

The numbers behind successful transformations

Crunching the numbers on transformations suggests good news for companies that go broad, move fast and renew often, prioritize health, and keep stretching their aspirations.

by Kevin Laczkowski, Tao Tan, and Matthias Winter

“What gets measured,” Peter Drucker famously observed, “gets managed.” One might add a corollary that what goes unmeasured—or gets measured only superficially—risks being mismanaged or, at least, undermanaged.

So it is with transformations. As we’ve noted before, the term “transformation” can be vague, and it too often refers only to minor or isolated initiatives.¹ What should define a transformation is in fact the opposite: an intense, well-managed, organization-wide program to enhance performance and to boost organizational health. And the results should always be measured.

As part of an analysis we term “transformatics,” we’ve assembled and scrutinized a data set of more than 200 large transformations stretching back nearly a decade. More recently, we isolated the 82 public companies that had undertaken a full-scale transformation and had an observable 18-month transformation track record to see what we could learn from a statistical analysis of their experiences. The research highlighted four indicators that showed a statistically significant correlation with top-quartile financial performance during the 18-month test period (for more about the methodology, see sidebar “Transformatics: Inside the metrics of transformation”). Taken together, the four indicators suggest some potential lessons for senior managers seeking to maximize the odds of a successful transformation. Let’s look at each in turn.

¹ See Michael Bucy, Stephen Hall, and Doug Yakola, “Transformation with a capital T,” *McKinsey Quarterly*, November 2016, McKinsey.com.

1. Go big, go broad

The first indicator of top-quartile transformation is the scope of the effort itself. Successful companies, our findings suggest, typically favor an all-in, enterprise-wide transformation, rather than constraining the transformation to individual business units or functions. A more comprehensive scope increases the chances of creating value-generating opportunities across functions. This was the case for the basic-materials company whose story is described in more detail in the sidebar “The power of scope: A case study.” It also proved effective for a consumer-goods company we know whose leaders designed a series of transformation processes to harvest the fruits of improved integration across the company’s supply-chain, manufacturing, and sales units.

Exhibit 1

Growth can be as transformative as cost cutting.



Outperformers address both the bottom and top lines. Our data show that 41 percent of transformation value is generated from growth initiatives (Exhibit 1). That’s a reminder that “transformations” are not just about cost cutting. In fact, we found that reducing general and administrative expenses, including head-count reductions, comprised on average just 9 percent of gross transformation targets.

Another important aspect of scope appears to be the number of people involved. Whether targeting the bottom line or the top, companies that scored in the top quartile mobilized a substantial chunk of their workforce—at least 8 percent—to drive transformation initiatives. Some top performers deployed 20 percent or more. Mass mobilization allows organizations to pursue large numbers of granular efforts under the umbrella of well-defined workstreams that can, collectively, generate big results. In the transformations we studied, 68 percent of initiatives were worth \$250,000 or less, and only 16 percent were worth \$1 million or more. What’s more, 50 percent of transformation value came from smaller initiatives (which we define as less than 0.5 percent of the total value achieved from the transformation value)—little gains that rolled up to big wins.

As we’ve noted before, smaller initiatives are typically easier to deliver and also more empowering because they tend to be led by frontline employees. Their efforts give the employees more of a stake in the transformation’s success.² For example, one global industrial company empowered its frontline manufacturing workers to own portfolios of many small (less than \$25,000) lean-operations projects in targeted

² See Michael Bucy, Tony Fagan, Benoît Maraite, and Cornelia Piaia, “Keeping transformations on target,” March 2017, McKinsey.com.

The power of scope: A case study

In a business, the parts link together and compose the whole. To improve the whole, then, you have to improve the parts—right?

by William Fookes, Ignacio Marcos, and Alejandro Sandoval

That's the conventional wisdom: improve one part at a time, then move to the next part, methodically and consistently. This traditional view sounds sensible but appears to be wrong. Research by our colleagues shows that the most successful performance-transformation efforts cut across business units and functions, target both the top and bottom lines, and engage a substantial share of the workforce. Those findings are consistent with our experience, which is that cross-functional operations transformations—emphasizing the interactions between product development, procurement, manufacturing, supply chains, capital expenditures, and services (exhibit)—typically outperform their single-function counterparts by between 30 and 40 percent.

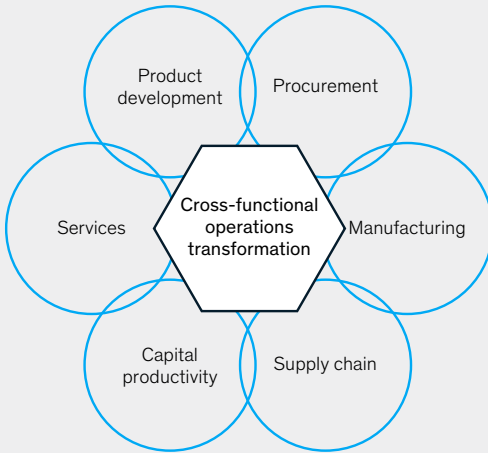
The experience of a company in the basic-materials industry vividly illustrates the power of scope in transformation efforts. The company started with a seemingly narrow problem: a need to optimize the way it used its fleet of trucks, which carried raw materials to manufacturing centers. The executive team hoped improvements would save the company \$5 million.

By taking a broader perspective on ways to maximize truck usage, the leaders found that every string they pulled and every question they asked connected the trucks to some other part of their operation. Truck use would be better if the company redesigned its internal road system and loaded materials more thoughtfully, in ways that matched the production process for different feedstocks.

In the end, the executives realized, no part of the company stood by itself. Every function connected to other functions. And that meant the company needed to scrutinize not just its truck fleet but also its entire end-to-end process, from understanding its customer needs through to the delivery of the finished product. Addressing the entire chain of value, in

Exhibit

Transformative change typically combines deep functional expertise with cross-functional initiatives.



Unlocking a company's full operational potential means building new institutional capabilities and organizational muscle.

turn, would open up larger opportunities to grow the business by delighting customers: providing them with a mix of products better suited to their needs, for example, thereby helping them to boost quality and reduce inventory levels.

As the basic-materials manufacturer identified the places where each piece of its operations intersected with other pieces, leaders also recognized opportunities to introduce systems that shared raw-material information more broadly, and highlighted additional possibilities. By applying advanced analytics, for example, the company optimized the positioning of raw-material processing equipment—a step that brought an additional productivity increase of 20 percent.

New management practices guaranteed the execution of new standard operational procedures, while also transitioning company culture toward becoming a continuous-improvement organization, constantly looking for ways to improve safety, performance, and quality. The result: more than \$60 million in bottom-line benefits, approximately 12 times more than the project the company had initially envisioned.

William Fookes is an associate partner in McKinsey's Santiago office, **Ignacio Marcos** is a partner in the Madrid office, and **Alejandro Sandoval** is a partner in the Buenos Aires office.

This case study was excerpted from "Transform the whole business, not just parts," which was developed by Bill Lacivita, a partner in the Atlanta office, as well as the authors listed above, and is available on McKinsey.com.

locations. Precisely because of the initiatives' small size, the responsible employees were able to deliver them more quickly, with fewer layers of approval. Granular initiatives and renewal under well-defined workstreams can collectively add up to big moves over time.

2. Move fast, renew often

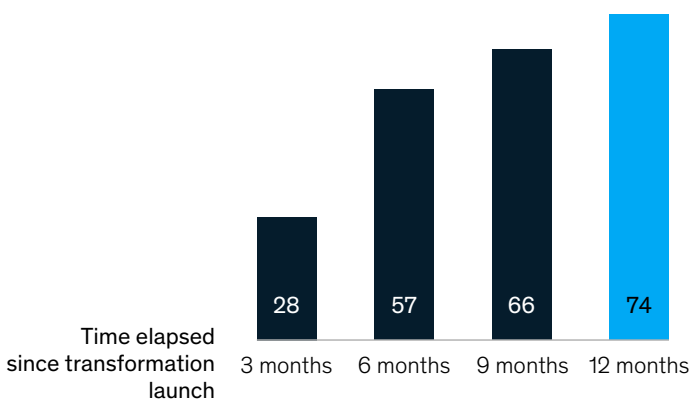
Top-quartile transforming companies, our findings suggest, move fast and renew often. In successful transformations, companies typically sprint out of the gates, turning their initial burst of idea generation into an achievable, rigorous plan within a few short months. Execution follows at an equally fast clip. That said, every transformation is unique; some by nature will take longer (for example, significant portfolio changes or major shifts in business models). When we drilled down into a subset of our data to get a sharper picture, we found that successful transformations typically implemented initiatives that ultimately corresponded to 28 percent of fully ramped-up value in the first three months, 57 percent in the first six months, and 74 percent in the first 12 months (Exhibit 2).

That makes sense. When companies can snag “quick wins”—such as more efficient use of working capital and better management of discretionary spending—early in the transformation process, they can then use the savings to fund longer-term ambitions such as organic growth and building employee capabilities. In this way, transformation becomes a virtuous cycle. To maintain momentum, companies in the top quartile restocked their number of initiatives by 70 percent after the first year, often backfilling initiatives that had been canceled or downsized. Some companies even make this a part of their annual planning process. A chemicals company we know tasks key members of its finance and operations leadership to conduct an annual, internal due diligence, as if it were an outside buyer, and then involves frontline leaders to develop and implement initiatives addressing the identified

Exhibit 2

The first few months of a transformation pack a powerful punch.

Share of transformation value achieved by top-quartile companies over the first year, %



opportunities. We observed that less successful transformations, on the other hand, were not only less likely to start strong but also less likely to keep going. Companies in the bottom quartile failed to renew their initiatives. That, too, makes sense because a lack of momentum can cause portfolios to stagnate, which impedes value creation.

3. Embrace organizational health

As easy as it is to overlook health in the quest for rapid performance improvement, it's also a mistake. For more than 15 years, our Organizational Health Index (OHI) has been monitoring health across a hundred countries and well over a thousand companies, aggregating the views of millions of employees and managers on management practices that drive outcomes along nine dimensions, including leadership, accountability, and innovation and learning. We score the results, allowing a company to see how it compares with others in the database. Companies with a healthy culture consistently outperform their peers. In fact, publicly traded companies in the top OHI quartile generate three times the total returns to shareholders (TRS) achieved by those in the bottom quartile.

We observe a similar relationship when it comes to transformations. When we compared the returns generated by transforming companies that fully implemented a defined set of health-improvement measures for enterprise-wide behavioral change with those that did not, the results were stark. The companies that fully implemented these health-improvement measures saw nearly double the excess TRS of companies that did not (Exhibit 3).



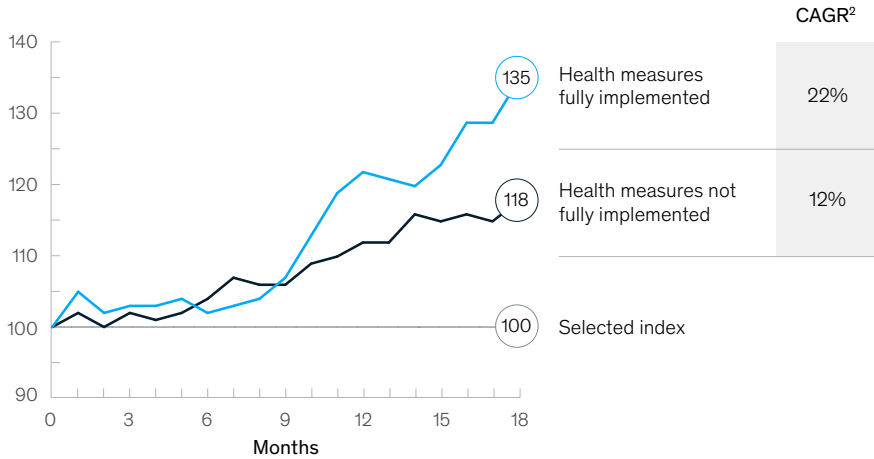
Transformatics: Inside the metrics of transformation

For close to a decade, we've been tracking the results of hundreds of transformations that collectively include more than 100,000 employees responsible for more than 250,000 distinct initiatives that collectively generated billions of dollars in bottom-line impact. To stress-test our thinking and control for externalities, we identified the 82 publicly listed companies that went through such a transformation for a measurable 18-month period and whose total returns to shareholders (TRS) could be paired with a representative off-the-shelf sector *and* geographic stock index, allowing us to measure excess TRS against the index for an 18-month period following the launch of a transformation. As a key part of that research, we conducted a “random forest” analysis that tested the characteristics of some 20 hypotheses against our data set. Of these hypotheses, the analysis isolated four indicators that proved to be statistically significant and often correlated with top-quartile excess TRS: the scope of the effort, its speed and renewal, the extent to which it implemented a defined set of health measures for enterprise-wide behavioral change, and the presence of bold aspirations and targets.

Exhibit 3

Committing to organizational health as part of your transformation can be a difference maker.

Alpha of total returns to shareholders, based on whether companies fully implemented organizational-health measures¹



¹In this analysis, alpha measures the performance of an investment against an off-the-shelf sector and geographic stock index. Stock price reflects total returns to shareholders and is (1) adjusted for dividends, (2) adjusted for splits, and (3) weighted on a market-capitalization basis; n = 14 for companies that fully implemented organizational-health measures and 68 for those that did not.

²CAGR = compound annual growth rate.

Outperforming companies set clear, measurable organizational-health targets in conjunction with their financial objectives, prioritizing elements that relied on measurable results, not buzzwords. Top executives themselves buy in and empower a dedicated team to help address deficiencies when they arise. Healthy companies put a premium on engagement from day one—they instill a norm of transparency and encourage dialogue right from the start.

4. Stretch your aspirations

Normally, you think of starting with aspirations. We close with them, because in our experience companies that achieve the most successful transformations often evolve their performance aspirations, making them more aggressive as the transformation gets rolling and accomplishing more than they thought possible at the outset. Our colleagues commented on this phenomenon in an article a few years ago, noting that, “In our experience, targets that are two to three times a company’s initial estimates of its potential are routinely achievable—not the exception.”

Our research shed some intriguing light on this view. We observed that successful transformations typically started with internal due diligence aiming to anchor the company’s potential for massive improvements in objective, discernable evidence. Companies that, based on what the due diligence showed, set gross transformation

targets at 75 percent or higher of trailing earnings were more likely to realize outsized TRS gains. On the other hand, we also saw that many of the companies with weaker transformation performance (the bottom half of excess TRS) had set their targets at 25 percent or less of trailing earnings. We are struck that the 3:1 ratio is consistent with the pattern recognition of our colleagues, and with our own. Bold performance aspirations do seem to matter, and, at the least, executives should not lock in on initial estimates that may be too low. There may even be a “Pygmalion effect” at work, with high expectations lifting results up and low expectations holding them down.

We often hear that “transformations are a crapshoot.” Certainly, every transforming company faces unique challenges, and there are variables that no company can control. Still, the indicators surfaced by our research suggest that leaders have significant influence over the success (or failure) of their company’s transformations. Lessons from these findings suggest that organizations that go broad, move fast and renew often, prioritize health, and keep stretching their aspirations can significantly outperform their peers. The numbers tell the story. Q

Kevin Laczkowski is a senior partner in McKinsey’s Chicago office, **Tao Tan** is an associate partner in the New York office, and **Matthias Winter** is a senior partner in the Zurich office.

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