
Keiko Morimoto

# The hidden value of organizational health—and how to capture it

**New research suggests that the performance payoff from organizational health is unexpectedly large and that companies have four distinct "recipes" for achieving it.**

**Aaron De Smet, Bill Schaninger, and Matthew Smith**

For the past decade, we've been conducting research, writing, and working with companies on the topic of organizational health. Our work indicates that the health of an organization is based on the ability to align around a clear vision, strategy, and culture; to execute with excellence; and to renew the organization's focus over time by responding to market trends. Health also has a hard edge: indeed, we've come to define it as the capacity to deliver—over the long term—superior financial and operating performance.

In previous articles and books, such as *Beyond Performance*,[1] we (and others) have shown that when companies manage with an equal eye to performance and health, they more than double the probability of outperforming their competitors. Our latest research, at more than 800 organizations around the world, revealed several new twists:

- We found that the linkage between health and performance, at both the corporate and subunit level, is much clearer and much larger than we had previously thought. With the benefit of more data and a finer lens, we discovered that from 2003 (when we began collecting data on health) to 2011, healthy companies generated total returns to

[1] Scott Keller and Colin Price, *Beyond Performance: How Great Organizations Build Ultimate Competitive Advantage*, first edition, Hoboken, NJ: John Wiley & Sons, 2011. See also Scott Keller and Colin Price, "Organizational health: The ultimate competitive advantage", *McKinsey Quarterly*, June 2011, mckinsey.com.

shareholders three times higher than those of unhealthy ones.

- We further discovered that companies consistently outperforming their peers generally conformed to the pattern of one of four distinct organizational "recipes." We had already recognized these patterns but hadn't understood their strong correlation with health, operational success, and financial performance.

- We also uncovered a practical alternative to the common (but too often disappointing) approach of seeking to improve corporate health by closing every best-practice gap. More tailored initiatives that combine efforts to stamp out "broken" practices while building signature strengths not only are more realistic but also increase the probability of building a healthy organization by a factor of five to ten.

In short, we're more convinced than ever that sustained organizational health is one of the most powerful assets a company can build. We're also clearer on how to achieve it, including the pitfalls to avoid on the road. We hope this is welcome news to leaders worried about the long term, who frequently complain to us that the benefits of their one-off reorganization initiatives are ephemeral.[2]

## How we track health

For the past ten years, we have measured and tracked organizational health in hundreds of companies, business units, and factories around the world. We ask employees (more than 1.5 million and counting) about their perceptions of the health of their organizations and what management practices they do or don't see in them. We then produce a single health score, or index, reflecting the extent to which employees say that their organizations are "great" in each of nine dimensions (or outcomes) of organizational health. To establish more precisely what each organization looks like, as well as its strengths and weaknesses, we also ask employees how frequently they observe[3] four to five specific management practices that drive those nine outcomes. Exhibit 1 provides some flavor of how the management practices, 37 in all, line up against the outcomes.

When we have done this with similar units—such as factories, processing units, and regions—in a given company, we have frequently found a strong correlation between organizational health (as measured by our survey) and the unit's financial or operating performance. And when we compared the health metrics of more than 270 publicly traded companies[4] with their financial-performance metrics, we found that the healthiest generated total returns to shareholders that were three times higher than those of companies in the bottom quartile, and over 60 percent higher than those of companies with "middle of the road" health profiles.

## Management practices matter

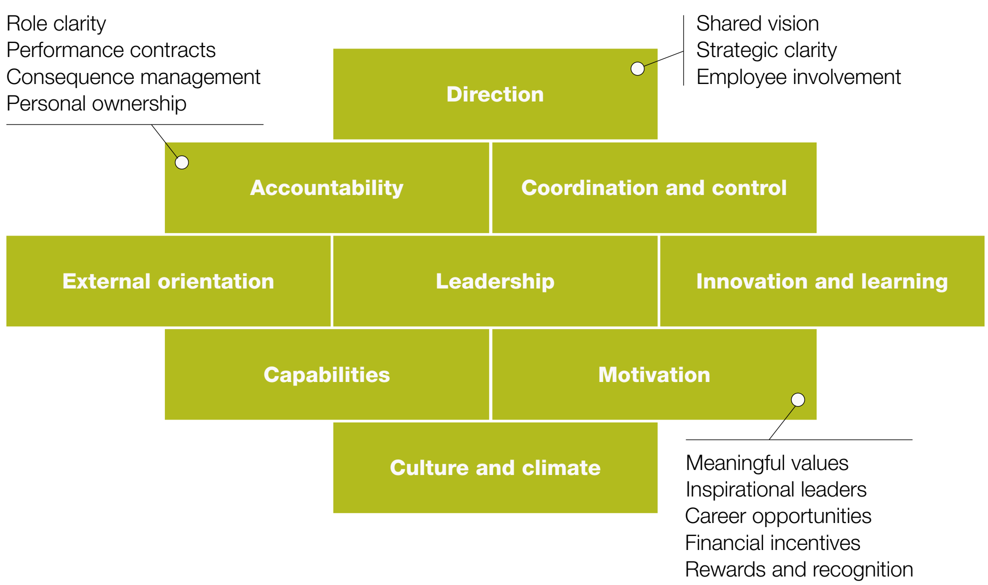
The most interesting findings, though, came when we looked more closely at the healthiest organizations in our database. Obviously, all had high health scores as measured by the nine outcomes of health. But when we delved deeper and looked at the 37 practices that management teams focus on to deliver those outcomes, we discovered that four combinations of practices,

[2] These were the fortunate ones. Our global survey shows that only one-third achieve their change goals.
[3] On a scale ranging from "never or almost never" to "always or almost always."
[4] The full database includes many nonpublic companies and government organizations that were excluded for this analysis.

Exhibit 1

**The organizational-health index tracks nine dimensions of organizational health, along with their related management practices.**

In all, the index covers 37 related management practices. Here are selected examples of practices for 3 of the dimensions.




or "recipes," were associated with sustained success. Indeed, further analysis showed that companies strongly aligned with any of these four organizational recipes were five times more likely to be healthy and to deliver strong, sustained performance than companies with mixed (or random) recipes.

Each of the four clusters we identified from the data reflects a distinct underlying approach to managing, including core beliefs about value creation and what drives organizational success. Each can be described by the specific set of management practices prioritized by companies that follow it (Exhibit 2).

The hallmark of the first, or *leader-driven*, recipe is the presence, at all of an organization's levels, of talented, high-potential leaders who are set free to figure out how to deliver results and are held accountable for doing so. This open and trusting culture is typical of highly decentralized organizations or of new businesses, where the resolve of strong leaders, effectively multiplied by their peers across the organization, is essential to create something from nothing. While most organizations use career opportunities to motivate employees, companies in this cluster use career opportunities as a leadership-development practice. Role modeling and real experience is more important than passing along sage lessons.

Exhibit 2

**Each of the four clusters identified from the data reflects a distinct approach to managing and can be described by a specific set of management practices.**

Top 5 out of 37 management practices prioritized by companies that follow given approach

| Leader driven | Market focused | Execution edge | Talent and knowledge core |
|---|---|---|---|
| Career opportunities | Customer focus | Knowledge sharing | Rewards and recognition |
| Inspirational leaders | Competitor insights | Employee involvement | Talent acquisition |
| Open and trusting | Business partnerships | Creative and entrepreneurial | Financial incentives |
| Financial incentives | Financial management | Bottom-up innovation | Career opportunities |
| Risk management | Government/community relationships | Talent development | Personal ownership |

Organizations following the second, or *market-focused*, recipe tend to have a strong external orientation toward not only customers but also toward competitors, business partners, regulators, and the community. These companies strive to be product innovators, shape market trends, and build a portfolio of solid, innovative brands to stay ahead of the competition. The best ones both respond to demand and develop products that help shape it (a strong recent example would be Apple as it reshaped several consumer-technology markets). They have a shared vision and the strategic clarity to ensure that employees explore the right market opportunities, as well as strong financial management to provide individual accountability and to ensure that responses to market trends are in fact profitable.

The third recipe, which we call *execution edge*, includes companies that stress continuous improvement on the front line, allowing them to raise quality and productivity constantly while eliminating waste and inefficiency. These companies place a heavy emphasis on sharing knowledge across employees and sites—not just as a way to foster innovation but, paradoxically, also as the primary way to drive standardization. Knowledge sharing helps to manage the frequent trade-offs between the top-down need for

Successful companies match their organizations to their aspirations; misalignment can often undermine both performance and health.

networkwide consistency and bottom-up encouragement of employees; without it, the best ideas might not get disseminated across different units of an organization. Such companies are unlike market-focused ones, which push alignment and consistency more strongly from the top down by analyzing external trends and developing a clear strategy for where the market is going.

The fourth and final recipe, *talent and knowledge core*, is found frequently among successful professional-services firms, professional sports teams, and entertainment businesses. Such organizations emphasize building competitive advantage by assembling and managing a high-quality talent and knowledge base. They typically focus on creating the right mix of financial and nonfinancial incentives to acquire the best talent, and then on motivating employees and giving them opportunities. In contrast to companies in the leader-driven group (whose value is created through teams directed by a strong leader), talent and knowledge-core organizations succeed thanks to highly skilled individual performers. (For more on how our findings translate in a narrower industry context, see sidebar, “Organizational health in consumer-goods companies.”)

## Building a healthier organization

What can be learned from the four healthy organizational clusters our latest research identified? How can companies adapt accordingly? We certainly wouldn’t suggest that they blindly seek to replicate one of the cluster recipes, ingredient by ingredient or practice by practice. Just like great chefs don’t copy and paste the recipes of others, companies must take these general archetypes as inspiration and identify a pattern of healthy practices that best fits their own organizations and strategies. In their continuing search for a better-functioning organization, companies should consider the following issues.

## Organizational health in consumer-goods companies

**Sorcha McKenna**

For companies in the consumer-goods industry, organizational health is an asset that can help sustain a competitive edge in mature markets and capture growth in emerging markets. In our experience, healthy consumer-goods companies are able to respond faster and more flexibly to the challenges they typically face in mature markets, such as stagnant growth, intense competition, and rising raw-material costs. Branded-goods manufacturers with a consistent approach to organizational health can make tougher choices faster and execute radical changes more successfully. In emerging markets, healthy companies are able to grow more quickly than their less healthy counterparts, in part by maintaining a strong and effective talent pipeline, leveraging their platforms and systems across markets, and developing innovations that differentiate them from competitors.

The four recipes my colleagues identified can help consumer-goods manufacturers achieve higher levels of organizational health and simultaneously drive better financial and operational performance.

**Leader driven.** Several consumer-goods companies used to follow this recipe. However, in many companies, the emergence of global brands has resulted in a lessening of local leaders' degrees of freedom. While local leaders are still accountable for results, they now rarely make big choices that will have an impact on a brand's overall strategy. At such companies, few local leaders have the opportunity to develop the skills that global leadership roles require.

**Market focused.** Most consumer-goods companies follow this recipe. They have a customer-centric approach to management. Many of the most successful consumer-product innovations of the 20th century—disposable diapers being one example—are a direct result of this strong customer focus.

**Execution edge.** Some consumer-goods companies, particularly those that operate in many small local markets, have used certain ingredients from this recipe—for example, they have developed centers of expertise in marketing and innovation that liaise closely with staff in local markets to facilitate the sharing of knowledge and best practices. Such an arrangement allows these companies to learn from local improvements and spread them quickly across the global network to deliver a real execution edge over competitors.

**Talent and knowledge core.** Although they certainly use some of the management practices strongly associated with a talent and knowledge core, this recipe in its pure form is rare among consumer-goods companies.

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## The imperative of alignment between strategy and health

Successful companies match their organizations to their aspirations. Once a company has identified the most appropriate organizational recipe for the chosen strategy, it should align the organization as far as possible with that mix of practices. If its most important day-to-day practices do not support its strategy, or are not consistent with the direction communicated by its leadership, the misalignment can often undermine both overall performance and health.

Such misalignments often happen in strategic shifts. A large company we know changed its product and service mix and rapidly accelerated its globalization strategy. It then realized that what it really needed was a new focus on developing high-potential leaders who could direct next-generation businesses and operate with a global mind-set. Such moves would bring the company closer to the leader-driven recipe. Its old execution focus was no longer a powerful competitive weapon.

This company developed what it called "critical paths" for a ladder of opportunities available to high-potential leaders. These paths culminated in an important role, such as general manager for a large region, and promoted to prominence leaders who were visibly inspirational. When the company's own research showed that trust accounted for 90 percent of its employees' perceptions of how effective their managers were, it focused its development efforts accordingly. (Coincidentally, trust was one of its three core cultural values.)

The company ultimately avoided the "commodity hell" it feared. It reliably increases its margins every year, leads its industry in segments where it elects to compete, and is recognized by respected analysts as a leading "talent factory."

## The importance of selection

Our earlier research had already shown that to be in the top group of healthy organizations, companies must do better than bottom-quartile ones across the full suite of 37 management practices. But a better-than-bottom score is generally enough for practices that are not essential to a company's recipe. The trick is to be truly great in a handful of practices—and not to worry a lot about the rest, which is just as well, because no company has the capacity, resources, or management time to be great at all 37. The power of the four recipes our research unearthed is that they provide an indication of where to concentrate improvement efforts.

We discovered that 73 percent of the companies that strongly or very strongly follow one of the four recipes *and* are not in the bottom quartile for any practice enjoy top-quartile health. By contrast, only 7 percent of companies that have at least one broken practice *and* a less-than-strong embrace of any of the recipes are in the top quartile. Taken together, this represents a better than 10:1 ratio of effectiveness. It also suggests that the right course is to fix all broken practices (by improving them enough so that a company escapes the bottom quartile) and to turn a targeted handful of practices into true strengths. Trying to exceed the median benchmark on a large number of practices is not effective.

## The danger of recipe killers

Our research also identified recipe killers—the management equivalent of baking a beautiful chocolate soufflé but then adding too much salt and rendering the dish inedible. The new data suggest that, just as concentrating on too many practices diminishes an organization's odds of achieving top health and success, adding the wrong practices to the recipe can be extremely harmful.

One example of this is the overemphasis on command-and-control leadership styles in companies trying to follow the execution-edge recipe. Most people think execution requires that approach. Actually, execution requires tremendous on-the-ground energy, so the best execution-driven organizations employ internal competition and bottom-up innovation to empower the front line to excel. Overuse of top-down processes would kill that dynamic—and, indeed, in our data set the least healthy execution-edge organizations are those that have the authoritative-leadership practice in their top ten.

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Building organizational health can be a powerful lever for improving the long-term performance of companies. Leaders can't ignore this lever, given the accelerating pace of change in most industries.

Companies can achieve organizational health in any of the four ways we have discussed here. But gratifying simplicity masks hidden risks. Choose your recipes and ingredients carefully, as the wrong mix may leave a bad taste in the mouths of employees, executives, and investors alike.

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