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Operations Practice

The missing productivity ingredient: Investment in frontline talent

Companies that give the same strategic thought to workforce investment that they do to capital investment can unleash operational excellence.

This article is a collaborative effort by Ezra Greenberg and Fernando Perez, with Dylan Lambert, Marino Mugayar-Baldocchi, and Tyler Freeman, representing views from McKinsey's Operations and Strategy & Corporate Finance Practices.

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Finding enough workers with the right skills is now a global challenge. On top of changing demographics and widening skill gaps, companies face burned-out middle managers, workers needing flexibility, generational disconnects, and eroding real wages. Little wonder, then, that few businesses report lasting success at reigniting productivity after a decades-long slowdown.

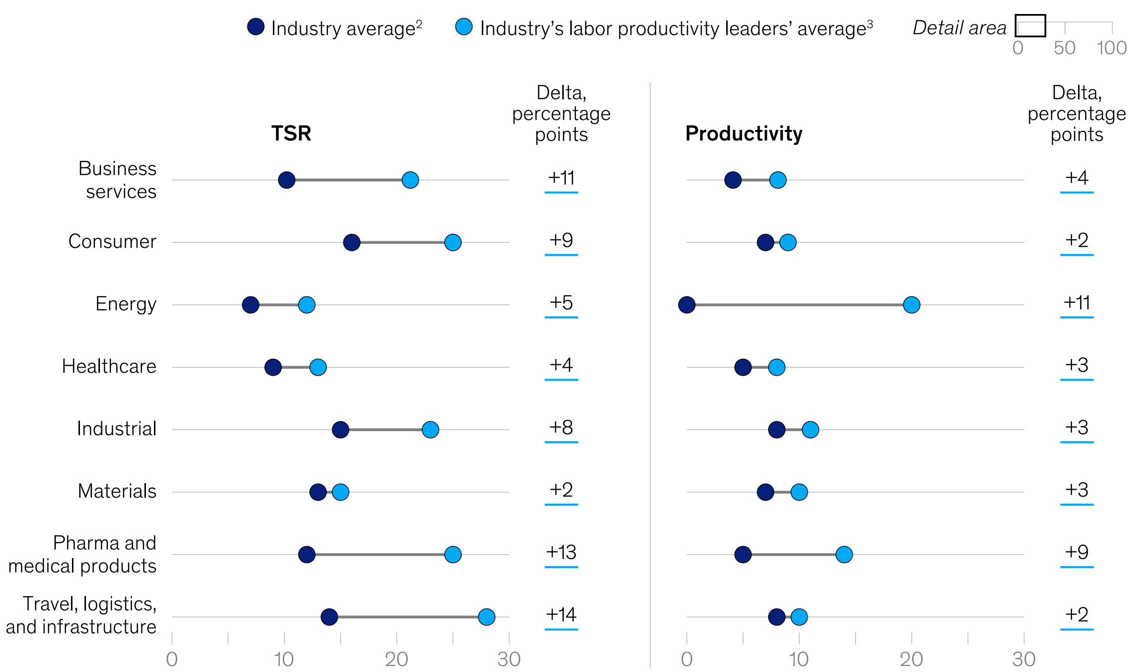
Business leaders have responded by expanding investment in technologies ranging from automation and robotics to digital processes and AI. Some organizations have reaped productivity gains, but many more have fallen short of expectations. McKinsey analysis has shown that the average company captures only about one-third of the expected value from digital transformations and initiatives.[1]

To help companies unlock new possibilities for labor productivity growth, we set out to learn from businesses that have outperformed their respective sectors in both TSR and labor productivity growth (see sidebar, "About our research"). This article summarizes our findings, which identified 56 companies that performed better than their sector peers in both categories (Exhibit 1). Most important, we learned that these labor productivity leaders display a mindset very different from other companies' mindsets about their labor-related spend.

Exhibit 1

Labor productivity leaders outperform their sectors on both TSR and productivity growth.

Industry vs industry's labor productivity[1] leaders in 2007–22, %



[1]Growth in revenue per full-time equivalent position.
[2]Companies across 24 OECD countries with data covering 2007–23 (n = 1,430).
[3]Companies identified as labor productivity leaders (n = 56).
Source: Value Intelligence by McKinsey

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[1]Kate Smaje, Laura LaBerge, and Rodney Zemmel, "Three new mandates for capturing a digital transformation's full value," McKinsey Digital, June 15, 2022.

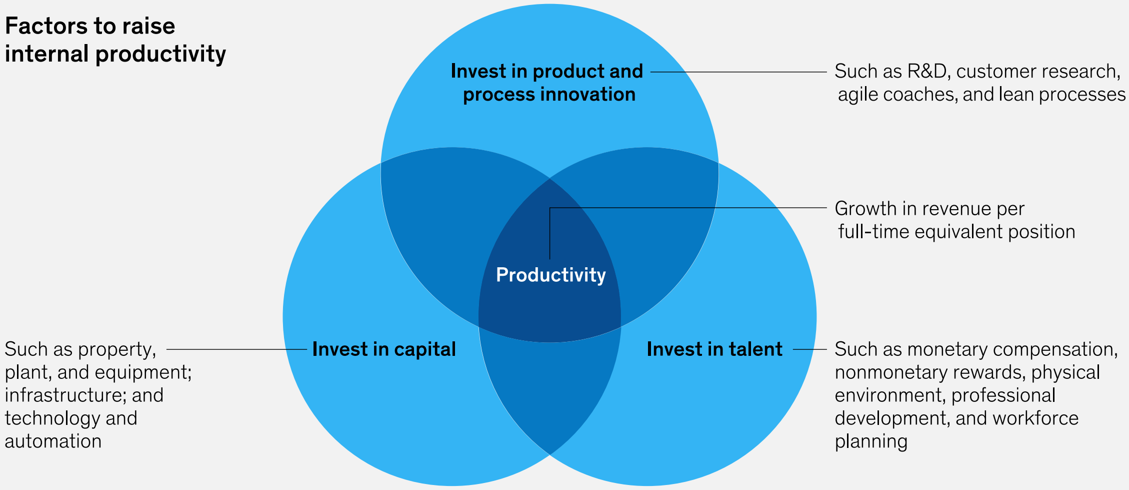
About our research

McKinsey's previous research on how organizations can outperform in productivity growth showed that companies can unlock a significant opportunity by investing in three broad categories: talent, capital assets (including technology), and product and process innovation (exhibit).[1]

Our current research examines the first and second areas of investment: talent and capital (the two core factors of production). We started with the top 5,000 publicly traded firms across 24 countries in the OECD. We selected the 1,430 companies whose data covered the period from 2007 to 2023 and isolated the top quintile in each sector for both TSR and labor productivity growth (defined as revenue divided by the CAGR for full-time-equivalent positions). We call the resulting 56 companies, representing about 1 percent of the starting sample, the labor productivity leaders: They overcame the talent stability and productivity challenges many of their peers still struggle with today.

Exhibit

Productivity comes from coordinated action across categories of investment.



Source: Ezra Greenberg, Asutosh Padhi, and Sven Smit, "2024 and beyond: Will it be economic stagnation or the advent of productivity-driven abundance?," McKinsey, Jan 12, 2024

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[1] Ezra Greenberg, Asutosh Padhi, and Sven Smit, "2024 and beyond: Will it be economic stagnation or the advent of productivity-driven abundance?," McKinsey, January 12, 2024.

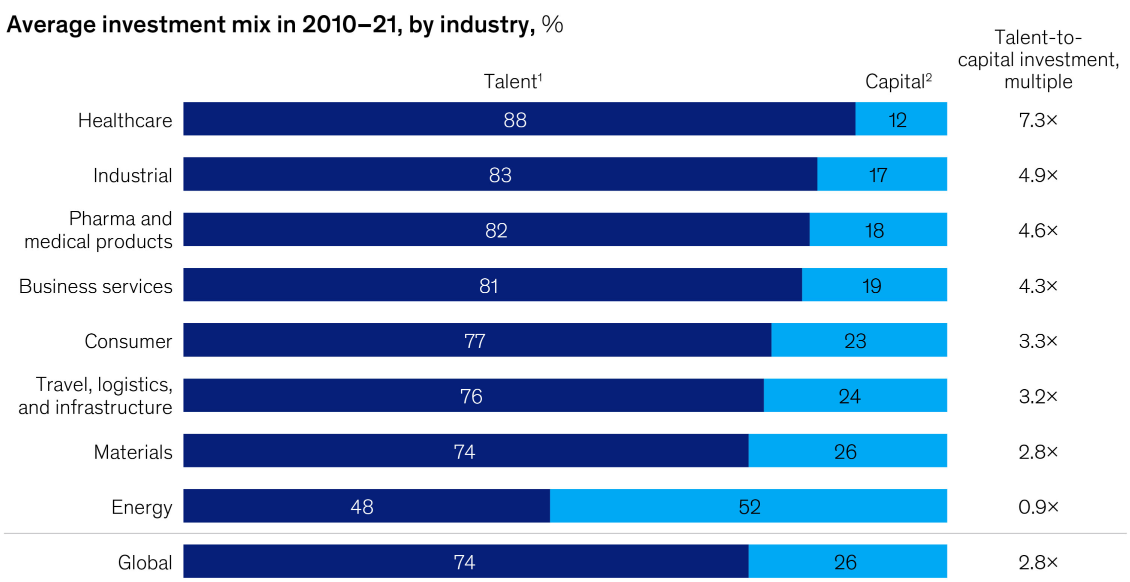
From cutting labor cost to investing in talent

Historically, business leaders have understood that capital and talent must work jointly to drive productivity. But that basic insight has only rarely kept companies from treating talent—especially the frontline workforce—primarily as an operating cost to be minimized.

Our data reveal just how shortsighted this belief has been. Across almost every sector, we find that, on average, companies spend three times as much per year on talent as they do on capital assets (Exhibit 2). Our estimate may actually understate the investment in talent, considering that it omits recruiting, training, nonmonetary rewards, and equity grants—and that some capital expenses, such as in safety equipment, are primarily for employee experience.

Exhibit 2

Across eight major industries, companies typically spend at least three times as much per year on talent as on capital.



Note: Analysis of conglomerates, financial services and insurance, real estate, and technology, media, and telecommunications not shown.
[1]For comparability between wage data (from income statements) and capital investment data (from balance sheets), "talent investment" defined as total wages divided by weighted average cost of capital.
[2]"Invested capital" defined as sum of net operating working capital; property, plant, and equipment; right-of-use assets; operating intangibles; and net other operating assets.
Source: Value Intelligence by McKinsey

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Moreover, this finding holds true even in capital-intensive sectors, such as materials (which includes metals, mining, and pulp and paper) and industrial (including automotive, aerospace, and other advanced manufacturers). Energy is the only sector in which the labor productivity leaders spend more on capital than on labor—and only barely so, at a split of 52 and 48, respectively.

Despite this stark imbalance in spending, few companies attempt to calculate their ROI in labor with the same rigor they apply to ROI in capital assets, which they regularly assess in light of their cost of capital to measure shareholder value creation. That fundamental gap in metrics encourages companies to continue accounting for labor spend only as a cost, so they lose sight of highly attractive business cases for talent investment. Conversely, labor productivity leaders demonstrate that when companies work to maximize employee value creation, shareholder value creation follows.

With talent representing so much of a firm's investment in production factors, getting it right is essential. Talent shortfalls—whether due to stability challenges (such as high attrition, absenteeism, and chronic vacancies), low engagement, or mismatched skills—are even more expensive, especially when combined with limited labor productivity growth.

Our research finds that for manufacturers in the United States, the real cost of frontline labor challenges is typically about $17,000 to $30,000 per active employee, including expenses ranging from recruiting and training to shift coverage and lost production. For an organization with 10,000 employees, that cost could amount to an annual EBITDA impact on the order of $250 million.

The labor productivity leaders illustrate, however, that a judicious approach to talent investment can help organizations not only minimize these losses but also generate new opportunities for productivity, differentiation, and growth.

How labor productivity leaders invest in talent

Labor productivity leaders minimize their exposure to talent risks by viewing their frontline workforces as worthy of investment rather than just an opportunity to reduce costs. Each productivity leader we analyzed invested in talent differently, but all invested in one or more of the following seven core aspects of workforce development. Taken together, these elements can help positively shape the relationship between a company and its workforce:

— *Reassessing compensation*. Often a company's first reaction to workforce issues is to increase monetary compensation, as was highly visible during the COVID-19 pandemic. Employers in sectors from healthcare to logistics, retail, and technology raised hourly wages, rolled out signing bonuses, and provided additional monetary incentives to boost retention. But over time, these measures often proved difficult to sustain economically. They were also easily replicated by competing employers, underscoring their limited value in boosting long-term retention. And they often failed to reward the most engaged and productive employees, who have a disproportionate effect on a company's prospects.

Unilever, the global consumer goods manufacturer, has applied a different approach by adapting its global operating model to provide living wages (beyond statutory minimums) across the entire company. It is now extending this commitment to its supply chain. Unilever's ambition is for half of its suppliers to have signed its Living Wage Promise by 2026, with full compliance for all suppliers by 2030.

A few companies have created new forms of equity ownership plans that are structured to provide unusually generous grants of stock to frontline employees who meet basic eligibility criteria. For example, since 2017, Ingersoll Rand has awarded more than $250 million in stock grants to all employees with at least one year of tenure. During that time, the company's TSR has grown by more than 400 percent, drastically outperforming the S&P 500. Ingersoll Rand's 2023 annual report credits the stock grant program as a significant contributor to its results by fostering an ownership mentality across the entire organization.

— *Optimizing work and environment design*. Companies' investments in reimagined workflows and spaces can improve safety, reduce waste, and enhance the working environment. Such investments usually represent capital costs in accounting, but they nevertheless set a strong baseline for employee morale. Moreover, these measures—for example, upgrades to facilities in areas such as lighting, pathing, ventilation, and human support technology—can reduce hidden losses. Research from the National Safety Council finds that in the United States alone, the total cost of worker injuries averages to more than $1,000 per worker, including wage and productivity losses, medical and administrative expenses, and employers' uninsured costs.

WM (formerly known as Waste Management) earned substantial returns from its investments in robotic side-loading trucks and automated core disposal and processing facilities. This allowed the company to redesign frontline work, reduce repetitive work, and improve worker safety. From 2017 through 2023, revenue grew by 6 percent per year while head count remained almost flat.

Automation has also helped several quick-service restaurants increase productivity by double digits, freeing employees from rote, manual tasks, such as order taking, and redeploying them to ensure quality and improve customer experience. Chipotle Mexican Grill recently deployed a machine that can peel avocados, a task that previously involved hours of human work for every store's lunch rush.

At Disney parks and resorts, mobile-tablet-based tools now allow supervisors to spend about two-thirds of their time engaging with the front line to solve problems and identify opportunities in real time. More broadly, the company sets baseline expectations for all employees—regardless of role, title, or function—to support frontline activities and engage directly with customers. These measures further reinforce Disney's focus on guest and employee experience while creating chances for everyone to develop deeper insights into the company's operations.

— *Improving workforce planning and scheduling*. Labor productivity leaders are enhancing their capabilities of forecasting labor demand and supply and creating dynamic and happier workforces by providing scheduling flexibility. A global equipment maker has developed a highly sophisticated capability management system based on a skill matrix. It helps operations leaders understand the skills their employees have and the gaps for further development. Covering dozens of job codes, technologies, and domains, the system lets managers redeploy workers in real time when emergencies arise or production needs change. But its larger impact is over the long term: The system informs how managers set priorities for technology investment while enabling workers to identify opportunities for learning and growth.

Major technology investments aren't always necessary. Facing chronic worker shortages at rural plants, managers at US dairy cooperative Land O'Lakes rethought decades-old requirements that workers commit to 12-hour shifts. The answer wasn't an investment in robots: The launch plant was already heavily automated. Managers instead discovered that some types of work could be performed in shorter pulses without disturbing overall production flow. Although designing new, flexible jobs made shift planning more complex, the benefits from improved retention and reduced overtime have made the effort worthwhile. Each flex role also attracts about twice as many applicants as a traditional 12-hour role does, a crucial advantage in remote areas with shallower labor pools.

— *Investing in talent attraction and onboarding*. Many of the productivity leaders are directly addressing constrained labor supply by expanding the pipeline of future workers. Quanta Services, a US company dealing with construction procurement and engineering, has spent more than $150 million in strategic people development initiatives—including partnerships with local colleges and universities to graduate new technicians with the latest knowledge. Productivity growth has been strong: From 2007 to 2022, revenue increased twice as quickly as head count did.

— *Measuring talent effectiveness*. The outperformers in our research invest in tools and practices that create transparency while fostering both individual and collective accountability. These efforts can be as simple as a monthly award for the highest-output or most-improved production line or as a bonus keyed to the most effective root cause: problem-solving. But Unilever illustrates how a more thoughtful, integrated approach can have more dramatic results. At a factory facing serious production shortfalls, the company rolled out a new reward program that provided small financial incentives for meeting new production and morale targets while encouraging problem resolution. Absenteeism fell by about one-half, productivity improved by more than 10 percent, production waste fell by more than one-quarter, and revenue rose by more than 20 percent.

— *Building strong cultures and employee experiences*. A community-oriented workplace culture can create a strong sense of belonging among employees, healthy relationships among coworkers and supervisors, and an environment in which positive recognition reinforces desired behaviors. A global durable-goods manufacturer, for example, has set up an all-employee internal website where anyone can share improvement ideas—even ones outside their areas of work. A technical team reviews the submissions, with winning entries eligible for deployment and, in some cases, financial incentives. Almost all employees now participate in this social suggestion box by either submitting ideas or voting on submissions. The site itself costs very little to run yet nets more than $1 million in cost savings per year and boosts engagement dramatically.

— *Investing in talent development*. Many company leaders say that they want to develop their employees' capabilities, but their visions often reach only as far as standard on-the-job training and tuition reimbursement. Those basic tactics aren't enough to excite today's workforce. Labor productivity leaders instead build a holistic set of development opportunities, including online instruction, classroom training, life-skill development, and individual professional development.

Companies in some sectors have started collaborating with universities to build tailored programs and providing tuition reimbursement for courses already on offer. In some cases, companies have found it more effective to build their own programs. One electronic-component manufacturer, for example, discovered that outside institutions couldn't provide training to meet the demands of its cutting-edge manufacturing processes. The company hired its own experts to design a homegrown training program that has led to double-digit increases in the number of promotions of workers who have now acquired the right skills to advance.

Building a talent investment engine

In developing the substance of a talent investment program, companies can't rely only on the HR department, whose expertise in capability-building design is essential but only part of the puzzle. Instead, we find that labor productivity leaders usually assemble a dedicated, cross-functional team encompassing HR, operations, engineering, finance, technology, and other departments. Crucially, these teams include representation from the front line to ensure that the proposed investments met real needs.

The process companies use for planning and prioritizing talent investments can largely follow the model already used for capital expenses. Because local insights are especially important for talent investment decisions affecting the front line, company leaders may want to allow for greater flexibility for investments under a certain threshold. Larger proposals would be subject to a quarterly review by the center to vet business cases and determine sequencing.

Most important, the center can establish clear success metrics for all talent investments, assessing their effects on productivity, workforce stability, and other KPIs. As the results come in, the company can build a library of interventions that local leaders can adapt as needed. Revised performance management and incentive systems that recognize effective talent investment can provide longer-term reinforcement.

Productivity leaders show how investments in talent can yield exciting results when they are given at least as much thought as investments in capital are given. Simple labor cost optimization isn't enough: Instead, the challenge is to maximize returns on talent investment. That mindset shift can not only stabilize short-term workforce problems but also achieve productivity breakthroughs that can sustain competitive advantage for the long haul.

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