlying economics of one large industrial company, which is forced by GAAP to recognize some revenue as product revenue and some—from similar assets and contracts—as lease revenue. Managers and investors would be better off focusing their dialogue on a restated set of numbers that treats all revenue equally.[5] Other examples can be found in businesses that combine manufacturing and large projects, where percentage-of-completion accounting, and in extreme cases even real-estate accounting, can significantly distort aggregated data to the point of irrelevance for a value assessment. Here, managers should clearly separate the data for different businesses and focus on non-GAAP metrics to convey the state of the business.

Finally, managers should eliminate the need for the endless clarifying questions that take up the bulk of most earnings calls by releasing more—and more transparent—data. That means full operating-income statements and key operating-balance-sheet items for business units, ideally by geography, reconciled to the consolidated statements. A number of companies routinely publish full income statements and balance sheets for their financial businesses, either in their regular filings, like GE, or as a separate full report, like Caterpillar Financial Services. Nonfinancial companies that come closest to the ideal, such as Novartis, often offer a full income statement and capital schedule per business unit, in annual statements. These data are typically available internally, and given the size of larger business units, investors deserve a deeper look into the financials than they are getting from the required disclosure.

For competitive reasons, not every company can be equally transparent. However, most are too conservative. A table with historical volume and price movements by region, for instance, would clarify where growth opportunities are. This kind of transparency allows a clearer, more focused discussion without giving away a strategic position that competitors wouldn't know already. It is hard to imagine why every company can't disclose data more readily unless they're deliberately being obscure or simply unable to measure the data internally. Either possibility should make investors more skeptical about underlying performance.

Simple actions can greatly improve investor communication. It's time for companies to modernize their approach.

[1] Companies in the United States can report data that are not based on the generally accepted accounting principles (GAAP) but need to reconcile to the GAAP information, which has to be presented with equal prominence in the announcement.

[2] See Dominic Jones, "Google brings transparency to the earnings call question queue," irwebreport.com, October 15, 2009, and "Google announces fourth quarter and fiscal year 2009 results," investor.google.com, January 21, 2010.

[3] See Benjamin Romano, "Zillow takes questions via Twitter in real-time during earnings call," xconomy.com, May 8, 2013.

[4] From a 2000 Form 8-K filing. The policy is still in place.

[5] Unfortunately, this might not be allowed, as some publications by accounting authorities in the United States seem to indicate that companies are not allowed to publish a complete set of non-GAAP financials even if reconciled with GAAP financials.

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Illustration by Keith Negley

# Organizing the government-affairs function for impact

**Reinier Musters, Ellora-Julie Parekh, and Surya Ramkumar**

*The value at stake from government and regulatory intervention is huge. Companies that approach external engagement in a disciplined way capture more of it.*

The business value at stake from government and regulatory intervention is huge: about 30 percent of earnings[1] for companies in most industries, we estimate, and higher still in the banking sector, where the figure tops 50 percent.[2] Translating those percentages into euros, dollars, or yen can yield eye-popping results: one European utility found that the ongoing value at stake from regulation was €1.5 billion, or about €30 million for every employee involved in handling the company's regulatory affairs. Another large global company estimated that in a major acquisition, it was €500 million a year over a decade.

Since there's so much money on the table, you might assume that companies would organize government relations as carefully as they do other business functions. Surely, for example, companies

have people in place to understand the relevant economics, structures, and processes to drive this understanding into important business activities, and regulatory-affairs professionals who work in a collaborative and integrated fashion with business-unit leaders to capture value.

Yet the reality is quite different. In our most recent annual survey, fewer than 30 percent of the executives responding said that their external-affairs groups had the organizational setup and talent necessary to succeed.[3] Only about 20 percent of executives reported frequent success at influencing government policy and regulatory decisions—a proportion that has not increased in the four years we've conducted the survey. Our conversations with external-affairs executives at global companies highlight the challenges:

- "The government-affairs team in our company is buried under a support function, with limited clout and without the business leaders really understanding what they do."
- "We have separate government-affairs and external-communications functions. They operate independently and don't report to the same executive. We don't always communicate on key regulatory issues as much as we should."
- "Within the company we have different functions involved in external engagement; identifying the number of employees involved at the corporate, business, and country levels is a gigantic exercise for us."
- "Our public-policy team works in the shadows, so no one really knows what the worst outcome could have been if they had not engaged stakeholders smartly. Tracking and quantifying impact is very difficult."

In this article, we'll highlight three organizational principles that we've observed leading companies apply to decrease the likelihood of such problems and to increase the value they get from their regulatory functions. The importance of these groups will only grow as industries such as food and beverages come under new forms of regulatory scrutiny (say, related to issues of obesity), while others (notably the extractive industries, such as mining) receive heightened attention from regulators in resource-rich emerging markets.

## 1. Clarify scope and structure

Regardless of what the groups are called (public affairs and government affairs are common choices) top companies make sure that these organizations excel at economic analysis and stakeholder engagement, not just at lobbying and industry-group participation. By having staff dedicated to handling tasks such as identifying issues, developing positions, and gathering compelling international benchmarks, leading government-affairs units can anticipate a much broader range of possible regulatory outcomes. Notably, leading

groups quantify the impact of these outcomes on all parties involved, not just their own companies, by including the regulator and even the broader industry in their analyses. This approach dramatically improves the quality of engagement and can even break through seemingly deadlocked situations—for example, when a company can quickly and accurately show a regulatory proposal's negative consequences for national employment rates or tax revenues.

Top companies identify important stakeholders up front and work with them using a key account management–style approach that borrows from best-practice sales organizations. Designating senior executives as "owners" for important relationships, including those in social media, allows for smoother scheduling and coordination of day-to-day activities. More important, this approach makes it easier for a regulatory-affairs group to provide consistent, coherent, and proactive communication supporting a company's regulatory strategy.

One telecommunications company learned the hard way how important it is to map connections, when its regulatory-affairs team discovered, after the fact, that one of its business-unit heads was often golfing on weekends with the president of the country in which it is based. To avoid such missed opportunities in the future, it explicitly mapped out its most important relationships and designated executives as either primary or secondary contacts to manage them. A mining company in an African country adopted a similar approach after learning that each of its business units was engaging separately with an important government minister—an arrangement that made it impossible for the company to communicate a consistent message.

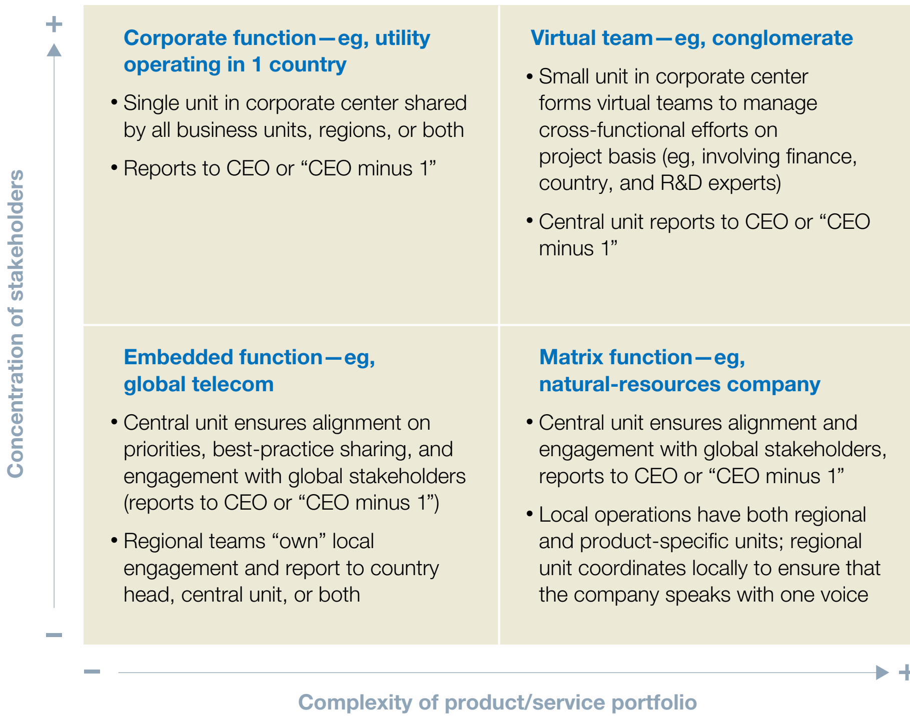
All of the companies we studied tend to structure their government-affairs units in one of four ways (exhibit). Yet they face a host of design considerations, such as the size of the team, as well as its physical location (including special ones chosen for strategic reasons, such as Brussels; Washington, DC; and, increasingly, Beijing). In situations where decentralized regulatory-affairs teams are required—say, in highly regulated industries calling for deep country-level expertise—we've seen companies successfully create dual-reporting relationships to link external affairs with both the country head and the corporate function. The home office helps quantify the value at stake, shares best practices, and makes sure the company's broader interests are accounted for.

An alcoholic-beverage maker, for instance, designates corporate-level "champions" responsible for regulatory issues involving taxation and marketing rules. These executives gather best practices in areas such as engaging stakeholders and assessing strategic options, and then bring them to countries or regions as needed.

Regardless of how the government-affairs function may be structured,

Exhibit

**Companies tend to structure their government-affairs units in one of four ways.**




companies that take its role seriously typically give it some prominence on the organizational chart. Engagement with high-level stakeholders (such as government ministers), after all, is a CEO-level concern, so having the function's leader report to the chief executive, or at most one level down, is appropriate.

## 2. Orchestrate activities across the business

When ties to the CEO are more distant or ambiguous, regulatory-affairs groups risk losing touch and becoming disconnected from important business issues. Once isolated, the function may even come to seem as if it speaks a language different from the one the business units use—a common complaint. Such disconnects are deadly, since the ability to convene and collaborate across functions on regulatory issues is vital for success. When regulatory-affairs units aren't viewed as good partners, they can't help the businesses to engage with regulators, coordinate the development of positions proactively, monitor social media, or profile stakeholders, among other activities.

Regulatory-affairs functions can also become alienated from organizations by

getting involved with issues too late—for example, reviewing proposals from other departments after they are completed. This often breeds misunderstandings and casts the regulatory group in the role of naysayer, a perception that's tough to overcome. Late involvement can have substantial economic costs as well, if, for example, a product is developed without input from regulatory affairs and later fails to get approval from regulators.

By contrast, an airport-management company we studied views the regulatory-affairs group as a "broker of intelligence" and has processes to ensure that it works closely with other functions. For example, biweekly meetings at the middle-management level bring together representatives from strategy, pricing, legal, finance, operations, and safety to work with regulatory affairs on pressing concerns. Individuals are designated to lead the necessary analyses on an issue-by-issue basis.

Similarly, a large European insurance company holds ongoing roundtables to help colleagues in other functions understand how to address and respond to regulatory issues. These forums are popular among managers and help the regulatory group remain part of the company's inner circle of management decision making.

The European arm of a diversified manufacturer aims to avoid organizational disconnects by maintaining a small group of geographic and topic experts who help the business units with priority issues, project by project. When the company wants quick but deep engagement on an issue (say, the taxation of a category of offerings in a particular geography), product and country experts can join colleagues from the local finance and operations teams to work with the relevant business unit.

## 3. Build talent and accountability

Once a company clarifies what the external-affairs group will do, how it should be structured, and how it should collaborate with other functions, the next task is staffing it with good people. Among most companies, we have observed three types of leaders: industry veterans, with deep legal or economic training (the role's classic profile); high-profile lobbyists or former politicians, who bring credibility and clout (useful when companies face pressure on a particular issue); or internally promoted business insiders (useful in strengthening cross-functional connections and gaining buy in).

Even among companies that otherwise excel on the talent dimension, nearly all struggle to measure the impact of regulatory affairs.

Any of these three can work well, so long as the leader coordinates effectively across business units while getting—and keeping—the respect and attention of senior management. Increasingly, leading companies tap all three types—for instance, by choosing people who are strong in one area and complementing their skills with those of others outside the function, including providers such as specialist lobbying firms.

Moreover, some companies are starting to use rotation programs that move staffers between the regulatory function and the business units to give these employees experience and improve the odds that their insights will be relevant to the businesses. Companies that combine the regulatory and strategy functions, as some utilities do, tend to be best at this approach. The instinct to cross-pollinate talent is a good one: among low-performing companies, very few external-affairs personnel have line experience. At one company we studied, only the department head had it; more junior colleagues played supporting roles. Such arrangements not only deny these employees valuable opportunities but also put companies at considerable risk if experienced staffers decide to leave.

By contrast, more sophisticated companies appear to view the relationship between the businesses and the government-affairs function as a two-way street. A European telecom operator, for example, integrates regulatory skills into the training that every C-suite occupant receives upon promotion. Similarly, a tobacco company holds regular academies for its marketing and sales personnel to keep their engagement skills sharp.

To increase understanding of the regulatory function's importance, a European power company publishes an internal newsletter that keeps senior management abreast of evolving regulatory topics and aware of the considerable value at stake. The newsletter keeps the group more connected to business issues and improves morale by raising its profile in the company.

Even among companies that otherwise excel on the talent dimension, nearly all struggle to measure the impact of regulatory affairs in a structured way and

thus provide meaningful incentives for staffers. While few best practices have been identified so far, some companies are taking the same analyses they use to understand the regulatory value at stake for a given issue and adapting them to their performance-management systems. These quantitative measurements are then complemented by more indirect indicators, such as the quality of relationships with important stakeholders or changes in the level of access to them over a period of time. Such approaches, while still in their early days, could prove a useful means of linking performance to real business outcomes.

Good regulatory management starts with good organizational design. Companies can increase the odds of getting more business value from this important function by picking the right design and making the most of it, breaking silos and building bridges with other functions, and developing talented people and quantifying their impact.

[1] Earnings before interest, taxes, depreciation, and amortization (EBITDA).

[2] For more, see Robin Nuttall and Sergio Sandoval, "The new value at stake in regulation," January 2010, mckinsey.com.

[3] From January 29 to February 8, 2013, we surveyed 2,186 executives on external affairs at their companies. The respondents represented the full range of regions, industries, company sizes, tenures, and functional specialties.

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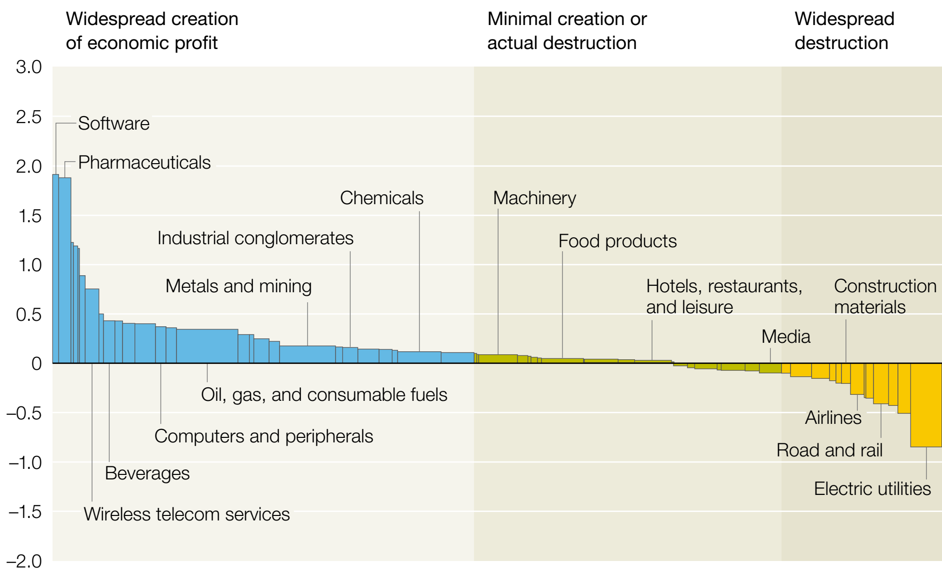
**Extra Point**

# Did your industry beat the market?

**Chris Bradley and Taichi Hoshino**

Different companies and industries create and destroy value at vastly different rates. Just how different? The exhibit shows the distribution across industries of economic profit: what's left of a company's net operating profit after its capital costs are subtracted. Between 2007 and 2011, a number of industries (those on the left of the chart) created substantial economic profit, a significant slice (on the right) had negative results, and many were in the middle. To a large extent, these differences reflect industry-wide trends—shifting tides can lift or submerge many boats. But performance isn't a foregone conclusion—not all companies conform to the ebb and flow of industries. In fact, our research also shows that a below-average company in a good industry appears no more likely to beat the market than an above-average company in a bad one.

**Average economic profit by industry,**[1] 2007–11, $ billion




[1] For 2,888 companies in 60 industries; column width proportionate to number of companies in industry. Widespread creation of economic profit = >$0.1 billion per company; minimal creation or actual destruction = $0.1 billion to –$0.1 billion per company; and widespread destruction = below –$0. 1 billion per company.

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For more on industry winners and losers, see "The strategic yardstick you can't afford to ignore," on page 24.

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