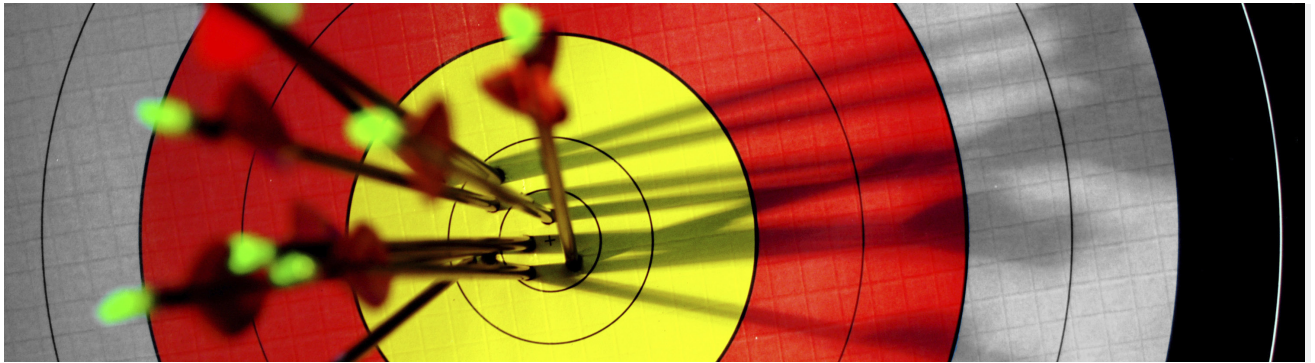


Insights into organization



How do I transform my organization's performance?

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Article at a glance

Why is this important?

To maintain excellent performance in the face of external changes and intensifying competitive pressures, leaders must be able to adapt their organizations to deliver. Unfortunately, few can. Evidence shows that only a third of excellent companies stay that way in the long term, and even fewer are successful at executing change programs.

What do I need to know?

Transforming the performance of an entire organization is an enormous undertaking, but it can be mastered. The key is to put the same emphasis on – and apply the same rigor to – managing the “soft stuff” as you do with the “hard stuff.” By doing so, you can create a culture of continuous improvement that will enable your organization to thrive for years to come. But be warned: getting this right will require you to think counter-intuitively about many issues.

How do I make it happen?

Our advice is to follow a proven five-phase process that tackles the fundamental questions you must consider on a transformation journey. Where do we want to go? How ready are we to embark on the journey? What are the practical steps that will take us to our destination? How should we manage the journey itself? And once we’ve completed our transformation, how do we keep moving forward?

What is it worth?

Following this approach has helped some companies achieve turnarounds and others take performance from great to even better. One insurance company went in three years from a negative to a 12 percent return on invested capital and from the bottom quartile of organizational health to the top quartile globally. An already successful bank improved customer loyalty by 33 percent, set the industry pace in cross-selling, and raised employee engagement to an outstanding level.

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Most organizations are wired for mediocrity

and will shrink or disappear in the long term. Shocking, but true: only a third of excellent companies remain excellent for decades, and when organizations try to transform themselves, even fewer succeed. Meanwhile, economic, political, social, and technological change continues to accelerate, and competitive pressure grows more intense. Now more than ever, organizations need reliable methods to achieve substantial, sustainable advances in performance. Through the most extensive research effort ever undertaken in the field of management, we have developed a way to beat the odds: a five-phase approach that manages the “hard” and “soft” aspects of change with equal rigor.

Have you asked yourself lately . . .

- How can I dramatically improve my organization's business performance – and fast?
- What are the hidden pitfalls in transforming an organization, and how can I avoid them?
- How do I ensure that the performance improvements we make will last?
- How do I create a culture of continuous change so that we can stay on top for the long haul?
- How can I create a sustainable competitive advantage in a constantly changing world?

. . . If so, then you might want to continue reading.

Why is this important?

We live in times of unprecedented change. As competitive pressures mount, organizations need more than ever to operate at peak levels of performance. Paradoxically, though, maintaining a hawk-like focus on today's share price or this quarter's profits doesn't necessarily mean a company will come out on top, or stay there for long.

Excellence today is no guarantee of excellence tomorrow. Even superstars burn out. When McKinsey's Tom Peters and Robert Waterman published *In Search of Excellence* in 1982, they hailed 43 companies as excellent. Twelve years later, in *Built to Last*, Jim Collins and Jerry Porras identified 18 companies that they believed had what it took for long-term success. But what had become of them all by 2006 (well before the financial crisis)? Twenty percent no longer existed, 46 percent were struggling, and only 33 percent were still high performers.¹

Why do only a third of excellent companies manage to stay that way for decades? Not surprisingly, part of the answer is down to macroeconomic forces, industry factors, and pure luck. But these play a relatively minor part. It turns out that more than 70 percent of the difference in performance between companies is firm-specific – in other words, what a particular organization is doing that is different from its peers.

So how can your organization get on top and stay there? The secret lies in mastering change: how to make it happen, sustain it, and create an organization that can constantly adapt to and shape its environment. Unfortunately, reliable methods for mastering change are hard to come by. When John Kotter published his seminal work on leading change in 1996, he reported that fewer than one in three change programs succeed.² Despite the avalanche of books on the subject in the intervening 15 years, research indicates that today's odds are no better.

¹ Based on the analysis in Stuart Cranier and Des Dearlove, "Excellence revisited," *Business Strategy Review*, March 2002, updated to 2006.

² John P. Kotter, *Leading Change*, Harvard Business School Press, 1996.

What do I need to know?

When organizations fail to make change happen, it's often because they have neglected the four key principles below.

To sustain high performance, don't make it your primary focus

Business leaders are always being told to focus on performance. That's their job, isn't it? Up to a point – but performance isn't everything. If you weight your investments toward the things that help you reach your quarterly targets, it's easy to neglect your company's long-term health. We define health as an organization's ability to align, execute, and renew itself faster than competitors so that it can sustain exceptional performance over time.

To achieve and sustain excellence, leaders need to take deliberate steps to manage both the performance *and* the health of their organizations. When we surveyed more than 2,000 executives from organizations that had recently undertaken change programs, we found that those transformations that focused on health as well as performance were three times more likely to be regarded as successful than those that focused on performance alone.³

Delving deeper into company data confirmed the importance of health. Drawing on McKinsey's unique database covering more than 500 organizations, we analyzed the relationships between a broad range of business measures and found a strong positive correlation between performance and health in every case. For example, companies in the top quartile for organizational health are 2.2 times more likely than lower-quartile companies to have an above-median EBITDA⁴ margin, 2.0 times more likely to have above-median growth in enterprise value to book value, and 1.5 times more likely to have above-median growth in net income to sales. Across the board, roughly 50 percent of performance differences between companies can be attributed to differences in organizational health.

The results from our large sample are mirrored by those from within individual organizations. When we analyzed 16 refineries at a major oil company, for instance, we found that organizational health accounted for 54 percent of variations in performance.⁵ We also field-tested our thinking and approaches in a number of company transformations in a range of industries, comparing our balanced performance and health approach with more traditional performance-focused efforts. Results from these studies are shown in Exhibit 1.

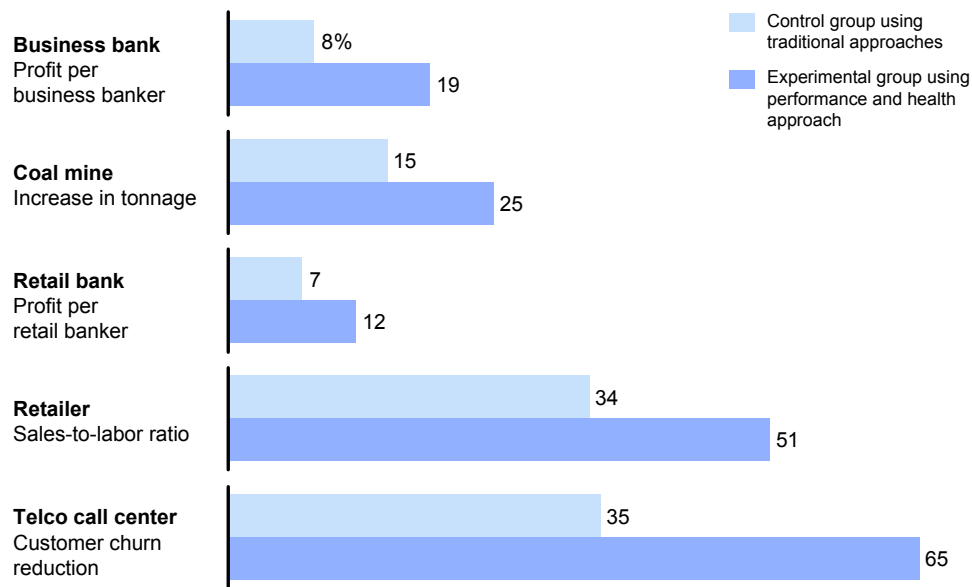
³ "What successful transformations share," *McKinsey Quarterly*, January 2010.

⁴ Earnings before interest, taxes, depreciation, and amortization.

⁵ See Scott Keller and Colin Price, *Beyond Performance: How great organizations build ultimate competitive advantage*, John Wiley & Sons, 2011, p.8.

Exhibit 1**Testing the power of performance and health interventions**

Comparison of traditional and experimental change efforts over an 18- to 24-month period



So the evidence is clear: leaders need to focus as much on health as on performance to get the best out of their organizations both now and in the long run.

The “soft stuff” can be managed as rigorously as the “hard stuff”

We often hear executives say that the health of their organization is important. However, they freely admit they struggle to find concrete ways to measure and manage it. In the survey mentioned earlier, two-thirds of executives wished they had better information to help them determine “what needs to be done to strengthen the company’s health for the longer term.”

This lack of guidance may be partly to blame for the ill fate of so many change programs. When we analyzed the reasons behind these failures, what we might assume to be the usual suspects – inadequate resources, poor planning, bad ideas, or chance events – turned out to account for less than a third of cases. The vast majority, more than 70 percent, were caused by factors related to organizational health, such as negative employee attitudes and unproductive management behavior.

Yet managers can get access to comprehensive, robust approaches to measure their organization's health. By that, we don't mean employee engagement or customer satisfaction surveys (useful though these may be in certain situations), but tools that yield a deeper insight into what drives an organization's alignment, execution, and renewal. The approach we have developed is the organizational health index or OHI, which assesses performance in terms of 37 management practices that have a proven correlation to financial results. The OHI provides a precise vocabulary and reliable measures for all aspects of the "soft stuff" that matter, making them as tangible and manageable as financial and operational metrics.

Copying best practices can be more dangerous than helpful

One of the great fallacies of management is that you can improve performance by copying best practices from other organizations. Though it may work in some operational areas, it can be a recipe for disaster in organizational health. That's because health is systemic, and best practices from one system can turn bad when transposed to another system.

Consider the case of company A, which wants to be more innovative. It decides to emulate a leading innovator and borrows company B's approach, where innovation is led by senior managers. But company A fails to appreciate that company B combines its top-down approach with management practices such as knowledge sharing and the pursuit of a common vision. Because large-scale innovation is by nature a collaborative effort, adopting these practices together makes it much more likely that they will yield the desired results. Indeed, our research shows this combination has a 78 percent probability of success.

Unfortunately, company A has a culture of internal competitiveness and an incentive system that rewards individual rather than collective performance. Combining these elements with efforts to drive top-down innovation created great confusion. Decisions were sidestepped, efforts were wasted, and initiatives never came to fruition.

So how can organizations make sure they put the right ingredients together? When certain management practices are carried out at distinctive levels, they can combine with others to deliver a "1 + 1 = 3" level of impact. And on the flip side, the wrong combinations can create a "1 + 1 = 0" level of impact. So the big question is, what's the best recipe?

The answer is that there isn't one, there are *four*. When we analyzed which of the 37 management practices best complement each other in supporting performance, we found four "archetypes" that are adopted by almost every successful organization:

- **Leadership driven:** leaders are the catalysts for performance, setting high expectations and supporting the organization in achieving them.
- **Execution edge:** discipline, sound execution, and continuous improvement are the foundation for great performance.
- **Market focus:** shaping market trends and building a portfolio of strong and innovative brands keep the organization ahead of the pack.
- **Knowledge core:** the organization treats its pool of talent and knowledge as its most important asset, and develops and deploys it effectively.

These archetypes suggest why leaders seeking to create sustainably excellent organizations find management literature of limited value. We found that most business books and articles are written from the vantage point of a single archetype and promote one combination of "best practices" as a model to suit all situations. But what's right for your organization is the archetype that plays to your greatest strengths and supports your performance aspirations best.

Common sense will often lead you astray

Much of current thinking on change management appeals to common sense. This should raise alarm bells. Leaders who rely on their common sense when influencing change typically spend time and energy on the wrong things, send messages that miss the mark, and create frustrating unintended consequences.

Why? Because common sense neglects a basic truth about human nature: that people often act irrationally. Scientific study has shown that we fall victim to subconscious thought processes that influence our behavior even when our rational minds tell us they shouldn't. That's what happens when we spend 10 minutes driving around to find the closest parking space to a store even though we could have saved half that time by parking in the first empty space and walking the extra few yards.

Behavioral scientists have found ways to understand how seemingly irrational decisions like this one are influenced by social, cognitive, and emotional biases, and can therefore be predicted. Leaders who want to make change happen should follow their example. The good news is that there's a small number of predictable biases that can be turned from miscues into powerful ways to help transform your organization.

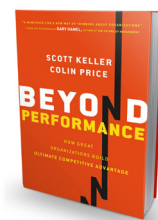
Here's the difference. Leaders using their common sense will want to tell employees about their organization's problems: costs growing faster than revenues, competitors catching up, or whatever the challenge may be. They'll decide what to do about it and tell employees the full story – what, why, and how – everywhere they go. They'll link the results of the transformation program to bonuses so that the effort has teeth. They'll invest in giving employees the technical skills they need to succeed. That all sounds fine – yet chances are they'll fail miserably. We've seen it happen time after time.

So what went wrong? These leaders did some of the right things, but not all. By relying on common sense, they failed to take advantage of less obvious but more potent ways of motivating employees. They missed an opportunity to create broad ownership of the new direction by involving a critical mass of people in setting the aspiration. They focused only on problems to be solved and neglected strengths to build on, breeding fatigue and resistance. They chose the most expensive form of incentives rather than cheaper and more effective ones, and forgot that relational skills are as necessary as technical skills. The result: failure, wasted effort, and frustration all round.

Hard facts behind the “soft stuff”

This article is based on a new book, *Beyond Performance: How great organizations build ultimate competitive advantage*, by Scott Keller and Colin Price (John Wiley & Sons, June 2011). Described by management expert Gary Hamel as “a manifesto for a new way of thinking about organizations,” it represents the culmination of the most comprehensive research program ever undertaken in the field of organizational effectiveness and change management. The effort lasted more than a decade and drew on input from more than 600,000 executives and employees from 500 organizations, some 900 academic books and articles, and hands-on practical work with over 100 organizations.

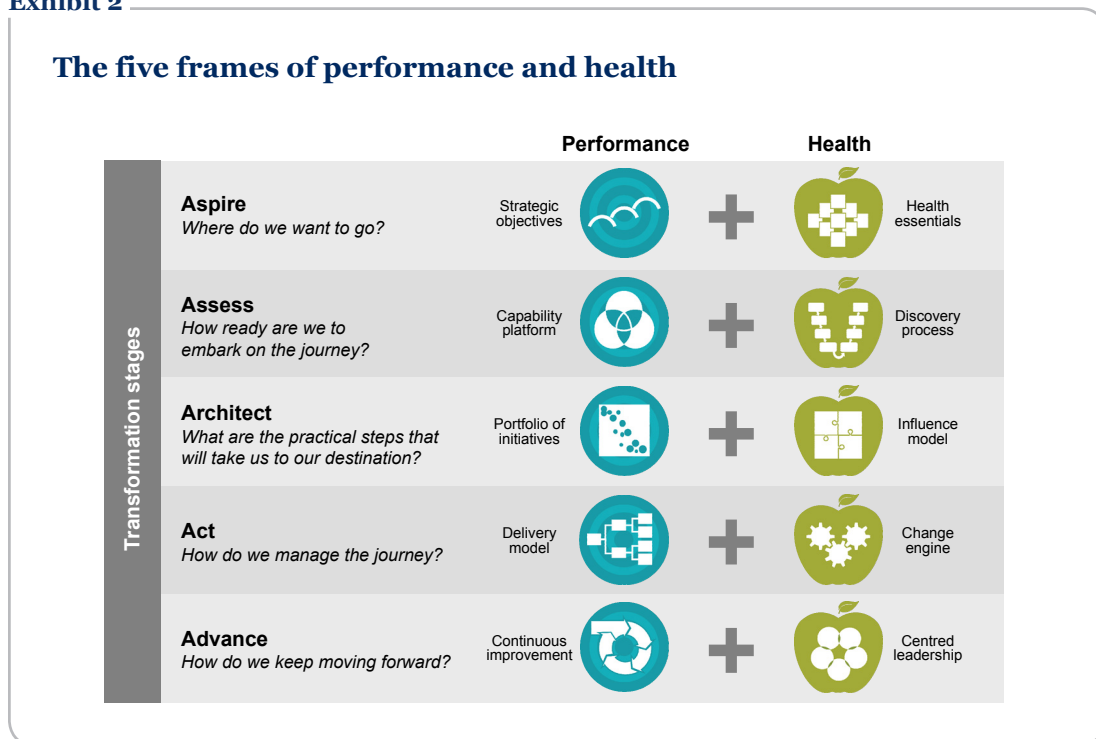
The book distills this deep knowledge to offer pragmatic, readily applicable methods and insightful, frequently counter-intuitive advice to help any leader and organization achieve a successful transformation and sustain excellence over the long term.



How do I make it happen?

If paying close attention to health as well as performance is the key to sustaining excellence, how can you achieve mutually reinforcing leaps forward on both fronts at the same time? The answer is to follow a structured process that we characterize as the “5As”: aspire, assess, architect, act, and advance. For each of these stages there are clear frameworks for performance and health that enable leaders to manage both with the same rigor and discipline (Exhibit 2). Together they make up what we call the “five frames” of performance and health. Let’s take them one by one.

Exhibit 2



Aspire: Where do we want to go?

The first step in setting an aspiration is to get the facts. For performance, that’s about analyzing competitive requirements, customer needs, shareholder expectations, industry benchmarks, and macroeconomic trends. For health, it involves gathering input from leaders and employees to establish how healthy the organization is and which archetype will best support its strategic objectives.

The most effective objectives take a medium-term view; that's because knowing where you want to be two or three years from now gives you the immediacy and tangibility you need to inspire stakeholders, set a rapid pace, break through resistance, and instill an action-oriented attitude across the organization.

Objectives should also be tough but doable. Avoid those that are incremental, cautious, or tailored to existing capabilities; they won't lead to breakthroughs or create pressure to push the limits. But don't go too far – if people think goals are unattainable, they'll give up trying. However, you'll probably have more headroom than you think before that happens.

Finally, use intuition as well as facts in setting your objectives, and involve a broad coalition of leaders – perhaps as many as a few hundred in a large organization. Only when a critical mass of leaders feel personal ownership of the aspirations can the organization unleash enough energy to realize them.

Assess: How ready are we to embark on the journey?

Once you've set your aspirations, it's time to assess how ready your organization is to change. Where are you starting from in terms of the skill and will – the organization's capabilities and mindsets – that matter most?

For performance, identify those few strategically important capabilities you need to reach your aspirations, whether they are in marketing, sales, manufacturing, supply-chain management, real estate, product development, or other areas, and take stock of where you stand. For health, use rigorous methods to probe the underlying mindsets that contribute to your present state of health, then select three to five that need to be strengthened or shifted to achieve your objectives. That's not a task for a psychologist; any business leader can identify the critical mindsets to work on by using practical methods such as interviews, focus groups, and targeted analytics.

During the assessment process, look for strengths to build on as well as weaknesses to tackle, and involve your broad leadership coalition in determining which capability and mindset shifts will make the biggest difference.

Architect: What are the practical steps that will take us to our destination?

Now that you know where you are starting from, where you want to end up, and how ready you are to make the journey, you can design your transformation route to take you to your destination.

For performance, develop a portfolio of initiatives that combines short-, medium-, and long-term efforts and balances radical innovations with incremental improvements to manage risk. The challenges you face will determine the initiatives you pursue, whether they be sales-stimulation programs, reductions in overhead spend, improvements to working-capital discipline, or other efforts. Taking a portfolio approach prevents

fragmentation, one of the biggest pitfalls for a change program, and helps you stay focused on your slate of initiatives.

For health, design interventions to reinforce or shift the mindsets on which you've decided to focus. Successful transformations cover the same four areas: telling a compelling story about the change, establishing reinforcement mechanisms such as incentives, building the necessary skills, and ensuring that leaders role model the changes. Weaving mindset interventions into performance initiatives whenever possible will enable your organization to experience the benefits of better health even as it works to improve performance.

At the end of this phase you'll have a map showing the steps you'll take to achieve the aspirations you've set. You'll have a portfolio of performance initiatives and health interventions, each with clearly defined actions, timelines, milestones, resources, accountabilities, metrics, and interdependencies.

Act: How do we manage the journey?

The time has come to make it happen. To do that, organize your initiatives into a clear structure, launch "military" and "marketing" campaigns to build ownership, and constantly evaluate progress.

To keep energy levels high through the long haul of implementation, make sure everyone understands how their contribution fits into the big picture. A powerful way to do this is to structure the program at three levels: a transformation *headline* that sums up your aspiration and the rationale behind it, a few broad performance and health *themes* that typically run for two to three years, and the specific *initiatives* that further these themes, each taking a few months or so to complete.

Understanding how all the different pieces of the transformation fit together won't be enough on its own, though. To unleash more energy, ensure people feel that they own the program personally. Ownership can be built in two ways: first through what we call a "military" campaign, by using formal leadership accountabilities such as the executive steering committee, initiative sponsors, and change champions, and second through a "marketing" campaign, by using viral tactics such as "bootleg" videos of confidential leadership discussions, "unauthorized" intranet blogs, and "rogue" communications to mobilize self-directed change among employees .

Finally, keep track of how your program is progressing so that you can manage it dynamically. This means regularly measuring its impact on four key dimensions: *initiatives* (are they on time, on budget, and shifting key performance indicators?), *performance* (are outcomes such as revenue, cost, and risk improving?), *health* (are mindsets and behaviors shifting?), and *enterprise value* (is the ultimate business outcome getting better?).

Advance: How do we keep moving forward?

If your organization hits its performance and health targets as and when expected, then your transformation is over and done with, right? Not quite: your transformation isn't complete until you have paved the way for a smooth transition to an era of continuous improvement. Without that, you'll have difficulty sustaining change, and your competitors may catch up again.

Your transformation will already have created many of the things you need to support continuous improvement, such as stronger problem-solving skills, confidence that you can find better ways to work, and a switch from silos to collaborative thinking. But you also need to rewire your infrastructure by developing systems for sharing knowledge, processes to capture opportunities for improvement, methods to facilitate continuous learning, and dedicated expertise.

Infrastructure is half the story; the other half is leaders who can drive continuous improvement through the system. For that, five attributes are key, and together they make up something we call *centered leadership*: the ability to tap into sources of meaning and purpose, see opportunity in adversity and find creative solutions, build a web of internal and external relationships, take action in the face of uncertainty and risk, and manage energy levels in oneself and others.

In most cases, these attributes come from a lifetime of experience, but a transformation offers ideal conditions to hot-house their development: hectic activity, widespread uncertainty, and plentiful opportunities for feedback. In fact, the journey to centered leadership begins not now but right at the beginning of your organization's transformation, and continues throughout it. That applies both to you as the senior leader and to the hundreds of other leaders who receive targeted leadership development as part of the program.

With infrastructure and centered leaders in place, your organization will be able to continuously improve its performance and health. That will help you stay ahead, but it doesn't mean you'll never again need to make a step-change in the way you work. Advances in technology, new customer needs, or shifts in the competitive landscape may require you to embrace transformation again – and if so, you'll know exactly how to go about it this time: by applying the five frames of performance and health. When an organization can both continuously improve and transform itself as needed, it possesses the ultimate competitive advantage.

What is it worth?

Organizations that have transformed themselves using the approach we describe have achieved remarkable results. Consider two contrasting examples: a turnaround and a great company that got even better.

An insurance company saw its position come under threat as sweeping government reforms opened up the market to new entrants. It had lost money for two years running, its market share was eroding fast, and its cost structure was the industry's highest. Investigation revealed that decision making was slow, systems and capabilities inadequate, and employee satisfaction at an all-time low.

A new CEO was charged with turning around the business, and with a broad coalition of senior leaders he set three key aspirations: to restore profitability within 12 months, to secure investment for growth initiatives within 24 months, and to regain industry leadership over time. To achieve these goals, the company decided to pursue an execution-edge archetype that required strengths in agent productivity management, risk-adjusted pricing and underwriting, and lean cost management, as well as a shift in mindsets relating to entitlement, hierarchy, and bureaucracy.

The company accordingly implemented a portfolio of initiatives driven by the senior team and coordinated by a program management office. After three years, the return on invested capital had gone from a negative number to 12 percent, profit had increased by over 200 million, and the cost base had been reduced by 11 percent. In health terms, the company had shifted from the lowest quartile to among the top 3 percent globally; as an example, workforce motivation had risen from a rating of 32 percent to 73 percent.

At a large bank, the incoming CEO had inherited an organization with a strong culture that already led the industry in many products and customer segments. With no burning platform, he wondered how he could define his era of leadership, so he commissioned a review of current performance and future trends. This exposed worrying developments on the horizon: opportunities for acquisition were few, regulation was getting tighter, credit quality was deteriorating, and customer preferences were changing.

Further analysis revealed that the bank had a healthy execution-edge archetype. It committed itself to pursuing historic growth rates despite the adverse trends, and decided to focus on capturing value by "mining the seams" between traditional silos to boost cross-selling and customer loyalty. This would involve shifting to a market-focus archetype, but without losing the strengths and disciplines of the execution-edge archetype.

The bank followed the five-phase approach to make these aspirations a reality. Three years later, it had succeeded in maintaining earnings and revenue growth at historic levels, increased customer loyalty by 33 percent, and exceeded cross-selling targets, setting the pace for the industry. On the health front, it improved its ratio of engaged to disengaged employees by 75 percent, scoring more than three times the industry average, and achieved its goal of embodying the market-focus archetype.

To operate at the peak levels of performance that today's fast-changing markets demand, companies need reliable methods to make change happen at two levels: transformational step-changes in performance and health, and continuous improvement in the way they do business from day to day. Thanks to years of exhaustive research and hands-on experience, we now have a deep understanding of what this involves, and proven tools to make it happen. This approach has been so effective in so many industries and from so many different starting points that we regard successful transformation and sustained excellence as a real possibility for almost any organization.

Insights into organization

Insights into organization is a series of articles written by experts and practitioners in McKinsey & Company's Organization Practice. Their purpose is to address senior executives' most important and challenging questions on people-related issues. Topics covered include organization behavior, design, and diagnostics, merger management, performance transformation, leadership, and talent management. For more information, please contact Garrett Ulosevich at garrett_ulosevich@mckinsey.com.

Related articles in the series

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The secret of a successful transformation lies in the ability to implement complex change at scale. The challenge is twofold: managing the implementation of multiple initiatives and keeping energy levels high during a process that can take years. By building a few critical design elements into their program, organizations can unlock major improvements and boost their long-term performance.

How do I create a distinctive performance culture?

Thanks to globalization and the instant flow of information, competitors today can quickly mimic a successful strategy – but not a superior performance culture. By adopting a proven approach that combines pragmatic business sense, problem-solving rigor, and behavioral insight, companies can bring about cultural change that delivers significant bottom-line impact.

How do I align and mobilize my organization to execute strategy?

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