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Building the **healthy** corporation

It is difficult—but vital—for managers to strike a balance between the short and long terms.

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"Language is a city to the building of which every human being brought a stone." —Mark Twain

Growing numbers of organizations—including banks on both sides of the Atlantic, a global natural-resources group, and a leading UK retailer—are adding an important new "stone" to the 21st-century business lexicon. "Performance and health" is a metaphor that derives its power from a simple comparison with the human body. Just as people may seem reasonably well today but may not have the physical condition for the rigors of a long and active life, so too companies that are profitable in the short term may not have what it takes to perform well year after year.

Managing companies for success across a range of time frames—a requisite for achieving both performance and health—is one of the toughest challenges in business. Recently, it has been especially hard: turbulent economic conditions, for example, have concentrated the collective minds of many executives on pure survival. The fact that 10 of the largest 15 bankruptcies in history have occurred since 2001 is a strong deterrent to business building, playing up its inherent risks.

Businesses complain that financial markets increasingly focus on quarterly results and give little credit to strategies for creating longer-term value, particularly if they depress today's profits. Empirical evidence largely

Article at a glance

Many companies are fixated on their next set of financial numbers—a form of myopia that is undermining their ability to manage themselves in a balanced way for the longer term.

Competitive pressures notwithstanding, all businesses must act today to ensure their future growth year after year.

Executives should monitor a small but robust set of metrics that reflect what's happening in the different areas of the business and cover a range of time horizons.

Managing for performance and *health also has deep implications for strategy and requires a new approach to communication with investors and analysts and to the development of leaders.*

contradicts such claims (see sidebar, "The stock market values health as well as performance," on the next spread). But some noisy analysts undoubtedly do focus on short-term performance and thus unwittingly drive wedges between managements, boards, and investors.

Management teams must urgently take the lead in showing their boards and the capital markets that they are nurturing the long-term health of their companies. They must act not only to improve corporate performance in the near term but also to lay the foundations today for consistent and resilient growth in years to come.

Companies out of balance

Tools intended to encourage a more balanced approach and to promote "systems thinking" have been available to managers for some time. But our experience suggests that these tools are either being applied too mechanically (and therefore ineffectively) or being squeezed out by the focus on survival and by perceived pressure from investors. And that's to say nothing of the increased near-term demands created by new regulations on financial reporting, particularly in the United States.

Good short-term results are important, of course; only by delivering them will management build confidence in its ability to realize longer-term strategies. But companies must also act today to ensure that they can convert their growth prospects, capabilities, relationships, and assets into future cash flows.

One major European financial-services company recently discovered how easy it is for performance and health to get out of balance. After the company had achieved an impressive turnaround in its short-term financial performance in the three years to 2004, it found to its dismay that this success had been accompanied by falling customer service levels, a huge increase in staff turnover, and a fall in its share price. Management complained that the financial markets didn't understand what the company had achieved. But in reality they understood, all too well, that its short-term success had been purchased at the expense of its underlying health.

Such shortsighted behavior is widespread. In one recent survey,[1] a majority of the managers polled said that they would forgo an investment offering a decent return on capital if it meant missing their quarterly earnings expectations. Indeed, more than 80 percent of the executives responding said they would cut expenditures on R&D and marketing to ensure that they met their quarterly earnings targets—even if they believed that the cuts were destroying long-term value.

This survey shows that even if more organizations are now talking the language of health, many address the issues only at a superficial level. For instance, "scorecards"—a favorite approach of many companies to balancing near- and long-term considerations—too often consist of disconnected metrics that confuse the organization and lack any real impact. One public-sector agency we know—an extreme case, to be sure—came up with 96 key performance indicators at the end of a two-year initiative; the list was effectively dead on arrival when it was rolled out for implementation. The chief executive of an international bank was recently shocked to find that members of his senior-management team were responding only to revenue targets and deliberately ignoring broader metrics of performance and health.

What underlies the breakdown of many long-term initiatives is the tendency of managers to defend the performance of their own silos instead of debating and helping to shape action across the whole organization. In silo-structured companies, managers typically argue about the virtues of one metric as opposed to another (especially if transfer prices are involved), deflect debate to other parts of the organization, and set up barriers to change. This kind of behavior isn't deliberately malevolent; it is driven by deeply held beliefs about a manager's roles and boundaries and reinforced by the idea that the body corporate is the sum of many discrete units, each with independent characteristics, that should be monitored with a battery of metrics. Unfortunately, this mind-set undermines any systemic understanding of how to manage activities coherently, across the whole organization, to underpin healthy growth.

An emerging awareness of health

The good news is that a clear health consciousness is developing after the startling corporate-health failures of recent years, and convincing prescriptions for change are emerging. In responses to a McKinsey survey, conducted in early 2005, of more than 1,000 board directors, most of them made it clear that they want to devote less time to discussing

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[1] John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "The economic implications of corporate financial reporting," NBER working paper number 10550, January 11, 2005 (http://papers.ssrn.com).

the latest financial results and much more to setting strategy, assessing risks, developing new leaders, and monitoring other issues that underpin a company's long-term health. Fully 70 percent of the directors want additional information about markets: a more detailed analysis of customers, competitors, and suppliers, for example. Upward of half want additional information about organizational issues, such as skills and capabilities. Two in five are eager for the facts about relations with outside stakeholders, such as regulators, the media, and the wider community.[2]

Above all, boards want to help their companies seize prospects for long-term growth and avoid exposure to risks from organizational blind spots or from any unwillingness to acknowledge external change. Thinking deeply about performance and health helps executives to address both aspirations.

What makes companies healthy?

Companies that attend to five different aspects of performance and health can build the resilience and the organizational capacity not only to deliver but also to sustain both.

[2] Robert F. Felton and Pamela Keenan Fritz, "The view from the boardroom," *The McKinsey Quarterly*, 2005 special edition: Value and performance, pp. 48–61 (www.mckinseyquarterly.com/links/17940).

The stock market values health as well as performance

The fixation of a few analysts on the short-term results in next quarter's earnings announcements shouldn't blind management to the reality that these announcements also contain objective and reliable information about *long-term* performance. And that is why most investors pay attention to them.

However, an examination of share prices shows that expectations of future performance are the main driver of shareholder returns: in almost all industries and almost all stock exchanges, cash flow expectations beyond the next three years account for 70 to 90 percent of a share's market value. These longer-term expectations in turn reflect judgments on growth and long-term profitability—a lesson relearned after the dot-com bust.

Long-term expectations vary from one industry to another. Cash flows in the global semiconductor industry, for example, must grow by more than 10 percent a year during the next ten years to justify current market valuations. In retailing and consumer packaged goods, the required growth rate ranges from 3 to 6 percent; in electric utilities, it is around 2 percent.

Future expectations also clearly drive the stock price of individual companies, thus explaining the often widely differing P/Es or market-to-book ratios of companies with similar reported earnings. In the pharmaceutical sector, for example, the market ascribes great value to a healthy drug pipeline, despite the fact that it will not affect earnings in the short term.

Even the private equity sector, renowned for its focus on short-term operational improvements, believes that health matters. Most private equity firms look to realize their investments in a five-year time frame, but they must still have a credible proposition for future earnings and cash flow growth to underpin a sale or IPO.

Strategy

First, a company's strategy should be reflected in a portfolio of initiatives[3] that consciously embraces different time horizons. A typical large company does, of course, include business units with distinct strategies, but few of them could really help it adapt to events or capitalize on new opportunities. Some initiatives in the kind of portfolio that we recommend should bolster a company's short-term performance. Others should create options for the future—new products or services, new markets, and new processes or value chains. A key management challenge is to design and implement initiatives that balance the company's performance and underlying health on a risk-adjusted basis.

Such a portfolio of initiatives helps companies overcome certain traditional shortcomings of strategy, such as its episodic nature and a tendency to ignore the resources and capabilities needed for execution and to plan the future instead of *for* the future. By developing and managing a portfolio of initiatives—rather than a single approach to strategy—companies can lower the risk that unpredictable events will place them on the wrong foot.

Metrics

A robust set of organizational metrics allows executives to monitor a company's performance and health. What's needed is a manageable number of metrics that strike a balance among different areas of the business and are linked directly to whatever drives its value. A vast assortment of metrics is self-defeating.

Companies should identify the health and performance metrics most important to them: product development, customer satisfaction, government relations, or the retention of talent, for example. (The answer will of course depend on a company's industry and strategy.) Most organizations track standard financial metrics. But we would also expect some metrics to cover operations (the quality and consistency of key value-creating processes), organizational issues (the company's depth of talent and ability to motivate and retain employees), the state of the company's product markets and its position within them (including the quality of customer relationships), and the nature of relationships with external parties, such as suppliers, regulators, and nongovernmental organizations (NGOs).

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[3] Lowell L. Bryan, "Just-in-time strategy for a turbulent world," *The McKinsey Quarterly*, 2002 special edition: Risk and resilience, pp. 16–27 (www.mckinseyquarterly.com/links/17773).

Systematically identifying and tracking health metrics that reflect the strategy of a business—and the forces driving its value—is difficult. A useful framework is to think of value creation in the short, medium, and long term.

Short-term health metrics show how a company achieved its recent results and thus indicate its likely performance over the next one to three years. A consumer products company, for example, must know whether it increased its profits by raising prices or by launching a new marketing campaign that increased its market share. An auto manufacturer must know whether it met its profit targets only by encouraging dealers to increase their inventories. A retailer might want to examine its revenue growth per store and in new stores or its revenue per square foot compared with that of competitors.

Another set of metrics should highlight a company's prospects for maintaining and improving its rate of growth and returns on capital over the next one to five years. (The time frame ought to be longer for industries, such as pharmaceuticals, that have long product cycles and must obviously focus on the number of profitable new products in the pipeline.) Other medium-term metrics should be monitored as well—for example, metrics comparing a company's product launches with those of competitors (perhaps the amount of time needed to reach peak sales). For an online retailer, customer satisfaction and brand strength might be the most important drivers of medium-term health.

A consumer products company must ***know*** *whether it raised its profits by raising prices or by increasing its market share*

For the longer term, companies should develop metrics assessing their ability to sustain earnings from their current activities and to identify and exploit new areas where they could grow. They must monitor any threats—new technologies, new customer preferences, new ways of serving customers—to their current businesses. And to ensure that they have enough growth opportunities to create value when those businesses inevitably mature, they must monitor the number of new initiatives under way (as well as estimate the size of the relevant product markets) and develop metrics that track the initiatives' progress.

Ultimately, it is people who make companies deliver, so metrics should show how well a business retains key employees and the true depth of its management talent. Again, what's important varies by industry.

Pharmaceutical companies, for instance, need scientific innovators but relatively few managers. Companies expanding overseas need people who can work in new countries and negotiate with governments.[4]

Constant fine-tuning is needed to come up with the right mix of metrics. For a typical business unit, top management and the board should monitor no more than three to five metrics, representing different areas of the business for each time frame. To make sure that the metrics are appropriate, the finance department or the performance-management group should regularly reexamine the way the company creates value.

Companies must avoid the erroneous thinking that too often juxtaposes "hard" metrics for performance with "soft" ones for health. They can and should attach hard numbers to health metrics, such as the motivation and capabilities of their employees. Similarly, they can and should track their current performance with softer metrics, such as the quality of their latest earnings or of their relationships with opinion formers.

Communication

The next step is for companies to change the nature of their dialogue with key stakeholders, particularly the capital markets and employees. For the capital markets, that means first identifying investors who will support a given strategy and then attracting them.[5] Talking about corporate health to court hedge fund managers pursuing the next bid, for example, is pointless.

Management teams should also spend serious time with analysts who follow their companies, in order to explain their views on the industry and to show how strategies will create sustainable advantages. It may also be necessary to highlight metrics tracking performance and health. Vague talk about shareholder value, without a time frame or without addressing the specifics of a business, just isn't meaningful.

Companies might also be wise to separate discussions of quarterly results from those focusing on strategy, as several major international businesses have recently done. And they should ensure that analysts spend time with operational managers, whose effectiveness is often the crucial factor in attempts to estimate a company's ability to sustain its performance.

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[4] Richard Dobbs and Timothy Koller, "Measuring long-term performance," *The McKinsey Quarterly*, 2005 special edition: Value and performance, pp. 16–27 (www.mckinseyquarterly.com/links/17941).

[5] Kevin P. Coyne and Jonathan W. Witter, "What makes your stock price go up and down," *The McKinsey Quarterly*, 2002 Number 2, pp. 28–39 (www.mckinseyquarterly.com/links/17942).

Reaching out to employees is just as important. The complaint that "we don't know what's going on" often indicates that a company's leaders are communicating results rather than long-term intentions.

Leadership

Corporate leaders should remember their obligation to manage both performance and health. Thinking about health typically requires a range of new skills and characteristics—not necessarily those that worked well in the past. One hallmark of great, enduring companies is a willingness to involve future generations of leaders in their own development.

>>> *Few companies recognize the leadership capacity new strategies require. See "Leadership as the starting point of strategy" (www.mckinseyquarterly.com/links/17999).*

In addition, good leaders understand both the power and the attendant risks of what former Unilever chairman and CEO Niall FitzGerald called their "extraordinary amplification system." Those who casually or randomly articulate themes for action run a risk of making the organization schizophrenic. The combination of "initiative overload" and a reluctance on senior management's part to produce a simple and coherent agenda can be particularly damaging. At one defense industry organization, we counted more than 1,000 seemingly disconnected initiatives, 234 of them in procurement alone.

Focusing the leadership on personal behavior is also crucial to maintaining a company's health. We know of a public-sector body, a financial institution, and a natural-resources group that all refer to the leaders of business units as "princes" rather than "barons." This terminology resonates with the three organizations because princes are concerned for the whole, while barons protect their own turf—if necessary at the expense of the other parts. Companies can likewise encourage a wider perspective on the business, and stronger linkages across boundaries, by giving senior managers a portfolio of roles. Alternatively, some companies have successfully developed peer groups of business unit leaders who share a collective responsibility for their businesses. Other companies are strengthening their core functions and reversing the trend toward corporate atomization into a number of semiautonomous business units.

To create this kind of leadership, companies must take a longer-term view of the way they manage talent and career tracks and of the incentives created by money, recognition, and promotion. One company's approach is to implement a long-term incentive plan for top management—a plan that has weakened the direct link between remuneration and short-term earnings.

By contrast, the current trend of making people change roles every two or three years isn't necessarily good for long-term corporate health.

Governance

The growing demand for corporate probity and better governance has reinforced the CEO's pivotal leadership role. Board meetings therefore represent a useful opportunity—and discipline—for testing the organization's resilience to pressure and change over time. As we have seen from our survey, directors are eager to redirect their attention to this task. The need for resilience is greatest when investments take a long time to pay off, as they generally do for natural-resource and pharmaceutical companies and public-sector bodies. CEOs and boards lack rapid performance feedback in such cases and thus need to keep a close eye on a range of considerations: regulatory influence, marketing and supplier partnerships, and organizational skills.

Given the current economic and regulatory environment, a focus on short-term performance is understandable, but it is nonetheless unbalanced. Companies must again learn how to meet next year's earnings expectations while at the same time implementing the platforms needed to deliver strong and sustainable earnings growth year after year. Achieving this dual focus involves thinking about strategy, communication, and leadership in new ways. And it calls for the creation of a carefully designed set of metrics—balanced across the business and linked to the creation of value over the short, medium, and long term—that can help management teams and boards monitor their ability to stay on course. Q

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