

PUBLIC SECTOR PRACTICE

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# Improving performance at state-owned enterprises

**Public-sector companies can match the performance of their private-sector counterparts and even become world-class players.**

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**Despite the wave of privatization** across developing markets in the 1980s and '90s, state-owned enterprises continue to control vast swaths of national GDP: more than 50 percent in some African countries and up to 15 percent in Asia, Eastern Europe, and Latin America. These companies, controlled by a government or a government agency, struggle to meet the private sector's performance levels, and potential profits remain unrealized. During the current downturn, some state-owned enterprises—even as they face increased pressure to become more efficient—have been called on to support government stimulus plans through higher spending and job retention. Nonetheless, our research and experience show that notwithstanding the constraints of the public-sector model and the tough economic times, these enterprises can significantly improve their performance.

Even in normal times, for example, the average return on assets at state enterprises in China was less than half that of the private sector, a McKinsey study showed a few years ago. One reason is that many such companies, in China and elsewhere, are shielded from competitive pressures, but other factors contribute greatly as well. State enterprises often juggle multiple, unclear, or conflicting financial and social objectives, such as providing blanket, low-cost telephone service. Political interference can prompt decisions that threaten a company's financial goals. Finding talented workers at all levels is a problem too: the best and brightest gravitate toward the more lucrative private sector, and the tenure-based promotions common at state enterprises can conceal their best internal talent.

Yet there is hope. Some state-owned enterprises in emerging markets are closing the gap with their private-sector competitors. Petronas, the state-owned energy company in Malaysia, for example, began an operational-excellence campaign focusing on improved technical capabilities and a more effective working culture at its plants. After five years, the initiative delivered upward of \$1 billion in savings and new revenues. What's more, the company's operational effectiveness, judged by a metric combining utilization, quality, and performance, is now in the industry's top quartile.

While these better-performing companies draw from well-known best practices in the private sector, they also concentrate on three areas of specific importance in the public sector: clarifying objectives and securing an explicit mandate, focusing scarce resources on areas with the highest financial impact, and redefining the talent proposition. Governments play a big role in creating the right environment for state-owned enterprises to excel, but their chief executives can implement such moves without waiting for other officials to act.

### **Clarify objectives and secure an explicit mandate**

Too often, state-owned enterprises operate behind a curtain, revealing little information beyond their general mandate. One reason may be that their objectives are unclear or conflicting, but the lack of transparency can also be traced to political expediency, a desire to avoid comparisons with the private sector, or inexperience with clear, concise corporate communications. Leading state-owned enterprises can openly proclaim their objectives and clarify the trade-offs between their financial and social goals when they negotiate a transparent mandate with the government and other stakeholders.

In practice, that kind of transparency involves explicitly establishing financial objectives as the primary goal and setting both aspirational targets and minimum expectations, such as

covering the cost of capital. The experience of developed economies provides some guidance: in Sweden, for instance, the national rail operator was told to match industry standards for returns on equity (13 percent), interest coverage (2:1), and minimum debt-to-equity ratios (1:1). Also, nonfinancial social objectives, such as maintaining employment or offering universal service, should be identified, quantified, made transparent, and, where feasible, explicitly financed. Television New Zealand, for example, receives NZ \$10.7 million annually for its mandate to develop and air local programming.

The leaders of state enterprises must not only have the freedom to pursue these explicit objectives but also receive support publicly. An agreement between the leadership and government officials (normally including the prime minister or president) on the scope for action might be needed. The chief executive at an Asian commodities company, for example, negotiated an explicit mandate giving him unprecedented management leeway, including the right to name the top team (rather than accept political appointments), to dismiss underperforming workers, and to develop a performance-based compensation scheme for key positions. After months of talks, the country's head of state signed the pact. While it's too soon to judge its impact, the early signs—such as evidence of greater accountability among top executives—are promising.

These questions are best settled before CEOs formally accept the position—when they have the greatest leverage—especially if they will be responsible for improving corporate results. One effective tactic is to depict a number of scenarios and show the connections between outcomes and the measures needed to achieve them. In a *McKinsey Quarterly* interview,<sup>1</sup> Idris Jala, for instance, said he made these linkages clear while being considered for the CEO position at Malaysia Airlines and pushed hard for the “freedom to act” in order to make the airline profitable within the targeted three years. While Jala didn't get everything he wanted, he was granted freedom in the areas most relevant to fixing the business, including adjusting flight schedules, eliminating loss-making routes, and selling the company's headquarters building.

Once everything is in place, communicating the new financial targets and the moves that will be used to achieve them offers three significant benefits. First, transparency helps to create accountability, which can force government officials to keep their commitments, particularly if problems arise. Second, it can boost public support for the changes, which is especially important if political support is tenuous. Finally, it puts pressure on the internal organization to deliver. Malaysia Airlines, for instance, distributed its detailed turnaround plan widely, using newspapers and Web sites, among other channels. That helped to keep a broad range of stakeholders aligned on the objectives, the improvement measures, and the progress being made.

In addition, state enterprises must not only focus their portfolios of social, nonfinancial initiatives in order to deliver meaningful results to key stakeholders but also communicate those results. Unless CEOs of state-owned enterprises meet the core needs of the public and other critical stakeholders, they risk a political backlash that could undermine their efforts and the powers they have won. These companies can't ignore their portfolios of social initiatives, such as uniform national service, that aren't directly linked to financial targets. A state-owned power company, for instance, can't let its transformation initiatives impede its ability to supply the country with electricity, often at subsidized prices. Still, companies can sometimes challenge

<sup>1</sup> See Alex Dichter, Fredrik Lind, and Seelan Singham, “Turning around a struggling airline: An interview with the CEO of Malaysia Airlines,” [mckinseyquarterly.com](http://mckinseyquarterly.com), November 2008.

legacy nonfinancial obligations—for example, supporting unrelated industries through indirect subsidies, such as products, services, or financing offered at below-market rates.

### **Focus scarce resources for highest financial impact**

Even with transparent agreements, state-owned enterprises tread on shaky ground. Public scrutiny—and therefore the pressure to deliver quick results and avoid missteps—is intense. Wholesale changes can upset workers and raise the level of political risk. Leadership talent is scarce, and few people have experience executing change programs. As a result, judicious state-owned enterprises tend to begin their change programs by concentrating on a few areas that promise to have the greatest financial impact rather than embarking on a broad agenda that could fail for lack of resources. This focus also limits the possibility that divergent, and possibly conflicting, stakeholder interests will distract a company’s leaders from their core tasks.

Executives must choose their targets carefully. To emphasize urgency and plow through the bureaucratic inertia that’s common in state enterprises, it will often be necessary to establish special, CEO-sponsored teams that can bypass unnecessary management layers. The chief executive of the Indonesian state oil company Pertamina, for example, created breakthrough teams he monitored closely to speed up high-impact projects. Starting with about a dozen initiatives, the program has since been expanded to encompass the entire organization, generating about \$285 million in earnings before interest, taxes, depreciation, and amortization (EBITDA) in just over two years. For many companies, departments (such as procurement) that control big budgets and are prone to political interference (or that need to balance social objectives) often benefit from the increased focus such teams create.

By focusing on a select group of business units, CEOs can channel disproportionate investment to the areas with the highest potential. The Brazilian energy company *Petróleo Brasileiro* (Petrobras), for example, has focused for years on building capabilities in deep-water exploration and production. Since 1986, Petrobras has invested more than \$20 billion to develop technological advantages in this area, which it credits with raising production to 2.4 million barrels a day, from about 500,000 barrels.

Some CEOs even go so far as to separate from their core organization the areas with the highest potential. Such isolation can create room for these businesses to build decisive, performance-based cultures and to become models for the entire organization, potentially leading the way to broader cultural change.

To help focus on high-priority areas, leaders at state companies must also examine noncore activities and assets and, wherever possible, terminate, franchise, outsource, or shed them. Divestment of public assets is politically sensitive and usually requires approval on many levels, but executives have found creative ways to expedite the effort. The commodities company cited earlier, for example, transferred the running of its shipping fleet to an international partner. This move, which required no ownership changes or head count reductions, saved the company tens of millions of dollars in less than six months, primarily thanks to the partner’s better discipline and operating practices.

### **Redefining the talent proposition**

State companies find it difficult to attract talented people and to motivate the high performers they already have because the environment is perceived as staid, hierarchical, and bureaucratic. Since career progression is often based on tenure rather than performance, employees with leadership skills may see little reason to shine. Redefining the talent proposition can influence these attitudes. State-owned enterprises must promote the unique opportunities they provide talented people, offer competitive compensation, and intensify their efforts to manage performance.

To bring in outside talent, state-owned companies should make their case stronger. After all, they offer exciting challenges in nation building, opportunities to work on projects with a much broader impact than those available in the private sector, and the possibility of pursuing careers in a vast network of public and private companies. When these largely ignored benefits are marketed, the impact can be astounding. One state holding company recruited more than 100 young investment professionals after the CEO met personally with promising applicants to explain his vision for the country's state enterprises. Many accepted pay cuts from high-salaried positions to join the effort. Recruiters at the utility State Grid Corporation of China emphasize its mandate to modernize the country, particularly rural areas, as well as to provide career development, competitive salaries, and stable employment.

Public-sector enterprises such as State Grid are taking advantage of the downturn to recruit overseas nationals, particularly those with experience in financial services and accounting. State financial companies in Shanghai are actively recruiting in Chicago, London, and New York. While many private-sector employees still think that work at such enterprises carries a stigma, career uncertainty during the downturn has made others open to the opportunities.

To tip the balance in many decisions, state enterprises must bring compensation packages closer to private-sector standards. China Mobile, the country's largest mobile-service operator, offers its managers compensation plans that compete directly with those of the multinationals. When broad changes in compensation aren't feasible, some companies develop dual compensation programs for high-quality workers in targeted areas. For example, one Eastern European telecommunications company offers short-term contracts at higher salaries for selected positions, giving applicants a choice between higher pay and increased job security.

Another critical element for developing and retaining talented leaders is to intensify performance management. Meaningful rewards and consequences must be based on merit, not tenure. Many state companies have only a superficial performance culture—formal evaluation processes, for instance. Most employees may routinely get top rankings, regardless of performance, and these rankings have little connection to promotions or other incentives. One way to put teeth into the performance evaluation process is to implement a forced-ranking system, in which a specified proportion of workers must receive high and low rankings, with the bulk clustered around average, which after all is what “average” means. Together with genuine conversations about performance and with incentives linked to the rankings, the system not only sends a clear signal that performance matters but can also evolve into a more natural ranking system focusing on opportunities and clear metrics.

For many state companies, especially in difficult economic times, removing underperformers is challenging, but these employees must face consequences if organizations are to build cultures

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based on superior work. Some state enterprises have tried to use peer pressure—for example, by openly ranking people according to a relevant metric, such as sales volumes or transactions completed—to improve performance or even shame underperformers into departing voluntarily. Others shift them to noncritical positions, where at least they can no longer hinder the work of others.

State enterprises must also be more open to hiring talented foreigners, who can bring needed skills, especially in areas (such as finance and marketing) that have taken a back seat to technical skills. Since many state enterprises are prohibited from hiring foreigners, especially for senior positions, their leaders should work to ease such restrictions in areas in which they are significantly behind the private sector.

Finally, state-owned companies that redefine the talent proposition can’t forget the current staff. Tenured employees with substantial job security often become less motivated, especially if a company has lost some of its public standing and profitability to more dynamic private-sector competitors. Om Prakash Bhatt, chairman of State Bank of India, the country’s largest bank by assets, brought new meaning to the jobs of its 200,000 workers by holding candid conversations with people at all levels.<sup>2</sup> He explained the bank’s market position, inspired employees with his vision, and told them that no one would be promoted or otherwise rewarded unless the bank’s performance improved. A structured communications plan, which included reminders of the bank’s past stature, was part of an overall program that helped the institution to arrest a slide in market share and to become more profitable, among other improvements.

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Despite the obstacles, state-owned enterprises can match the private sector’s performance standards and even become world-class players. A clear mandate, an intense focus, and a workable talent strategy can bring quick results. Chief executives at these companies don’t have to wait for governments to take the lead. They already have the tools at their fingertips. **Q**

<sup>2</sup>See Roger Malone, “Remaking a government-owned giant: An interview with the chairman of the State Bank of India,” [mckinseyquarterly.com](http://mckinseyquarterly.com), April 2009.

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