McKinsey&Company

# McKinsey Quarterly

2013 Number 1

## Putting time to work

How to boost returns on your company's most overlooked asset

McKinsey Quarterly
2013 Number 1

## This Quarter

In the time it takes you to read this short essay, several e-mails may land in your inbox, a meeting could appear in your calendar, and your to-do list might grow. Is it any wonder that in a recent McKinsey survey of senior executives, just 9 percent expressed high levels of satisfaction with their use of time and about one-third were actively dissatisfied?

The roots of this dissatisfaction, argue my colleagues Frankki Bevins and Aaron De Smet in their article, "Making time management the organization's priority," run far deeper than technology, and the solutions demand far more than better personal time management. Organizational dynamics, starting with the fact that time rarely gets treated as a scarce resource, is central to the problem and demands institutional solutions such as time budgets, more thoughtful organizational design, and better tools and incentives for effective time management.

Time challenges are a factor at all levels, including the very top: corporate boards, whose members have been asked to do more in the wake of the past decade's scandals and crises. In "Board governance depends on where you sit," Harvard Business School professor and former Medtronic CEO Bill George suggests one implication is that directors may not have enough time to serve on as many boards as they did in the past. Then, in a wide-ranging series of articles, McKinsey experts share their experiences on ways boards and senior-management teams can engage with one another to boost the quality of a company's overall strategy, technology agenda, marketing approach, and M&A performance. No board will have time to do all these things well, making ruthless prioritization critical.

A number of other articles in this issue explore the difference senior leaders can make through thoughtful interventions to align the organization with its priorities. My article, "Leadership and the art of plate spinning," addresses three paradoxes that leaders must embrace to achieve organizational alignment. In another article, "Increasing the 'meaning quotient' of work," my colleagues Scott Keller (coauthor of our 2011 book, *Beyond Performance*) and Susie Cranston describe some simple steps senior executives can take to infuse their organizations with greater meaning—materially boosting the satisfaction and productivity of their people in the process. Technology can be a powerful ally, argue Roland Deiser, a senior fellow at the Peter F. Drucker and Masatoshi Ito Graduate School of Management at Claremont Graduate University, and Sylvain Newton, a leader at General Electric's Crontonville executive-training center. But exploiting technology's full organizational potential demands a new set of leadership competencies, which the authors set forth in "Six social-media skills every leader needs."

None of the ideas in these articles is a silver bullet, of course. But we hope that, collectively, they will help senior executives reduce the organization's "drag factor" in the wind tunnel of today's challenging business environment—where the need for leadership is greater than ever, but there isn't enough time to lead.

**Colin Price**
Director, London office

On the cover

## Putting time to work



Features

## Features

### Improving performance through better board engagement



## Departments

# Idea Exchange

Readers mix it up with authors of articles from *McKinsey Quarterly* 2012 Number 4

In the previous issue of *McKinsey Quarterly*, Marla M. Capozzi, Ari Kellen, and Sven Smit warned that trying to emulate Apple—or any of the world's most successful companies—can be risky. In that same issue, Toby Gibbs, Suzanne Heywood, and Matthew Pettigrew argued that employees and managers should be measured as much on their contribution to an organization's long-term health as to its performance. Here, the authors respond to reader comments on mckinseyquarterly.com.

## The perils of best practice: Should you emulate Apple?

**Jorge Vogeler**
*CEO, quipeutlefaire.fr, France*

"Does this mean that we should question the use of benchmarks as a management practice? If the 'What would Apple/Steve Jobs do?' approach does not really work, then maybe trying to hit benchmarks from other companies does not work either."

**The authors respond:**
"You raise a great question. Benchmarks have their place, but they should always be used as guides—not solutions. What we see as problematic is the overuse or, worse, the misuse of benchmarks. For example, when the relevant variables are difficult to isolate (as is the case with a topic like innovation) executives should approach benchmarking with caution. Although asking questions like 'What would Steve Jobs do in a situation like ours?' may force a useful shift in perspective that generates creative insights and frees up thinking, companies must chart their own paths from insights to execution."

## Encouraging your people to take the long view

**Stephanie Hurt**
*Associate professor, Meredith College, Raleigh, North Carolina*

"Employee assessment, and thus reward, has a lot to do with country culture and evaluation frequency, which are very closely linked to *what* is being assessed in a given place at a given time. US executives, when compared to more patient investors, have always been rewarded (and have in turn rewarded their teams) on a shorter-term basis."

**The authors respond:**
"This is certainly very true—employee expectations of rewards vary substantially by country and also by industry. However, even if it is not possible to reward long-term contributions and results directly, it is still possible to link rewards to actions that create longer-term organizational health. Companies should change the definition of 'good' executive performance by, for example, including capability building (defined broadly and not just limited to participation in training courses) in their executive assessments."

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# Understanding Asia's conglomerates

**Martin Hirt, Sven Smit, and Wonsik Yoo**

Conglomerates are shaping the competitive landscape in Asia. Would-be rivals must understand them to compete with them.

Conglomerates may be out of favor in much of the developed world, but don't tell that to senior executives who contend with fast-growing conglomerates in major Asian markets, where this business model remains a competitive force.

McKinsey research finds that over the past decade, the largest conglomerates in China and India expanded their revenues by more than 20 percent a year, while conglomerates in South Korea exceeded 10 percent annual revenue growth (see sidebar, "About the research"). These companies diversified at a blistering pace, making an average of one new business entry every 18 months (Exhibit 1). The nature of those moves was striking: nearly half of the companies favored businesses that were completely unrelated to the parent companies' operations.

Of course, only time will tell if Asian conglomerates' "step out" approach to diversification will endure as the region's economies mature. Nor is it clear how much shareholder value will be created—and sustained—by these companies' growth. Nonetheless, a closer look at its characteristics and at the aggressive, M&A-fueled strategies that sustain it offers insights for senior executives seeking growth in Asian markets and gives potential entrants a useful glimpse into the evolving nature of competition there.

## Big and growing

Over the past decade, conglomerates in South Korea accounted for about 80 percent of the largest 50 companies by revenues. In India, the figure is a whopping 90 percent. Meanwhile, China's conglomerates (excluding state-owned enterprises) represented about 40 percent of its largest 50 companies in 2010, up from less than 20 percent a decade before. All these companies generated strong topline growth: an average of 23 percent a year over the past decade for conglomerates in China and India, and 11 percent for those in South Korea. Such growth is remarkable considering the large size of the companies involved—an average of $3 billion in revenues a decade ago and $12 billion in 2011.

## Stepping out

When we looked more closely to determine the sources of this revenue growth, we found a strong connection with new business entry. The average rate of revenue growth for companies that entered at least one new business over the period we studied was 25 percent a year—more than two times higher than the revenue growth of companies that didn't.

Also notable were the strategic motivations behind the new business entries. Fully 49 percent were step-out moves into businesses completely unrelated to the parent companies' existing activities—for example, a South Korean chemical company acquiring a life insurer or a Chinese mining group's

Exhibit 1

**The largest conglomerates in China, India, and South Korea are entering new businesses at a startling pace.**

Number of new businesses conglomerates entered,[1] 2000–10


[1]For the top 10–15 industrial conglomerates by 2011 revenues in each country (35 conglomerates in total); excludes state-owned enterprises.

Source: Companies' investor-relations materials, annual reports, and Web sites; Kisline; McKinsey analysis expansion into the media industry. The remaining half were about equally split between two kinds of moves: category expansions into adjacent businesses and value-chain expansions that positioned the parent company up- or downstream from its existing business (Exhibit 2).

## Large returns, large risks

Although step-out moves were the most common form of new business entry we observed, they were far from the most successful. Just 22 percent of those we studied had a beneficial impact on revenue growth, profits, and market share relative to those of competitors. In fact, our findings almost certainly *understate* the difficulties involved in diversifying into entirely new businesses, since companies rarely publicize the full financial and organizational implications of unsuccessful moves. Nonetheless, when step-out moves were successful, they delivered strong results—$3.8 billion in additional revenues, on average (Exhibit 3).[1]

Exhibit 2

**Nearly half of the business entries made by top Asian conglomerates from 2000 to 2010 were unrelated to the parent companies' existing business.**

Share of new businesses by type, for conglomerates[1] in China, India, and South Korea, 2000–10, %

100% = 274 business entries

| | |
|---|---|
| 22 | **Category expansion into adjacent businesses:**<br>• Hanjin (Korean Air) expands into low-cost-carrier business<br>• Tencent expands instant-message (IM) offering from personal to corporate service |
| 29 | **Value-chain expansion:** Downstream or upstream expansion from existing business<br>• Hailiang (copper processing/manufacturing) extends into copper-trading business<br>• Doosan (construction equipment manufacturer) expands into hydraulic equipment manufacturing (a core part of excavators) |
| 49 | **Step out:** Totally new business, not linked to existing ones<br>• Hanwha (chemicals and leisure) expands into life-insurance business by acquiring KLI<br>• Fosun (mining and steel) enters media industry |

[1]For the top 10–15 industrial conglomerates by 2011 revenues in each country (35 conglomerates in total); excludes state-owned enterprises and financial conglomerates.

Source: Companies' investor-relations materials, annual reports, and Web sites; Kisline; McKinsey analysis

Regardless of how related the new business was to the existing one, the most common paths to success were M&A, joint ventures, and technology partnerships. Together, these accounted for three-quarters of the successful moves we studied.

## Outlook and implications

Given the rapidly changing business climate in much of Asia, we believe senior executives in other regions should approach these findings judiciously. Certainly, not all Asian companies will follow the path of the conglomerates we examined. For example, state-owned companies and companies in markets with strong traditions of board governance (such as Malaysia) might find it difficult to convince skeptical boards of the need for bold step-out moves. Furthermore, if governance structures in Asia continue to evolve toward the shareholder-driven models prevalent in Europe and the United States—away from family-ownership or -control models that can introduce major shareholders' personal interests into the equation—the growth patterns will probably change.

Nonetheless, there are equally valid reasons to believe that Asian conglomerates' push for growth through aggressive diversification could continue for some time. For starters, many Asian conglomerates have ready access to capital, as well as aggressive growth ambitions that cause them to view strong local reputations and relationships as platforms for stretching into new areas. They seem to be particularly attracted to nascent industries, such as green energy, where dominant global leaders have yet to emerge. Local market dynamics also play a role.

Exhibit 3

**Step-out business entries deliver more revenues on average, but the odds for success are low.**

New businesses in China, India, and South Korea

| | **Average revenues,**[1] $ billion | **Probability of success,** % |
|---|---|---|
| Step out | 3.8 | 22 |
| Category expansion into adjacent businesses | 1.2 | 38 |
| Value-chain expansion | 0.8 | 21 |

[1] For successful new entries with publicly available data; excludes unsuccessful cases because of limited financial information.

Source: Companies' investor-relations materials and Web sites; Kisline; Thomson Reuters Datastream; McKinsey analysis

## About the research

To learn more about the strategic choices Asian conglomerates are making, and the competitive implications for companies everywhere, we examined some 274 business entries made by the 35 largest conglomerates (by revenues) in China, India, and South Korea between 2000 and 2010. The sample included 231 subsidiaries that together spanned 38 industries. We excluded financial conglomerates and state-owned enterprises from the sample because the former are often prohibited by regulation from diversifying, while the latter often enter business areas for noneconomic reasons, receive strong government support, or both.

Our work drew on all publicly available information associated with the companies and their subsidiaries—for instance, annual reports, investor-relations materials, and analyst reports. We also looked at private databases, such as Bloomberg and Thomson One.

Ambitious conglomerates in smaller Asian economies, for example, may seek growth in new geographies given the relatively limited opportunities at home.

High growth aspirations intersect with a singular feature of emerging Asian economic life: the extraordinary need for infrastructure, since conglomerates are often involved with it. Finally, they can offer up-and-coming managers broader career-development opportunities, boosting their attractiveness to local talent in a region characterized by tight talent markets.[2] Potential competitors will be well served by developing a better understanding of these and other sources of the conglomerates' advantage.[3]

The bottom line: business leaders in Asia are building large, fast-growing companies around the conglomerate business model. Understanding the drivers of that growth may give competitors and emulators alike a firmer footing in a volatile business environment.

[1] With respect to the profitability of the moves, the available data were limited and we therefore cannot draw a definitive conclusion. Nonetheless, among the success cases, for the relatively small sample size of cases where the profit data were publicly available, we observed that 80 percent of them generated profits above the industry average. For cases where profits were below market average, the hefty investment requirement associated with the move appeared to be the main culprit, not the intrinsic health of the business.

[2] For a broader discussion of conglomerates, including those in emerging markets, see Joseph Cyriac, Tim Koller, and Jannick Thomsen, "Testing the limits of diversification," mckinseyquarterly.com, February 2012.

[3] Any discussion of conglomerates and how they seek advantage should be grounded in an understanding of the best-owner principle, which states that no business has an inherent value in and of itself. It has a different value to different owners or potential owners—a value based on how they manage it and what strategy they pursue. For more about this principle, see Richard Dobbs, Bill Huyett, and Tim Koller, "The CEO's guide to corporate finance," mckinseyquarterly.com, November 2010.

*The authors wish to thank Conor Kehoe for his contribution to the development of this article.*

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# Big data in the age of the telegraph

**Caitlin Rosenthal**

Daniel McCallum's 1854 organizational design for the New York and Erie Railroad resembles a tree rather than a pyramid. It empowered frontline managers by clarifying data flows.

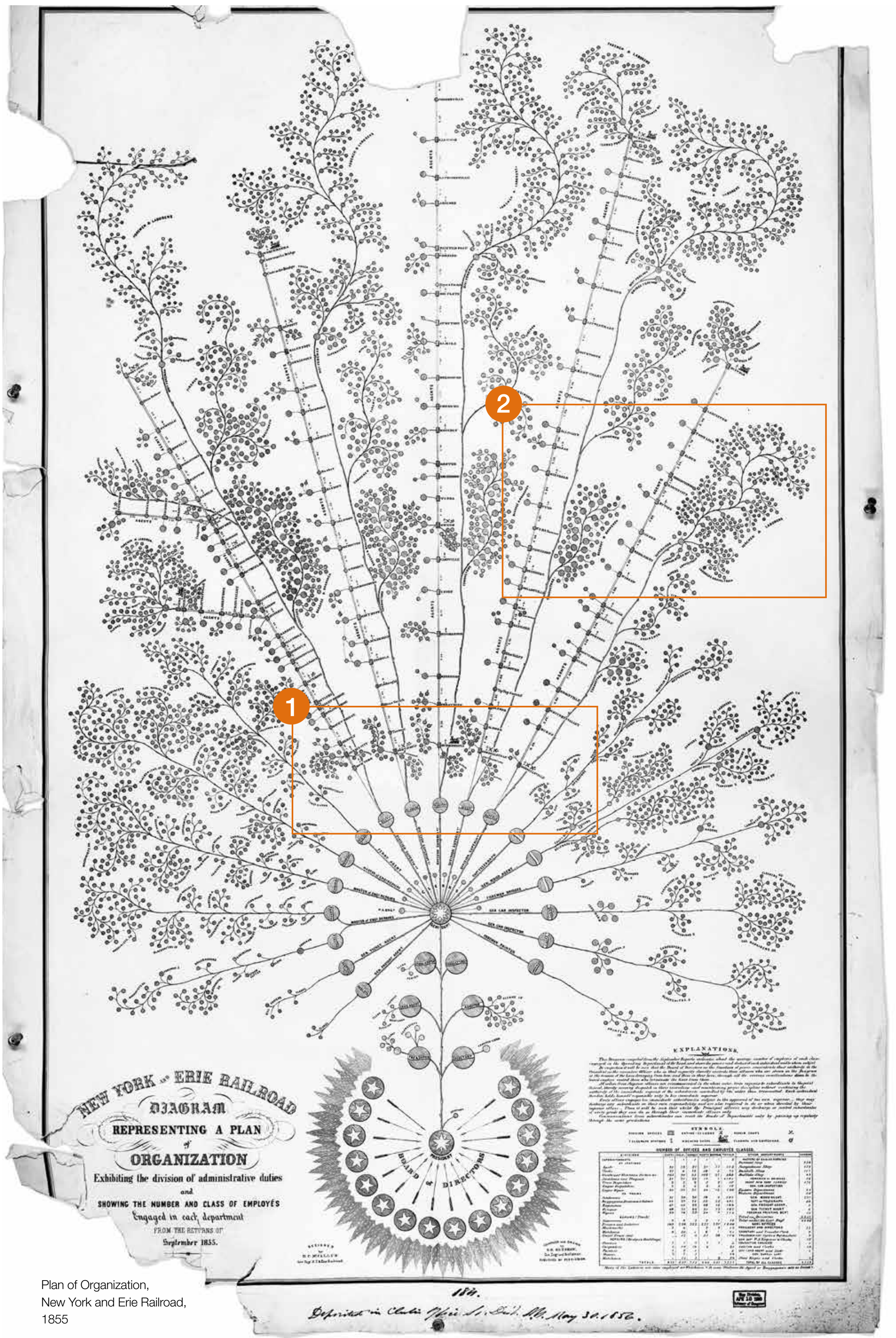
In 1854, Daniel McCallum took charge of the operations of the New York and Erie Railroad. With nearly 500 miles of track, it was one of the world's longest systems, but not one of the most efficient. In fact, McCallum found that far from rendering operations more efficient, the scale of the railroad exponentially increased its complexity.[1]

The problem was not a lack of information: the growing use of the telegraph gave the company an unprecedented supply of nearly real-time data, including reports of accidents and train delays.[2] Rather, the difficulty was putting that data to use, and it led McCallum to develop one of the era's great low-tech management innovations: the organization chart. This article presents that long-lost chart (see exhibit, "The first modern organization chart"; and sidebar, "Tracking a missing org chart") and shows how aligning data with operations and strategy—the quintessential modern management challenge—is a problem that spans the ages.

## 'Big data,' then and now

Just as information now floods into companies by the tera-, peta-, and exabyte, during the mid-19th century, governments, businesses, and universities produced and grappled with what one historian has called an "avalanche of numbers."[3] To be sure, McCallum's rail lines may not have generated even a megabyte of information. But this was indeed big data for him and his senior deputies, who were managing a system of unprecedented proportions. Although the telegraph's speed made more information available, organizing and acting on it became increasingly difficult. One delayed train, for example, could disrupt the progress of many others. And the stakes were high: with engines pulling cars in both directions along a single set of rails, schedule changes risked the deadly crashes that plagued 19th-century railroads.

*(continued on page 16)*




Plan of Organization,
New York and Erie Railroad,
1855

Courtesy of the Geography
and Map Division,
Library of Congress.

Exhibit

# The first modern organization chart

Daniel McCallum created the first organization chart in response to the information problem hobbling one of the longest railroads in the world. In surprising contrast to today's top-down organization pyramids, in McCallum's chart the hierarchy was reversed: authority over day-to-day scheduling and operations went to the divisional superintendents down the line, who oversaw the five branch lines of the railroad. The reasoning: they possessed the best operating data, were closer to the action, and thus were best placed to manage the line's persistent inefficiencies.

1


Each superintendent was responsible for the physical geography of the tracks and stations and for the men who moved along the rails: conductors, brakemen, and laborers. Coordinating activities between these two branches, the superintendents managed both the fixed depots and the rolling stock that moved between them.

2

As McCallum reflected, "A superintendent of a road 50 miles [long] . . . may be almost constantly upon the line engaged in the direction of its details." But on railroads like his, which stretched for hundreds of miles, no individual manager could be responsible for all of the necessary schedule changes.

## Reversing the information hierarchy

In crafting the organizational plan, McCallum sought to improve the way the railroad used information. Through 21st-century eyes, the chart looks both antiquarian and surprisingly modern. Far from the static, hierarchical pyramids that we today associate with such charts, his was modeled after a tree. McCallum drew the board of directors as the roots, himself and his chief officers as the tree's trunk, and the railroad's divisions and departments as the branches.

Critically, McCallum gained control by giving up control, delegating authority to managers who could use information in real time. He put what we would call the organization's C-level at the ground level, supporting the railroad, not directing its operations. Following one of McCallum's key precepts—"a proper division of responsibilities"—authority over day-to-day scheduling went to the divisional superintendents down the line.

Most of the chart spans the domains of these superintendents: the railroad's five branch lines. Each superintendent was responsible for two subbranches of the tree. The first was a straight branch representing the physical assets of tracks and stations, the second a winding branch consisting of the men who moved along the rails, from the conductors and brakemen on the trains to the laborers who maintained the tracks. The divisional superintendents were responsible for coordinating these two branches—the depots and the rolling stock, and the employees who moved between them.

Even as McCallum decentralized decision making along the railroad, he also insisted that targeted metrics had to be reported back to its board of directors. That data flowed down from the branches of the tree to its roots, where McCallum and the board could use the information for oversight and long-term decision making. Here, McCallum's goal was prioritization: assuring that the board, with its finite capacity, received relevant and actionable data. As "interesting as this information is," he reflected, it is only in its "practical application . . . that its real value consists." McCallum therefore designed a system of hourly, daily, and monthly reports that enabled him to calculate practical metrics, such as cost per ton-mile and average load per car. By comparing the profitability and efficiency of different routes, the board could identify opportunities for improvement.

## A message for today's leaders?

Modern managers, of course, have more sophisticated tools than McCallum did. Top executives can now access detailed

## Tracking a missing org chart

Former Harvard Business School professor Alfred Chandler (1918–2007), who helped establish business history as a rigorous academic discipline, described the momentous impact of managerial innovations, such as the organization chart. Chandler identified Daniel McCallum as the originator of the New York and Erie's pioneering plan and describes the chart in tantalizing detail in several of his books. I began searching for it during my doctoral studies at Harvard, writing to archives in New York and Ohio and even combing through Chandler's personal papers. In the course of my search, I learned that Chandler himself had never seen the chart and based his description on a detailed advertisement in the *American Railroad Journal*.[1]

I was almost ready to give up on my search when the unexpected happened at an academic conference: Peter Knight, a professor of American studies at the University of Manchester, handed out a series of images on the history of capitalism, and I immediately recognized that one was the missing organization chart! I was astonished to learn that Peter had found it in the Library of Congress. With the help of its reference librarians, I located another copy at St. Lawrence University, in upstate New York.[2] The discovery came in time for the chart to be included in my doctoral dissertation, completing a quest Chandler began when researching his own dissertation on the pioneering financial analyst Henry Varnum Poor.

Chandler continued writing about McCallum and the chart in many foundational business-history studies, including his Pulitzer Prize winner, *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press, 1977), as well as *Strategy and Structure: Chapters in the History of American Industrial Enterprise* (MIT Press, 1962), which is widely viewed as a seminal book in the development not just of business history but also of strategic thought.

[1] Chandler explains that he had not seen the chart himself (at least as of 1988), in Alfred Chandler, "Origins of the organization chart," *Harvard Business Review*, 1988, Volume 66, Number 2, pp. 156–57.

[2] In addition, Charles Wrege and Guidon Sorbo Jr. located the chart and discuss it in "A bridge builder changes a railroad: The story of Daniel Craig McCallum," *Canal History and Technology Proceedings*, 2005, Volume 24, pp. 183–218.

data, often in real time. Today's powerful battlefield-management systems, for instance, give generals the ability to direct combat missions at the microlevel, which was invisible to the board of the New York and Erie.

But while cheaper storage space and bandwidth will make such granular management options increasingly tempting, will they be optimal? Executive attention spans are already stressed, and many leaders report that they are overwhelmed by copious data flows.[4] A more fruitful approach might begin with McCallum's low-tech reflections on organizational structures and priorities. Within today's organizations, emerging social networks—often married to sources of big data—have a certain kinship with McCallum's logic. These networks too provide opportunities for greater information sharing and collaboration at relatively low levels in the organization, and they too can improve operations, customer service, and innovation. Curiously, digital mappings of these social interactions bear a resemblance to the nodes and branches of McCallum's chart.

Drowning in the details of operations, Daniel McCallum stepped back and redesigned the railroad's organization. His insights on how to meld local authority with information gave his managers better operating tools—which are just as relevant in the age of the Internet as they were in the age of the telegraph.

[1] This article's details on the railway's operations and organizational thought come from Homer Ramsdell and D. C. McCallum, *Reports of the President and Superintendent of the New York and Erie Railroad to the Stockholders, for the Year Ending September 30, 1855*, New York, NY: Press of the New York and Erie Railroad Company, 1856.

[2] Tom Standage quotes contemporaries who called the telegraph the "highway of thought" in *The Victorian Internet: The Remarkable Story of the Telegraph and the Nineteenth Century's On-line Pioneers*, first edition, London, UK: Weidenfeld & Nicolson, 1998. An excellent recent account of the telegraph's impact is Richard John, *Network Nation: Inventing American Telecommunications*, first edition, Cambridge, MA: Harvard University Press, 2010.

[3] The phrase "avalanche of numbers" comes from Ian Hacking, writing on the spread of probabilistic and statistical reasoning, in *The Taming of Chance*, first edition, Cambridge, UK: Cambridge University Press, 1990.

[4] Steve LaValle et al., "Big data, analytics and the path from insights to value," *MIT Sloan Management Review*, 2011, Volume 52, Number 2, pp. 21–32.

*The author wishes to acknowledge Michael Chui for his contribution to this article.*

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A quick look at automobiles

# Learning from Japan’s early electric-vehicle buyers

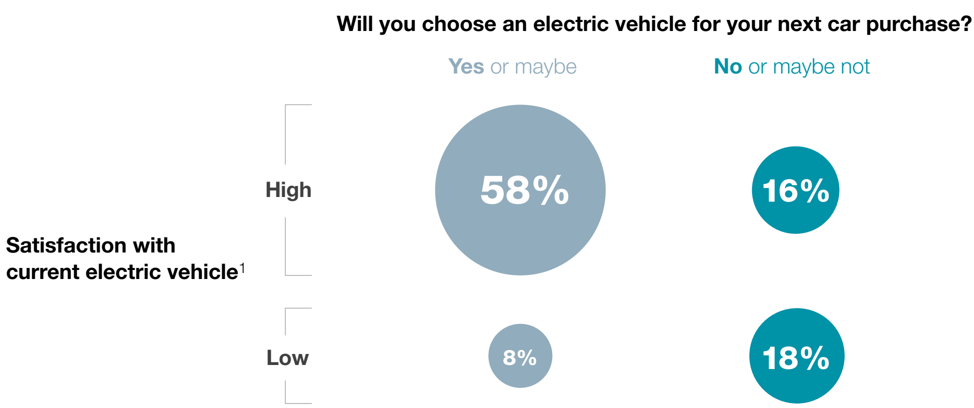
**Axel Krieger, Philipp Radtke, and Yoshi Takanuki**

If electric vehicles (EVs) are to develop from a niche into a mass market, carmakers should learn from early adopters who say they may not buy one again. Our recent research on such consumers in Japan finds that about one-third of them fall into this category. These buyers said they were “seduced” by low energy costs, attractive subsidies, and a good test drive. But they were less well informed about EVs than were environmentally conscious “green enthusiasts” (who love EV technology for its low energy costs and comfortable driving experience) and became less enthusiastic about their purchase when they faced issues such as higher electric bills and locating places to charge their cars. To lock in the reluctant buyers, EV makers should adopt retention and education programs to avoid negative market feedback that could “poison the well” for new buyers. We also found that although early adopters weren’t concerned about price, nonbuyers were. Until prices drop to the point where the level of mass-market uptake stimulates infrastructure development, manufacturers must learn how to build customer loyalty to broaden the market for EVs.

**Axel Krieger** is a principal in McKinsey’s Beijing office, **Philipp Radtke** is a director in the Munich office, and **Yoshi Takanuki** is a principal in the Tokyo office.

**Approximately one-third of early adopters in Japan may not buy an electric vehicle next time.**

% of electric-vehicle buyers




[1] High satisfaction = respondents who answered “very satisfied” or “satisfied”; low satisfaction = respondents who answered “somewhat satisfied” or “unsatisfied.”

Source: 2012 McKinsey online survey of 1,300 respondents, including 106 early electric-vehicle buyers, who had bought a car in Japan in the last 24 months; in-depth interviews; observational research; and focus groups

# Avoiding the consensus-earnings trap

**Tim Koller, Rishi Raj, and Abhishek Saxena**

The consequences of lagging behind or beating consensus-earnings estimates are profoundly overstated.

At most public companies, the pressure to meet or beat consensus-earnings estimates is strong. Do so consistently, many executives believe, and investors will reward a company, over the longer term, with a higher share price. Report earnings below consensus estimates—even by a small amount—and investors, they worry, will penalize it with a lower share price. A striking example: in early 2005, eBay reported that it had missed its fourth-quarter 2004 consensus estimate by just one cent and saw its share price plunge by 22 percent.

As a result, executives often go to some lengths to meet or beat current-year consensus estimates, even acting in ways that could damage the longer-term health of a business. Consider how some companies offer steep discounts in the final days of a reporting period to stoke purchase numbers. Others may forgo value-creating investments[1] in favor of short-term results or manage earnings to create the illusion of stability.

Taking steps like these is misguided, suggests our analysis of large US companies.[2] Falling short of consensus-earnings estimates for any particular year doesn't appreciably affect stock performance. Even consistently beating or meeting those estimates over several years doesn't matter once you take actual performance differences into account. In fact, a company's performance relative to consensus-earnings estimates seems to matter at all only when that company *consistently* misses them over several years.

This doesn't mean that executives should ignore consensus estimates: it's useful for them to compare their view of the macroeconomic outlook with that of investors and to use earnings estimates to infer how well analysts understand the drivers of a company's performance. Rather, our findings demonstrate that companies needn't go to extremes to meet or beat analysts' expectations, since investors consider more than just consensus-earnings estimates when valuing a company.

## The markets shrug

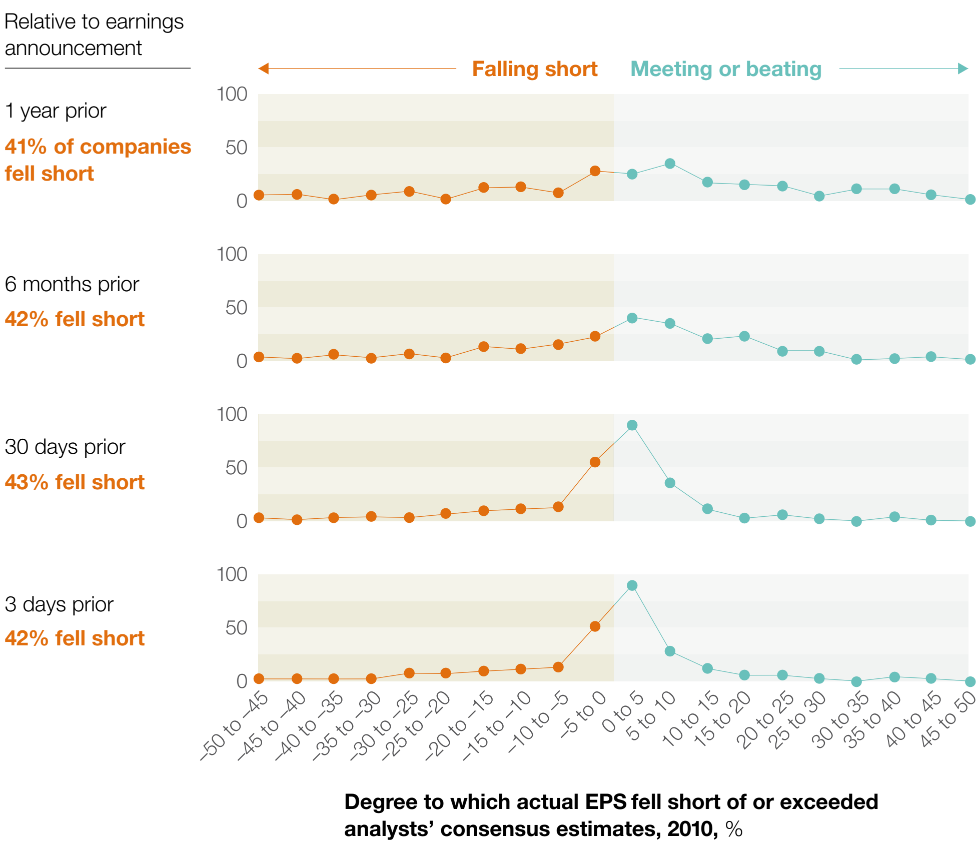
More than 40 percent of the companies we analyzed generate earnings below consensus estimates. According to standard practice, a company has missed the consensus estimate if its actual earnings are lower than the last available estimate for the year. Analysts' estimates typically start the year overly optimistic and, over its course, fall roughly in line with eventual reported earnings.[3] It's therefore noteworthy that the 40 percent figure holds whether you compare actual earnings with estimates from a year earlier, from just three days before an earnings announcement, or from the period between those extremes (Exhibit 1).

Executives concerned about a company's performance against consensus estimates should take comfort from our analysis showing that missing them by 1 percent would lead to a share price decrease of only two-tenths of a percent in the five days after the announcement. They can draw further lessons from the fact that the share

Exhibit 1

**Companies often fall short of consensus-earnings estimates.**

Distribution by gap between earnings per share (EPS) and consensus estimates, number of companies[1]




[1]Analysis of 266 companies, excluding outliers. Total number of companies falling within +/– 50% of consensus estimates: 1 year prior = 209, 6 months prior = 229, 30 days prior = 250, and 3 days prior = 252.

Source: Standard & Poor's Capital IQ; McKinsey analysis prices of 40 percent of companies moved in the direction *opposite* to the one consensus forecasts predicted.

For example, PPG Industries, a global supplier of paints, coatings, and chemicals, announced that its 2010 earnings were 4 percent below the consensus. But the market reacted positively (with an excess return of 7 percent) because, on digging deeper, investors saw that the long-term sales outlook in key investment areas had improved—and they expected new investment initiatives to create longer-term value. Conversely, Molson Coors, a North American brewing company, beat the consensus estimate in 2010, but the market reacted negatively, and the share price fell by 7 percent. Why? The market took into account the fundamental drivers of performance rather than earnings per share: the company's sales and margins had declined; it beat the consensus estimate only because its tax rate was lower than expected. In short, the degree to which a company's earnings meet or miss the consensus is less important than how those earnings were gained.

Finally, the notion that the markets reward companies with higher long-term returns when those companies consistently beat the earnings consensus turns out to be wrong. While some researchers[4] have found such a pattern, their analyses don't take into consideration the underlying performance of companies as measured by revenue growth and returns on capital. Our work shows that once you adjust for these performance factors, the apparent effect of consistently beating the consensus[5] disappears. Companies with strong growth or returns on invested capital had high shareholder returns regardless of whether they beat the consensus consistently. Only companies that consistently missed it showed a statistically significant negative effect from doing so.

## What really matters

Earnings announcements often include information that helps investors reassess the long-term performance outlook of companies. Earlier McKinsey research has shown that the market reaction at the time of an earnings announcement is influenced more by changes in analysts' expectations for longer-term earnings than by the most recent results. Our research found that a company might fall short of current-year earnings estimates and still see its share price increase if analysts revised those estimates upward for the next two years (Exhibit 2).

While it would be unrealistic for companies to focus entirely on drivers of long-term performance and ignore consensus-earnings estimates, we believe that certain practices ought to be avoided. At the beginning of the year, executives shouldn't shape their earnings targets or budgets just to meet the consensus estimates. Companies that attempt to meet them by spending less on product development, sales and marketing, or other costs essentially are handicapping long-term performance. As the year progresses, companies should avoid costly, short-sighted actions that in effect borrow from next year's sales to meet this year's

Exhibit 2

**A change in forecast EPS is more important than an earnings surprise.**

Analysis of 590 announcements of fiscal-year earnings for 2007 by European companies

| If changes in 2-year forward EPS[1] are positive . . . | . . . returns are likelier to be higher . . . Median excess return,[1] % | . . . whether or not consensus estimates are met Actual EPS vs consensus estimates[2] |
|---|---|---|
| Companies with **positive** change in 2-year-forward EPS | 2.4 | Higher |
| | 1.5 | Lower |
| Companies with **negative** change in 2-year-forward EPS | –0.6 | Higher |
| | –0.5 | Lower |

[1] EPS = earnings per share; median excess return = excess return over market return.
[2] Sample size: positive and lower = 127, positive and higher = 203, negative and lower = 118, negative and higher = 142.

Source: Timothy Koller, Marc Goedhart, and David Wessels, *Valuation: Measuring and managing the value of companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010; McKinsey analysis

consensus estimates. At year-end, they should never meet estimates by using cosmetic quick wins, such as “creative accounting” with accruals. Investors recognize these moves for what they are.

Much more than investors, executives know about what is happening in their markets and their companies and about the long-term growth opportunities. They should focus on the fundamentals and on communicating them to investors. That’s what is most important for share prices. ○

1 John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, “The economic implications of corporate financial reporting,” *Journal of Accounting and Economics*, 2005, Volume 40, Number 1, pp. 3–73. The authors found that a majority of CFOs would “avoid initiating a positive NPV project if it meant falling short of the current quarter’s consensus earnings.”

2 We analyzed Fortune 500 companies, excluding financial companies and those with a fiscal year-end other than December 31, for a total of 266 companies.

3 See Marc Goedhart, Rishi Raj, and Abhishek Saxena, “Equity analysts: Still too bullish,” mckinseyquarterly.com, April 2010.

4 See Ron Kasznik and Maureen McNichols, “Does meeting earnings expectations matter? Evidence from analyst forecast revisions and share prices,” *Journal of Accounting Research*, 2002, Volume 40, Number 3, pp. 727–59.

5 “Consistently beating” is defined as exceeding expectations by more than 2 percent in at least four out of seven years from 2005 to 2011. “Consistently missing” is defined as missing expectations by more than 2 percent in at least four out of seven years.

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The full version of this article is available on mckinseyquarterly.com.

A quick look at pulp and paper

# Measuring the real cost of water

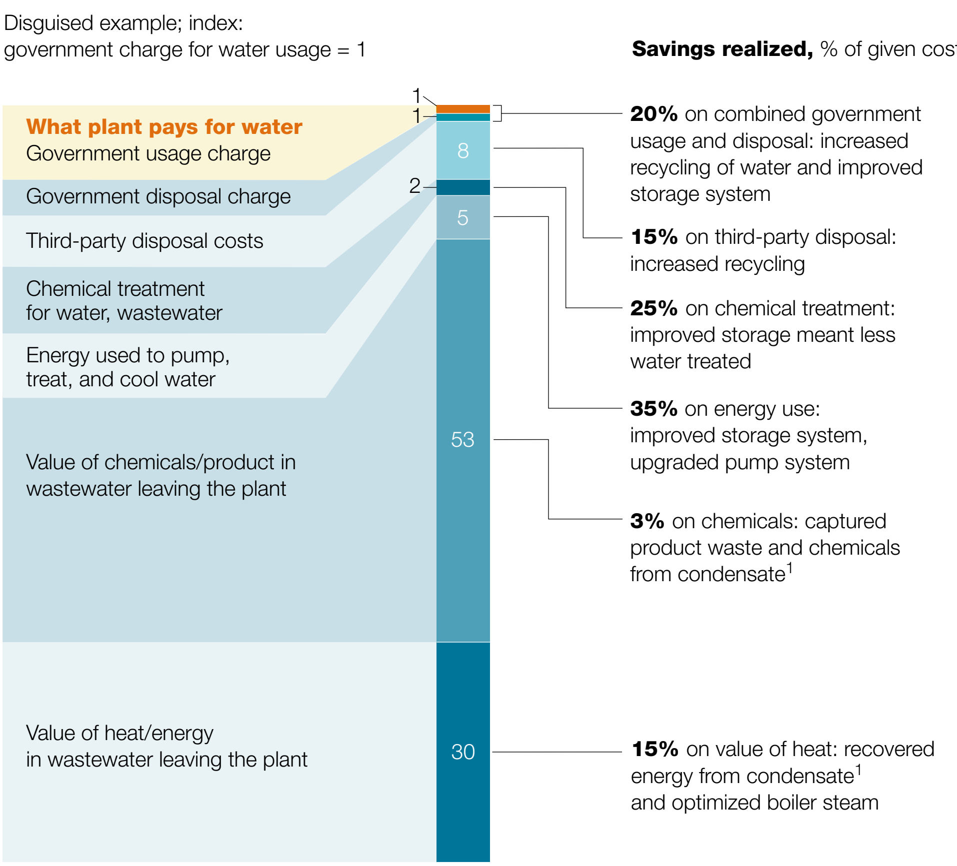
**Kimberly Henderson, Ken Somers, and Martin Stuchtey**

The low nominal cost of water in many regions means that a lot of investments aimed at cutting its use don't seem to offer satisfactory returns. The picture may change when organizations take a broader view of water: as a "carrier" of production inputs and outputs to which a variety of costs and recoverable values can be assigned. Since these elements may total as much as 100 times the nominal cost of water, optimizing its use can yield significant financial returns.

One pulp-and-paper company analyzed its water-use costs as a carrier, including tariffs, charges to dispose of effluents, and water-pumping and -heating expenses. It also examined the value of recoverable chemicals and raw materials "carried" by water from its factories and the potential heat energy lost in cooling processes. By closely surveying these operations, the company identified opportunities for better water storage and for reducing chemical use in paper bleaching. Additionally, the company recaptured heat from condensation processes and reduced the amount of steam consumed by boilers. These moves saved nearly 10 percent of measured carrier costs, reducing total operating expenses by 2.5 percent and improving sustainability by cutting water use nearly in half. Industries such as steel, packaged goods, chemicals, and pharmaceuticals have similar carrier cost–value profiles. Companies may be able to identify substantial savings by focusing on the broader economic costs of water. o

**Kimberly Henderson** is a consultant in McKinsey's São Paulo office, **Ken Somers** is a consultant in the Antwerp office, and **Martin Stuchtey** is a director in the Munich office.

**A pulp-and-paper company analyzed the 'carrier' elements in its water, revealing costs and value far above basic water fees.**




**Overall, the company saved approximately 10% on total carrier costs and consumed 45% less water.**

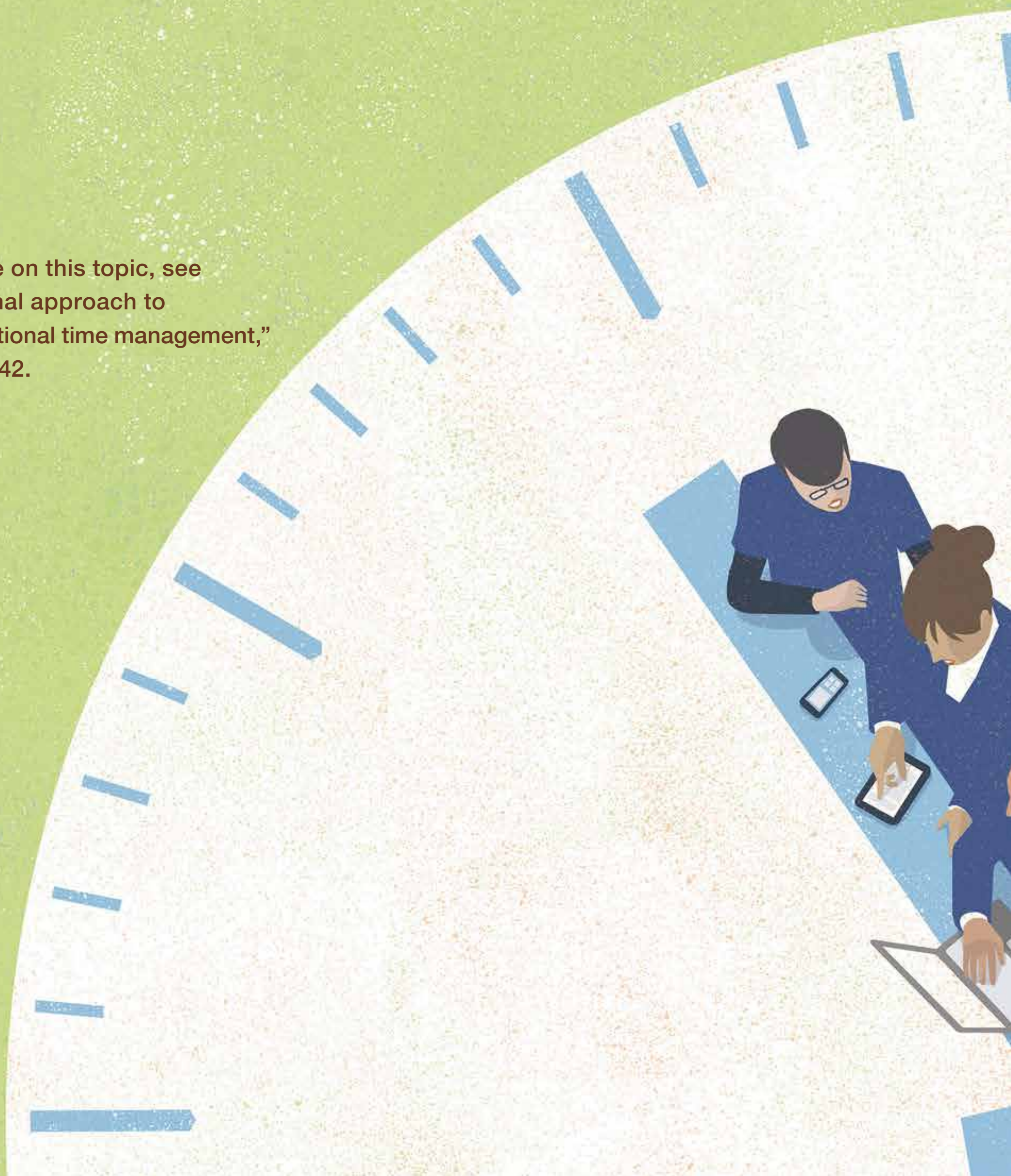
[1]Condensed steam, which carries value in the form of heat and chemicals (the latter are consumed in the water-treatment process required to upgrade water for use in boilers and turbines).

# Making **time management** the organization's priority

**Frankki Bevins and Aaron De Smet**

To stop wasting a finite resource, companies should tackle time problems systematically rather than leave them to individuals.

For more on this topic, see "A personal approach to organizational time management," on page 42.



**The problem**

Time scarcity is getting worse: always-on communications, organizational complexity, and unrelenting economic pressures are compounding an age-old challenge.

**Why it matters**

With almost 50 percent of executives saying that they're not spending enough time on strategic priorities, time challenges are a concern for companies, not just individuals.

**What to do about it**

Treat time management as an institutional issue rather than primarily an individual one.

Establish a time budget and limit new initiatives when the human capital runs out.

Beware of becoming so lean that you overwhelm managers; don't stint on high-quality assistants to help manage executive time.

Measure the time executives spend on strategic priorities and set explicit time-based metrics.

Use a master calendar to root out time-wasting meetings.

**When a critical strategic initiative** at a major multinational stalled recently, company leaders targeted a talented, up-and-coming executive to take over the project. There was just one problem: she was already working 18-hour days, five days a week. When the leaders put this to the CEO, he matter-of-factly remarked that by his count she still had "30 more hours Monday to Friday, plus 48 more on the weekend."

Extreme as this case may seem, the perennial time-scarcity problem that underlies it has become more acute in recent years. The impact of always-on communications, the growing complexity of global organizations,[1] and the pressures imposed by profound economic uncertainty have all added to a feeling among executives that there are simply not enough hours in the day to get things done.

Our research and experience suggest that leaders who are serious about addressing this challenge must stop thinking about time management as primarily an individual problem and start addressing it institutionally. Time management isn't just a personal-productivity issue over which companies have no control; it has increasingly become an organizational issue whose root causes are deeply embedded in corporate structures and cultures.

Fortunately, this also means that the problem can be tackled systematically. Senior teams can create time budgets and formal processes for allocating their time. Leaders can pay more attention to time when they address organizational-design matters such as spans of control, roles, and decision rights. Companies can ensure that individual leaders have the tools and incentives to manage their time effectively. And they can provide institutional support, including best-in-class administrative assistance—a frequent casualty of recent cost-cutting efforts.

Approaches like these aren't just valuable in their own right. They also represent powerful levers for executives faced with talent shortages, particularly if companies find their most skilled people so overloaded that they lack the capacity to lead crucial new programs. In this article, we'll explore institutional solutions—after first

[1] For more on global organizational challenges, see Martin Dewhurst, Jonathan Harris, and Suzanne Heywood, "The global company's challenge," mckinseyquarterly.com, June 2012; and Toby Gibbs, Suzanne Heywood, and Leigh Weiss, "Organizing for an emerging world," mckinseyquarterly.com, June 2012.

reviewing in more detail the nature of today's time-management challenge, including the results of a recent survey.

## Time: The 'infinite' resource

When we asked nearly 1,500 executives across the globe[2] to tell us how they spent their time, we found that only 9 percent of the respondents deemed themselves "very satisfied" with their current allocation. Less than half were "somewhat satisfied," and about one-third were "actively dissatisfied." What's more, only 52 percent said that the way they spent their time largely matched their organizations' strategic priorities. Nearly half admitted that they were not concentrating sufficiently on guiding the strategic direction of the business. These last two data points suggest that time challenges are influencing the well-being of companies, not just individuals.

The survey results, while disquieting, are arguably a natural consequence of the fact that few organizations treat executive time as the finite and measurable resource it is. Consider the contrast with capital. Say that a company has $2 billion of good capital-investment opportunities, all with positive net present value and reasonably quick payback, but just $1 billion of capital readily available for investment. The only options are either to prioritize the most important possibilities and figure out which should be deferred or to find ways of raising more capital.

Leadership time, by contrast, too often gets treated as though it were limitless, with all good opportunities receiving high priority regardless of the leadership capacity to drive them forward. No wonder that so few leaders feel they are using their time well or that a segmentation analysis of the survey data (Exhibit 1) revealed the existence not only of dissatisfied executives but of four distinct groups of dissatisfied executives —"online junkies," "schmoozers," "cheerleaders," and "firefighters"—whose pain points, as we'll see, reflect the ways organizations ignore time.

[2] The online survey was in the field from November 8 to November 18, 2011, and garnered responses from 1,374 executives at the level of general manager or above. Respondents represent all regions, industries, company sizes, forms of ownership, and functional specialties. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

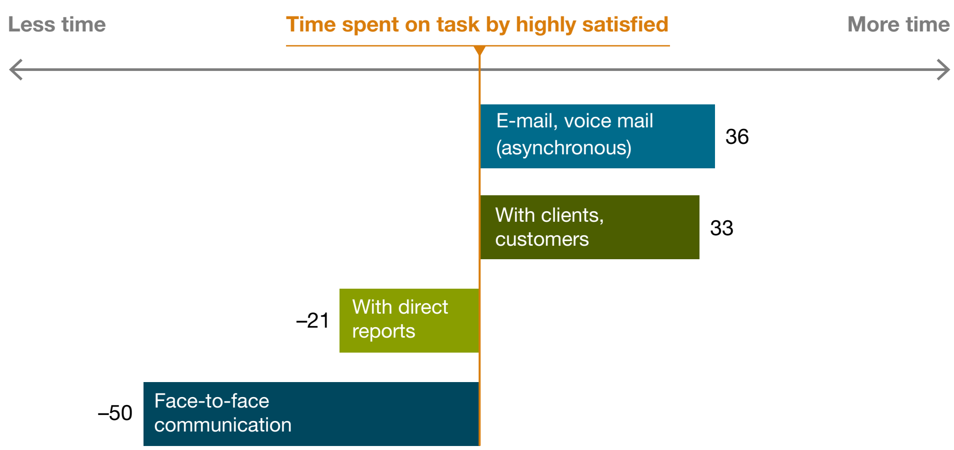
Exhibit 1

**Executives who are dissatisfied with their use of time fall into four distinct groups.**

Gap in time spent by dissatisfied vs satisfied executives,[1] %

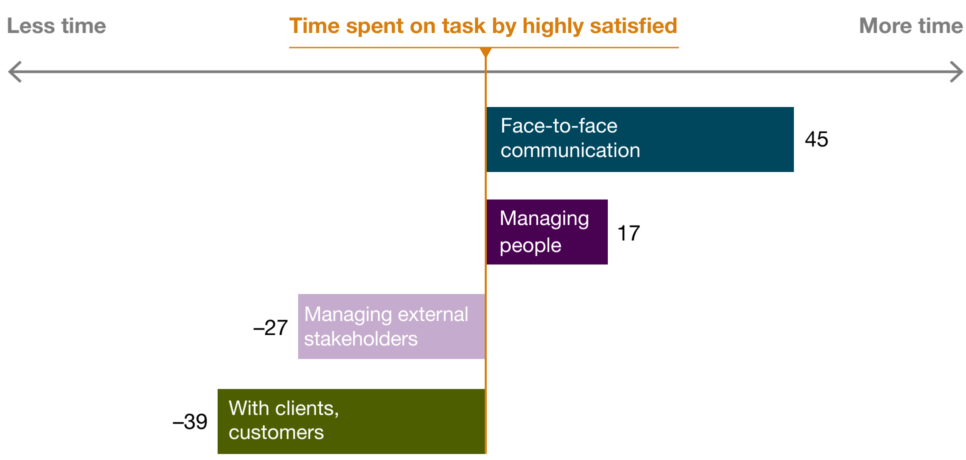
## Online junkies (n = 108)

Office centered; spend more time than most e-mailing or on phone and less time than others motivating people or being with direct reports




## Cheerleaders (n = 111)

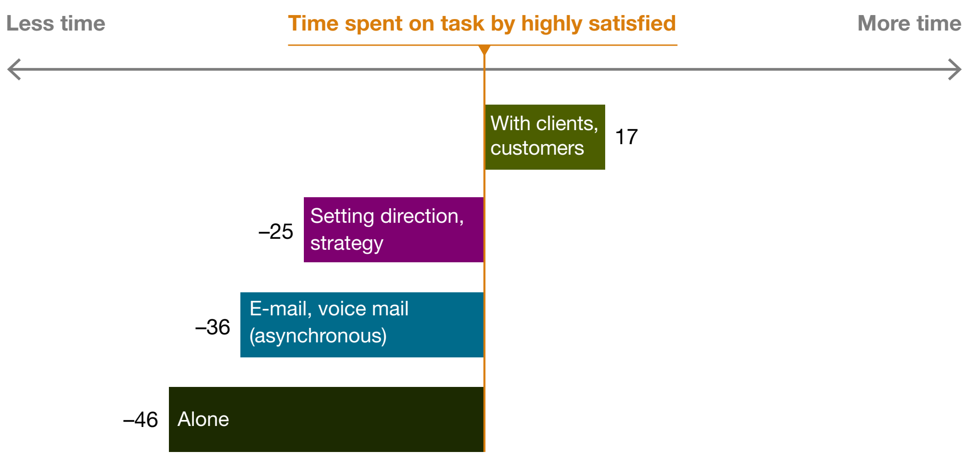
Spend more time than others interacting face to face or in meetings with employees and only limited time with external stakeholders; much less likely than others to use e-mail or phone




[1] Gap calculated as % of time spent by satisfied executives in a given activity, situation, or communication mode. For dissatisfied executives, n = 433, for satisfied executives, n = 124.

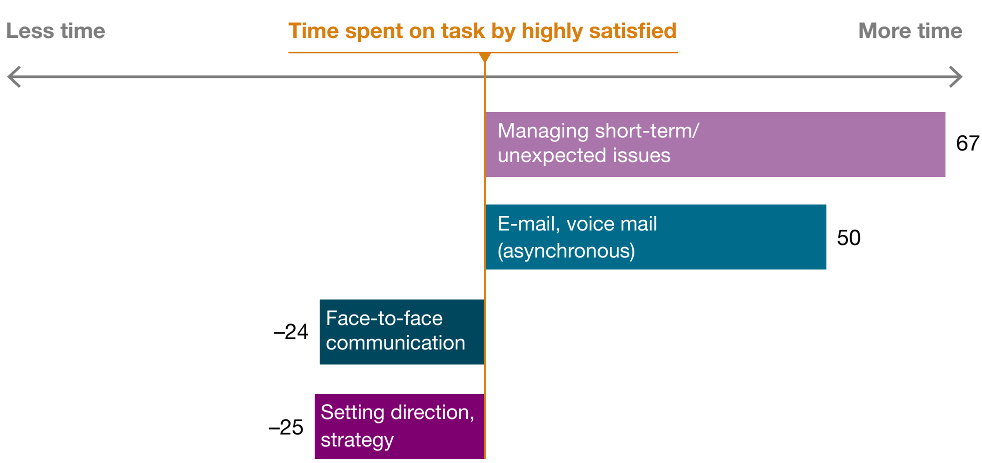
## Schmoozers (n = 107)

Spend almost all their time with external stakeholders but lack thinking time and neglect strategy; a few privileged employees get face-to-face access—but no open-door policy for the rest




## Firefighters (n = 107)

Spend much of their time responding to emergencies via e-mail and phone; are on their own more than others—but rarely use time to think or to set direction




Source: Nov 2011 McKinsey survey of 1,374 executives at the level of general manager or above, representing all regions, industries, company sizes, forms of ownership, and functional specialties

## Initiative overload

The myth of infinite time is most painfully experienced through the proliferation of big strategic initiatives and special projects common to so many modern organizations. The result is initiative overload: projects get heaped on top of "day jobs," with a variety of unintended consequences, including failed initiatives, missed opportunities, and leaders who don't have time to engage the people whose cooperation and commitment they need. Organizations often get "change fatigue" and eventually lack energy for even the most basic and rewarding initiatives.

Many dissatisfied executives, particularly firefighters and online junkies, struggle to devote time and energy to the personal conversations and team interactions that drive successful initiatives. The online junkies spend the least time motivating employees or being with their direct reports, either one on one or in a group; face-to-face encounters take up less than 20 percent of their working day. The communication channels they most favor are e-mail, other forms of asynchronous messaging, and the telephone—all useful tools, but often inadequate substitutes for real conversations.

## Muddling through

Another unintended consequence of our cavalier attitude toward this supposedly infinite resource is a lack of organizational time-management guidance for individual managers.

Imagine someone on day one of a new job: she's been through the training and onboarding, arrives at the office, sits down at her desk, and then . . . ? What determines the things she does, her schedule, the decisions she gets involved with, where she goes, whom she talks with, the information she reviews (and for how long), and the meetings she attends? Nine out of ten times, we find, the top two drivers are e-mails that appear in the inbox and meeting invites, albeit sometimes in reverse order.

Diary analyses of how different people spend their time in the same role—sales rep, trader, store manager, regional vice president—often provoke astonishment at the sharply contrasting ways different individuals perform the same job. The not-so-good performers are often highly fragmented, spending time on the wrong things in the wrong places while ignoring tasks core to their strategic objectives.

Our survey suggests that a laissez-faire approach to time management is a challenge for all four types of dissatisfied executives, but particularly for the schmoozers (CEOs are well represented) and cheerleaders (often C-suite executives one level down). These individuals seem to be doing valuable things: schmoozers spend most of their time meeting face to face with important (often external) stakeholders, while cheerleaders spend over 20 percent of theirs (more than any other dissatisfied group) interacting with, encouraging, and motivating employees.

But consider the things these people are not doing. Cheerleaders spend less time than other executives with a company's external stakeholders. For schmoozers, more than 80 percent of interaction time takes place face to face or on the phone. They say they have difficulty connecting with a broad cross-section of the workforce or spending enough time thinking and strategizing. The same challenge confronts cheerleaders, who spend less than 10 percent of their time focused on long-term strategy. The bottom line: muddling through and devoting time to activities that seem important doesn't always cut it, even for a company's most senior leaders.

## Troublesome trade-offs

When new initiatives proliferate without explicit attention to the allocation of time and roles, organizations inadvertently make trade-offs that render their leaders less effective (see sidebar, "Drowning in managerial minutiae").

Companies often exacerbate time problems through the blunt application of "delayering" principles. One organization we know applied "the rule of seven" (no more than seven direct reports for managers) to all parts of the organization. It forgot that different types of managerial work require varying amounts of time to oversee, manage, and apprentice people. In some cases (such as jobs involving highly complicated international tax work in finance organizations), a leader has the bandwidth for only two or three direct reports. In others (such as very simple call-center operations, where employees are well trained and largely self-managing), it is fine to have 20 or more.

While the average span of control might still work out at seven, applying simple rules in an overly simplistic way can be costly: managers with too few direct reports often micromanage them or initiate unnecessary meetings, reports, or projects that make the organization more complex. Conversely, when managers don't have enough time to supervise their people, they tend to manage by exception (acting only where there's a significant deviation from what's planned) and often end up constantly firefighting.

We saw these dynamics most at work among our survey's firefighters. General managers accounted for the largest number of people in this category, which is characterized by the amount of time those in it spend alone in their offices, micromanaging and responding to supposed emergencies via e-mail and telephone (40 percent, as opposed to 13 percent for the schmoozers). Such executives also complained about focusing largely on short-term issues and near-term operational decisions and having little time to set strategy and organizational direction.

## Drowning in managerial minutiae

When we arrived early one morning for a leadership meeting with the director of operations at a large manufacturing company, we found her staring in frustration at her laptop. "What are you working on?" we asked.

"I wouldn't say I'm working on anything," she said grumpily. "I'm approving things. Like this $26 requisition for a set of business cards. I've got all these approvals that I need to approve backed up in the system. I swear I must spend 15 or 20 hours per month on this kind of nonsense. Approving this, managing that, signing off on time sheets, on sick leave, and on budget items in excruciating detail. Every time there is one of these efforts to cut costs in a function, work that had previously been done by a small group of clerks and administrators gets pushed out to executives and managers to do themselves, reducing the clerical department by five or six FTEs.[1] If we could measure the time costs for senior managers, we'd see that they are much bigger than the cost savings—but it's easier to just shove the work onto someone else and declare victory than to do the really hard work of finding out how to get more efficient."

[1] Full-time equivalents.

## Respecting time

The deep organizational roots of these time challenges help explain their persistence despite several decades of research, training, and popular self-help books, all building on Peter Drucker's famous dictum: "Time is the scarcest resource, and unless it is managed nothing else can be managed."[3]

So where should leaders hoping to make real progress for their organizations—and themselves—start the journey? We don't believe there's one particular breakdown of time that works for all executives. But the responses of the relatively small group of satisfied executives in our survey (fewer than one in ten) provide some useful clues to what works.

Overall, the key seems to be balance (Exhibit 2). On average, executives in the satisfied group spend 34 percent of their time interacting with external stakeholders (including boards, customers, and investors), 39 percent in internal meetings (evenly split between one on ones with direct reports, leadership-team gatherings, and other meetings with employees), and 24 percent working alone.[4]

Of the time executives in the satisfied group spend interacting with others (externally and internally), 40 percent involves face-to-face meetings, 25 percent video- or teleconferences, and around 10 percent some other form of real-time communication. Less than a third involves e-mail or other asynchronous communications, such as voice mail.

The satisfied executives identified four key activities that take up (in roughly equal proportions) two-thirds of their time: making key business or operational decisions, managing and motivating people, setting direction and strategy, and managing external stakeholders. None of these, interestingly, is the sort of transactional and administrative activity their dissatisfied counterparts cited as a major time sink.

In our experience, all of those dissatisfied leaders stand to benefit from the remedies described below. That said, just as the principles of a good diet plan are suitable for all unhealthy eaters but the

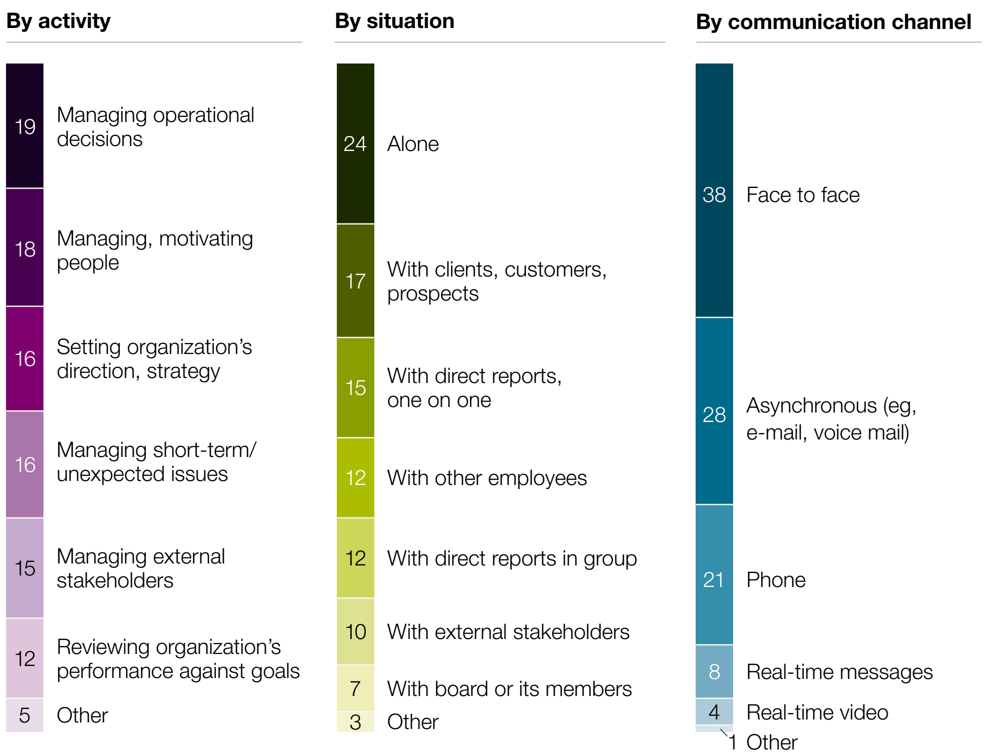
[3] See Peter Drucker, *The Effective Executive*, first edition, New York, NY: Harper & Row, 1967.

[4] About 3 percent said "other."

Exhibit 2

**How satisfied executives spend their time.**

Time allocation by highly satisfied group[1] (n = 124 executives), %




[1]Survey data are weighted by contribution of each respondent's nation to global GDP to adjust for differences in response rates.

Source: Nov 2011 McKinsey survey of 1,374 executives at the level of general manager or above, representing all regions, industries, company sizes, forms of ownership, and functional specialties

application of those principles may vary, depending on individual vices (desserts for some, between-meal snacks for others), so too these remedies will play out differently, depending on which time problems are most prevalent in a given organization.

## 1. Have a 'time leadership' budget—and a proper process for allocating it

Rather than add haphazardly to projects and initiatives, companies should routinely analyze how much leadership attention, guidance, and intervention each of them will need. What is the oversight required? What level of focus should the top team or the steering committee provide? In other words, how much leadership capacity does the company really have to "finance" its great ideas?

Establishing a time budget for priority initiatives might sound radical, but it's the best way to move toward the goal of treating leadership capacity as companies treat financial capital and to stop financing new initiatives when the human capital runs out. One large health system we know has established a formal governance committee, with a remit to oversee the time budget, for enterprise-wide initiatives. The committee approves and monitors all of them, including demands on the system's leadership capacity. Initial proposals must include time commitments required from the leadership and an explicit demonstration that each leader has the required capacity. If not, the system takes deliberate steps to lighten that leader's other responsibilities.

## 2. Think about time when you introduce organizational change

Companies typically look at managerial spans of control from a structural point of view: the broader they are, the fewer managers and the lower the overhead they need. Augmenting that structural frame of reference with the time required to achieve goals is critical to the long-term success of any organizational change. The hours needed to manage, lead, or supervise an employee represent a real constraint that, if unmanaged, can make structures unstable or ineffective.

Getting this right is a delicate balancing act. Excessively lean organizations leave managers overwhelmed with more direct reports than they can manage productively. Yet delayering can be a time saver because it strips out redundant managerial roles that add complexity and unnecessary tasks. One major health-products company we know recently made dramatic progress toward eliminating unnecessary work and taming a notorious "meeting culture" just by restructuring its finance organization, which had twice as many managers as its peers did.

Likewise, when another company—this one in the technology sector—reset its internal governance structures, it saved more than 4,000 person-hours of executive time annually while enhancing its strategic focus, increasing its accountability, and speeding up decision making. In particular, the company revamped complex decision-making structures involving multiple boards and committees that typically included the same people and had similar agendas and unnecessarily detailed discussions.

## 3. Ensure that individuals routinely measure and manage their time

At one leading professional-services firm, a recent analysis revealed that the senior partners were spending a disproportionate amount of time on current engagements, to the exclusion of equally important strategic priorities, such as external networking, internal coaching, and building expertise. Today individual partners have a data-backed baseline as a starting point to measure how well their time allocation meets their individual strategic objectives.

Executives are usually surprised to see the output from time-analysis exercises, for it generally reveals how little of their activity is aligned with the company's stated priorities. If intimacy with customers is a goal, for example, how much time are the organization's leaders devoting to activities that encourage it? Most can't answer this question: they can tell you the portion of the budget that's dedicated to the organization's priorities but usually not how much time the leadership devotes to them. Once leaders start tracking the hours, even informally, they often find that they devote a shockingly low percentage of their overall time to these priorities.

Of course, if you measure and manage something, it becomes a priority regardless of its importance. At one industrial company, a frontline supervisor spent almost all his time firefighting and doing unproductive administrative work, though his real value was managing, coaching, and developing people on the shop floor. The reason for the misallocation was that shop-floor time was neither structured nor measured—no one minded if he didn't show up—but he got into trouble by not attending meetings and producing reports. The same issue exists for senior executives: if their formal and informal incentives don't map closely to strategic priorities, their time will naturally be misallocated.

The inclusion in performance reviews of explicit, time-related metrics or targets, such as time spent with frontline employees (for a plant manager) or networking (for senior partners at a professional-services firm), is a powerful means of changing behavior. So is friendly competition among team members and verbal recognition of people who spend their time wisely. And consider borrowing a page from lean manufacturing, which emphasizes "standard work" as a way to reduce variability. We've seen companies define, measure, and reward leader-standard work, including easy-to-overlook priorities from "walking the halls" to spending time with critical stakeholders.

### 4. Refine the master calendar

To create time and space for critical priorities, business leaders must first of all be clear about what they and their teams will stop doing. Organizationally, that might mean reviewing calendars and meeting schedules to make an honest assessment of which meetings support strategic goals, as opposed to update meetings slotted into the agenda out of habit or in deference to corporate tradition.

While many large companies create a master calendar for key meetings involving members of the senior team, few take the next step and use that calendar as a tool to root out corporate time wasting. There are exceptions, though: one global manufacturer, for example, avoids the duplication of travel time by always arranging key visits with foreign customers to coincide with quarterly business meetings held overseas.

In our experience, companies can make even more progress by identifying which meetings are for information only (reporting), for cross-unit collaboration (problem solving and coordination at the interfaces), for managing performance (course-correcting actions must be adopted at such meetings, or they are really just for reporting), or for making decisions (meetings where everything is

While many large companies create a master calendar for key meetings involving members of the senior team, few use that calendar as a tool to root out corporate time wasting.

approved 99 percent of the time don't count, since they too are really for reporting). Executives at the highest-performing organizations we've seen typically spend at least 50 percent of their time in decision meetings and less than 10 percent in reporting or information meetings. But most companies allocate their leadership time in exactly the reverse order, often without knowing it: the way people spend their time can be taken for granted, like furniture that nobody notices anymore.

## 5. Provide high-quality administrative support

One of the biggest differences we saw in the survey involved the quality of support. Of those who deemed themselves effective time managers, 85 percent reported that they received strong support in scheduling and allocating time. Only 7 percent of ineffective time allocators said the same.

The most effective support we've seen is provided by a global chemical company, where the CEO's administrative assistant takes it upon herself to ensure that the organization's strategic objectives are reflected in the way she allocates the time of the CEO and the top team to specific issues and stakeholders. She regularly checks to ensure that calendared time matches the stated priorities. If it doesn't, during priority-setting meetings (every two weeks) she'll highlight gaps by asking questions such as, "We haven't been to Latin America yet this year—is that an issue? Do you need to schedule a visit before the end of the year?" Or, "Are these the right things to focus on? Since you're already going to Eastern Europe, what else should we schedule while you're out there? Do we need to clear the decks to make more time for strategic priorities?"

In addition, the CEO's administrative assistant "owns" the master calendar for corporate officers and uses it to ensure that the executive team meets on important topics, avoids redundant meetings, and capitalizes on occasions when key leaders are in the same place. Finally, to give senior leaders time to reflect on the big picture, she creates "quiet zones" of minimal activity two or three days ahead of significant events, such as quarterly earnings reports, strategy reviews with business units, and board meetings. Such approaches, which make the executives' allocation of time dramatically more effective, underscore the importance of not being "penny-wise and pound-foolish" in providing administrative support.

• • •

The time pressures on senior leaders are intensifying, and the vast majority of them are frustrated by the difficulty of responding effectively. While executives cannot easily combat the external forces at work, they can treat time as a precious and increasingly scarce resource and tackle the institutional barriers to managing it well. The starting point is to get clear on organizational priorities—and to approach the challenge of aligning them with the way executives spend their time as a systemic organizational problem, not merely a personal one.

*The authors wish to thank Caroline Webb—an alumnus of McKinsey's London office and a senior adviser to McKinsey on leadership, as well as chief executive of SevenShift Leadership—for her contribution to the development of this article.*

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# A personal approach to organizational time management

**Peter Bregman**

Improving the fit between the priorities of managers, their direct reports, and their supervisors—all the way up to the CEO—is a good place to start.

**The biggest and most destructive myth** in time management is that you can get everything done if only you follow the right system, use the right to-do list, or process your tasks in the right way. That's a mistake. We live in a time when the uninterrupted stream of information and communication, combined with our unceasing accessibility, means that we could work every single hour of the day and night and still not keep up. For that reason, choosing what we are going to ignore may well represent the most important, most strategic time-management decision of all.

To illustrate, let's look at the experiences of Todd,[1] the head of sales in a large financial-services firm and a direct report to the CEO. Todd had been struggling to change the way people approached the sales process. He wanted more measurement. He wanted people to target prospects that were more likely to bring in higher margins. He wanted people to be more strategic about which prospects to visit versus which simply to call. Finally, he wanted them to be more courageous about pursuing "stretch" prospects where the odds of success were low but the rewards would be high—and more willing to ignore prospects whose accounts weren't likely to be particularly profitable.

[1]Names and some details changed.

"I've told them all this multiple times," Todd said. "I've even sat them through a long training. But their behavior isn't changing. They're still selling the same old way to the same old prospects."

Todd's salespeople knew what he wanted from them and were able to do it. They also weren't lazy; they were working long hours and were working hard. Rather, the problem was that Todd's salespeople thought they could do it all. That's why they resisted segmenting their markets or measuring the potential of each prospect before planning a visit: they didn't want to miss any opportunities. Yet because their time was limited, they ended up missing some of the best.

If this problem bedevils salespeople in organizations like Todd's, imagine its impact on senior executives. The scope, complexity, and ambiguity of senior leaders' roles not only create near-infinite permutations of priorities but also make it more difficult to get real-time performance or productivity feedback. Is it any wonder that only 52 percent of 1,500 executives McKinsey surveyed said that the way they spent their time largely matched their organizations' strategic priorities? (For more on this research, see "Making time management the organization's priority," on page 26.)

We don't often place organizational problems (such as weak alignment between the priorities of a company's strategy or poor collaboration among the senior team) in the domain of time management, which is generally seen as an issue for individuals. To meddle with someone's to-do list or calendar feels like micromanaging. In addition, time management seems too simplistic a solution to a complex organizational challenge.

But in this case, the simplest solution may be the most powerful because most behavior-change challenges are simply about how people are spending their time. That's precisely where individual time management and organizational time management need to intersect. The question is how. Here's a straightforward approach.

**Step one:** identify up to five things—no more—that you want to focus on for the year. You should spend about 95 percent of your time on those things. Why five things? Why 95 percent of your time? Because getting things done is all about focus. If instead of spending 95 percent of your time on your top five, you spend 80 percent of your time on your top ten, you lose focus and things start falling through the cracks.

As an example, Todd's five things might include the following:

1. Clarify and refine the sales strategy for higher margins.
2. Speak and write to spread the word to higher-margin prospects.
3. Visit higher-margin prospects and clients.
4. Develop and motivate a sales team that focuses on higher-margin clients.
5. Provide cross-silo executive leadership.

Your five things form the structure of your to-do list. Divide a piece of paper into six boxes, five labeled with one of your areas of focus and the sixth labeled "the other 5 percent." That other-5-percent box is like sugar—a little might be OK, but no more than 5 percent of your day should involve activities that don't fit into your five areas of annual focus.

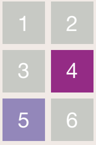
Once you've defined your six boxes, populate them with the tasks from your overflowing to-do list. If there are tasks—and there will be—that don't fit into one of your areas of focus, put them in the other-5-percent box. When I first started using a six-box to-do list, half of my tasks fell outside my top five. That changed within a day of using this to-do list as I learned to dismiss and delete the things that were distracting me from my strategic focus. (Of course, if the other-5-percent box is filled with mission-critical tasks that can't be deleted and will take more than a few hours a week, that suggests your top-five priorities may not be right—a valuable realization.)

**Step two:** once you've created your own six-box to-do list, help each of your direct reports create his or hers. This is where alignment—not just of strategies but of actions—takes place. Each of your employees' top-five things should come out of your top five. Your top five should come from your supervisor's top five and so on, with every person's top five ultimately traceable back to the CEO's.

Clarifying priorities for daily action at the most senior levels of the organization is particularly important precisely because the most senior jobs are often the most complex and scattered. Ultimately, the CEO is responsible for everything that happens in the organization. But focusing on everything is a surefire way to accomplish nothing. So it is the job of the CEO—together with the board of directors—to identify just a few things that will take the highest priority for the entire organization.

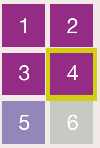
Exhibit

**How 'management by six-box to-do list' cascades priorities across an organization.**



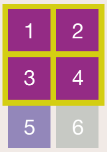

**CEO**

1. Long-term growth
2. A culture of quality
3. Robust talent management
4. Improved margins
5. Cross-functional collaboration
6. The other 5%




**Todd**

1. Clarify/refine sales strategy for higher margins
2. Speak/write to spread word to higher-margin prospects
3. Visit higher-margin prospects and clients
4. Develop/motivate sales team that focuses on higher-margin clients
5. Provide cross-silo executive leadership
6. The other 5%




**Todd's direct reports**

1. Evaluate all client business by margins
2. Identify higher-margin prospects
3. Connect with lower-margin clients by phone
4. Visit higher-margin prospects in person
5. Work with marketing to refine approach for higher-margin clients
6. The other 5%

In Todd's case, his CEO had identified higher margins as one of his own top five. So Todd—who, remember, reported directly to the CEO—focused his top five on that. And Todd's direct reports listed their own top five in line with Todd's (exhibit).

**Step three:** use these to-do lists to manage your employees more closely, without micromanaging. In one quick glance, you can look at their priorities, as well as the actions that they're taking to move those top-five areas of focus forward. If they're doing the wrong things, you can spot that immediately and guide them appropriately. And if they're doing the right things, you can acknowledge them for that and help them succeed.

The power of this process lies in its simplicity and its concreteness. These are not top-five goals or top-five objectives. They form the structure of each person's to-do list and translate, directly, into time spent on the job—which is the difference between getting something done versus simply declaring its importance.

‘Management by six-box to-do list’ encourages transparency and strategic alignment and empowers executives, managers, and employees to push back when asked to do too much outside the areas of strategic focus.

In short, “management by six-box to-do list” encourages organizational transparency and strategic alignment. It also empowers executives, managers, and employees alike to push back when they’re asked to do too much work that distracts them from the areas of strategic focus. When people start doling out tasks that are not in the areas of focus, there’s a structure to bring the distraction into the open, to discuss it, and to make an intentional decision as to whether it’s worth accepting or resisting. This approach takes the normal goal-setting process one step further, creating a much higher likelihood of follow through. Each day, managers and employees are connecting their day-to-day tasks with the organization’s priorities.

This is particularly useful in matrixed organizations, where people often have multiple dotted-line relationships to multiple managers, and in global organizations with cross-border lines of command that can be convoluted, resulting in friction between regional priorities, local management, and business-unit prerogatives.[2] In such instances, confusion increases, along with the complexity of the management structure. All managers believe that their priorities should take precedence. Tensions rise, along with passive-aggressive resistance and plain old procrastination due to overwhelming work demands.

The six-box to-do list clarifies this confusion by putting everything on paper and ensuring alignment—not just top down, but across the hierarchy as well. Each employee has her own six boxes—and if one dotted-line manager wants her to focus on something outside her top five, that becomes immediately evident and gets resolved at the level where it should get resolved: between the managers themselves.

Many organizations use MBOs (management by objectives), but those objectives are rarely looked at outside the annual performance

[2] For more on these challenges and some potential solutions, see Toby Gibbs, Suzanne Heywood, and Leigh Weiss, “Organizing for an emerging world,” mckinseyquarterly.com, June 2012.

review (or, in some cases, quarterly) and never translated into daily tasks. If a CEO is going to drive a strategy though an organization, the organization needs to build its daily actions around that strategy. Remember, the McKinsey survey found that only 52 percent of executives spent their time in ways that largely matched their organizations' strategic priorities. The six-box to-do list should increase that percentage.

• • •

At first, when Todd started using the six-box to-do list, everyone got nervous. Some of the anxiety was about putting to-do lists on display. But after the first few days, that turned out to be a nonissue. The real source of discomfort was that Todd's direct reports began to discard much of what they had previously planned to do.

It didn't take long for them to gain confidence—and pleasure—in limiting their efforts to those most likely to pay off. That focus recently enabled one of Todd's salespeople to make the largest, most profitable single sale that his division of the century-old company has ever made—without working weekends.

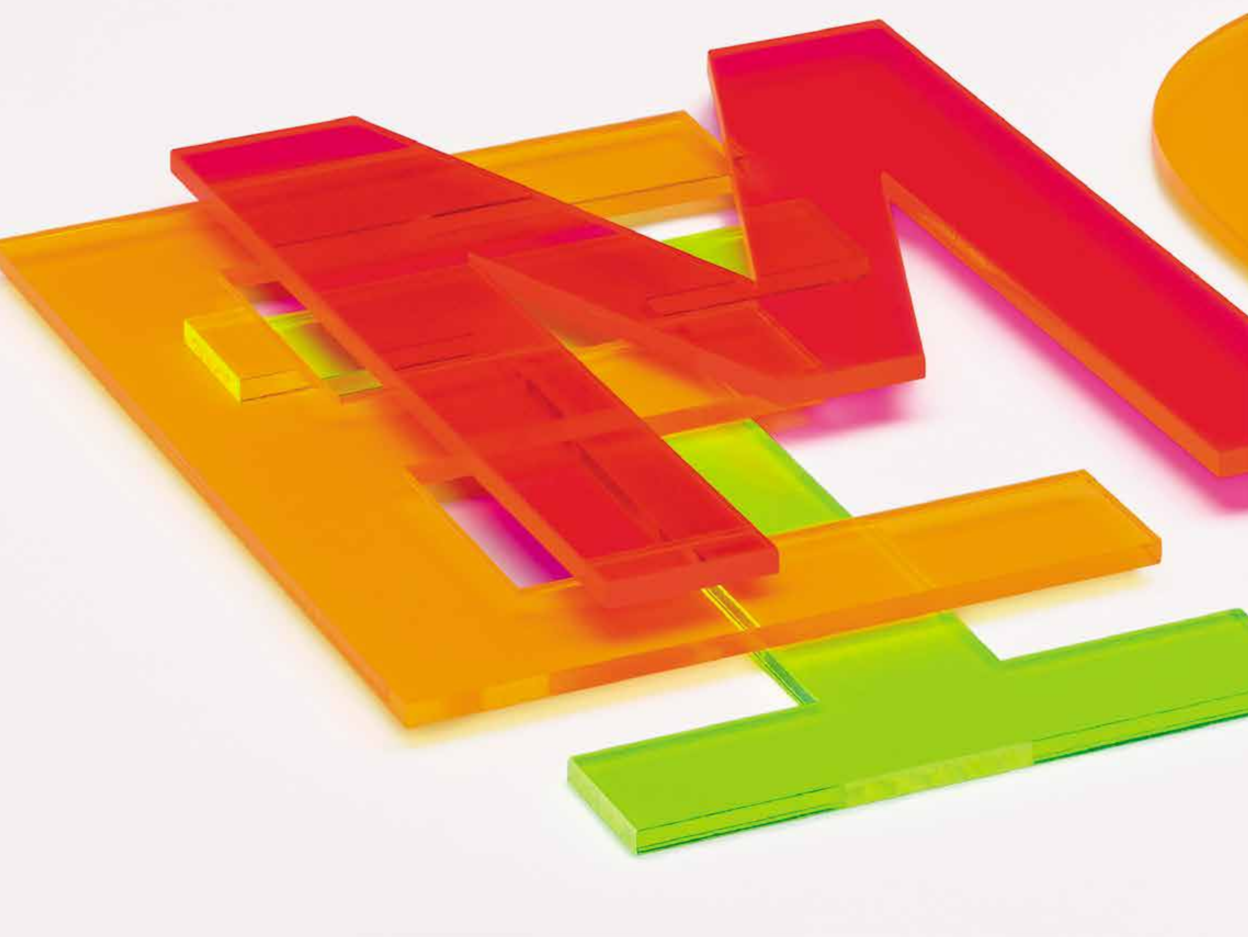
**Peter Bregman** is the author of *18 Minutes: Find Your Focus, Master Distraction, and Get the Right Things Done* (Business Plus, September 2011) and the CEO of Bregman Partners, which advises CEOs and their leadership teams.


We welcome your comments on this article. Please send them to quarterly_comments@mckinsey.com.

# Increasing the ‘meaning quotient’ of work

**Susie Cranston and Scott Keller**

Through a few simple techniques, executives can boost workplace “MQ” and inspire employees to perform at their peak.



### The problem

Executives tell us that they're struggling to create "MQ"—that sense among employees that what they do really makes a difference to themselves or to others.

### Why it matters

MQ helps drive peak performance, especially in periods of intense change. Companies that actively create meaning can significantly enhance workplace productivity.

### What to do about it

Don't resort to platitudes about communication, quality feedback, and empowerment. There are specific tools that really work.

For example, tell stories that demonstrate the impact of change on society, customers, working teams, and individuals—as well as on the company itself.

Allow employees, as far as practicable, to get involved in creating their own sense of direction.

Go beyond financial compensation to motivate people—small and unexpected gestures can be highly effective.

Illustration by Plural with Greg Shapps

**Musicians talk** about being "in the groove," sportsmen about being "in the zone." Can employees in the workplace experience similar performance peaks and, if so, what can top management do to encourage the mental state that brings them about?

We've long been interested in work environments that inspire exceptional levels of energy, increase self-confidence, and boost individual productivity. When we ask leaders about the ingredient they think is most often missing for them and for their colleagues—and by implication is most difficult to provide—they almost invariably signal the same thing: a strong sense of meaning. By "meaning," we and they imply a feeling that what's happening really matters, that what's being done has not been done before or that it will make a difference to others.

The idea of meaning at work is not new. Indeed, two contributions to *McKinsey Quarterly*[1] over the past year have highlighted this theme. In one, the authors demonstrate how misguided leaders often kill meaning in avoidable ways. The author of the other suggests that "meaning maker" is a critical role for corporate strategists. In this article, we will show from our research how meaning drives higher workplace productivity and explain what business leaders can do to create meaning.

## Meaning and performance

The mental state that gives rise to great performance—in sports, business, or the arts—has been described in different ways. The psychologist Mihàly Csìkszentmihàlyi studied thousands of subjects, from sculptors to factory workers, and asked them to record their feelings at intervals throughout the working day. Csìkszentmihàlyi came up with a concept we consider helpful. He observed that people fully employing their core capabilities to meet a goal or challenge created what he called "flow." More important, he found that individuals who frequently experienced it were more productive and derived greater satisfaction from their work than those who didn't. They set goals for themselves to increase their capabilities, thereby

[1] See Teresa Amabile and Steven Kramer, "How leaders kill meaning at work," mckinseyquarterly.com, January 2012; and Cynthia A. Montgomery, "How strategists lead," mckinseyquarterly.com, July 2012.

tapping into a seemingly limitless well of energy. And they expressed a willingness to repeat those activities in which they achieved flow even if they were not being paid to do so.

Athletes describe the same feeling as being in the zone. Bill Russell, a key player for the Boston Celtics during the period when they won 11 professional-basketball championships in 13 years, put it thus: "When it happened, I could feel my play rise to a new level. . . . It would surround not only me and the other Celtics, but also the players on the other team. . . . At that special level, all sorts of odd things happened. The game would be in the white heat of competition, and yet somehow I wouldn't feel competitive. . . . I'd be putting out the maximum effort . . . and yet I never felt the pain."[2]

Flow sounds great in theory, but few business leaders have mastered the skill of generating it reliably in the workplace. An easy first step is to consider what creates flow in your own work situation—a question we have put directly to more than 5,000 executives during workshops we've conducted over the last decade. In this exercise, individuals initially think about their own personal peak performance with a team, when, in other words, they have come closest to the feelings Csìkszentmihàlyi and Russell describe. Then they pinpoint the conditions that made this level of performance possible: what in the team environment was there more or less of than usual?

The remarkably consistent answers we've received fall into three categories. The first set includes elements such as role clarity, a clear understanding of objectives, and access to the knowledge and resources needed to get the job done. These are what one might term rational elements of a flow experience or, to use a convenient shorthand, its intellectual quotient (IQ). When the IQ of a work environment is low, the energy employees bring to the workplace is misdirected and often conflicting.

Another set of answers includes factors related to the quality of the interactions among those involved. Here, respondents often mention a baseline of trust and respect, constructive conflict, a sense of humor, a general feeling that "we're in this together," and the

[2]William F. Russell, *Second Wind: The Memoirs of an Opinionated Man*, first edition, New York, NY: Random House, 1979.

corresponding ability to collaborate effectively. These create an emotionally safe environment to pursue challenging goals or, to borrow from the writings of Daniel Goleman and others, an environment with a high emotional quotient (EQ). When the EQ of a workplace is lacking, employee energy dissipates in the form of office politics, ego management, and passive-aggressive avoidance of tough issues.

While IQ and EQ are absolutely necessary to create the conditions for peak performance, they are far from sufficient. The longest list of words we have compiled from executives' answers to our peak-performance question over the last ten years has little to do with either of these categories. This third one describes the peak-performance experience as involving high stakes; excitement; a challenge; and something that the individual feels matters, will make a difference, and hasn't been done before. We describe this third category as the meaning quotient (MQ) of work. When a business environment's MQ is low, employees put less energy into their work and see it as "just a job" that gives them little more than a paycheck.

The opportunity cost of the missing meaning is enormous. When we ask executives during the peak-performance exercise how much more productive they were at their peak than they were on average, for example, we get a range of answers, but the most common at senior levels is an increase of five times. Most report that they and their employees are in the zone at work less than 10 percent of the time, though some claim to experience these feelings as much as 50 percent of it. If employees working in a high-IQ, high-EQ, and high-MQ environment are five times more productive at their peak than they are on average, consider what even a relatively modest 20-percentage-point increase in peak time would yield in overall workplace productivity—it would almost double.

What's more, when we ask executives to locate the bottlenecks to peak performance in their organizations, more than 90 percent choose MQ-related issues. They point out that much of the IQ tool kit is readily observable and central to what's taught in business schools. The EQ tool kit, while "softer," is now relatively well understood following Goleman's popularization of the concept in the mid-1990s. The MQ tool kit is different.

## What to do differently

Business leaders, we know from other sources, are striving hard to find the missing MQ ingredients so they can improve motivation and workforce productivity. Late last year, for example, a survey (conducted by The Conference Board and McKinsey) of more than 500 US-based HR executives identified employee engagement as one of the top five critical human-capital priorities facing organizations.[3]

Management thinkers are also on the case. Gary Hamel urges modern managers to see themselves as "entrepreneurs of meaning." In *The Progress Principle*, Harvard Business School professor Teresa Amabile and her coauthor Steve Kramer present rigorous field research highlighting the enormous benefits that a sense of forward momentum can have for employees' "inner work life."[4] Csìkszentmihàlyi writes extensively about "the making of meaning" in his book *Good Business*.[5]

In our experience, though, there's often a disconnect between the desire of practitioners to create meaning in the workplace, the good ideas emerging from cutting-edge research, and the number of specific, practical, and reliable tools that leaders know how to use. Often, platitudes about communication, quality feedback, job flexibility, and empowerment are used as substitutes for such tools. Much of this amounts to little more than advice about how to be a good manager. Inspirational visions, along the lines of Walt Disney's "make people happy" or Google's "organize the world's information," have little relevance if you produce ball bearings or garage doors.

In McKinsey's research, we've uncovered a set of specific, actionable techniques underpinned both by experience and a significant body of social-science work. The full tool kit can be found in *Beyond*

[3] See *False Summit: The State of Human Capital 2012*, October 2012, a joint report from The Conference Board and McKinsey.

[4] See Teresa Amabile and Steven Kramer, *The Progress Principle: Using Small Wins to Ignite Joy, Engagement, and Creativity at Work*, first edition, Boston, MA: Harvard Business School Publishing, 2011.

[5] See Mihàly Csìkszentmihàlyi, *Good Business: Leadership, Flow, and the Making of Meaning*, first edition, New York, NY: Viking, 2003.

*Performance: How Great Organizations Build Ultimate Competitive Advantage*.[6] The three examples described here are not only among the most counterintuitive (and therefore the most often overlooked) but also the most powerful.

## Strategy #1: Tell five stories at once

We typically see organizational leaders tell two types of stories to inspire their teams. The first, the turnaround story, runs along the lines of "We're performing below industry standard and must change dramatically to survive—incremental change is not sufficient to attract investors to our underperforming company." The second, the good-to-great story, goes something like this: "We are capable of far more, given our assets, market position, skills, and loyal staff, and can become the undisputed leader in our industry for the foreseeable future."

The problem with both approaches is that the story centers on the company, and that will inspire some but by no means all employees. Our research shows that four other sources give individuals a sense of meaning, including their ability to have an impact on

- society—for example, making a better society, building the community, or stewarding resources
- the customer—for instance, making life easier and providing a superior service or product
- the working team—for instance, a sense of belonging, a caring environment, or working together efficiently and effectively
- themselves—examples include personal development, a higher paycheck or bonus, and a sense of empowerment

Surveys of hundreds of thousands of employees show that the split in most companies—regardless of management level, industry sector, or geography (developed or developing economies)—is roughly equal. It appears that these five sources are a universal human phenomenon.

[6] Scott Keller and Colin Price, *Beyond Performance: How Great Organizations Build Ultimate Competitive Advantage*, first edition, Hoboken, NJ: John Wiley & Sons, 2011.

A turnaround or a good-to-great story will strike a motivational chord with only 20 percent of the workforce. The same goes for a ‘change the world’ vision or appeals to individuals on a personal level.

The implication for leaders seeking to create high-MQ environments is that a turnaround or a good-to-great story will strike a motivational chord with only 20 percent of the workforce. The same goes for a “change the world” vision like those of Disney and Google or appeals to individuals on a personal level. The way to unleash MQ-related organizational energy is to tell all five stories at once.

A recent cost-reduction program at a large US financial-services company began with a rational-change story focused on the facts: expenses were growing faster than revenues. Three months into the program, it was clear that employee resistance was stymieing progress. The management team therefore worked together to recast the story to include elements related to society (more affordable housing), customers (increased simplicity and flexibility, fewer errors, more competitive prices), working teams (less duplication, more delegation, increased accountability, a faster pace), and individuals (bigger and more attractive jobs, a once-in-a-career opportunity to build turnaround skills, a great opportunity to “make your own” institution). The program was still *what* it was—a cost-reduction program—but the reasons it mattered were cast in far more meaningful terms.

Within a month, the share of employees reporting that they were motivated to drive the change program forward jumped to 57 percent, from 35 percent, according to the company’s employee-morale pulse surveys. The program went on to exceed initial expectations, raising efficiency by 10 percent in the first year.

## Strategy #2: Let employees ‘write their own lottery ticket’

The first strategy gives specific and practical guidance about how to *tell* the story. Yet the best meaning makers spend more time *asking* than telling.

In one of Daniel Kahneman’s famous experiments, researchers ran a lottery with a twist. Half of the participants were randomly assigned a lottery ticket. The remaining half were given a blank piece of paper and asked to write down any number they pleased. Just before drawing the winning number, the researchers offered to buy back the tickets from their holders. The question they wanted to answer was how much more would you have to pay people who “wrote their own number” than people who received a number randomly. The rational answer should be no difference at all, since a lottery is pure chance, and therefore every ticket number, chosen or assigned, has the same odds of winning. A completely rational actor might even want to pay less for a freely chosen number, given the possibility of duplicate ones. The actual answer? Regardless of geography or demographics, researchers found they had to pay at least five times more to those who chose their own number.

This result reveals a truth about human nature: when we choose for ourselves, we are far more committed to the outcome—by a factor of at least five to one.

In business, of course, leaders can’t just let everyone decide their own direction. But they can still apply the lessons of the lottery-ticket experiment. The head of financial services at one global bank we know first wrote down his change story, shared it with his team for feedback, and then in effect asked all individual team members to write their own lottery ticket: what change story, in each of the businesses, supported the wider message? His team members in turn wrote change stories, shared them with *their* teams, and the process continued all the way to the front line. Although this method took far longer than the traditional road-show approach, the return on commitment to the program was considered well worth the investment and an important reason the bank achieved roughly two times its revenue-per-banker-improvement targets.

Likewise, when Neville Isdell took charge at Coca-Cola, in 2004, he cocreated a turnaround strategy by bringing together his top 150 employees for three multiday "real work" sessions. The process was then cascaded further down into the organization, at small working meetings where participants could in effect write their own lottery ticket about the implications for their particular parts of the business. With hindsight, this process of creating and interactively cascading what became known as The Manifesto for Growth is seen as a pivotal intervention in a two-year turnaround in which the group stopped destroying shareholder value and generated returns of 20 percent, driven by volume increases equivalent to selling an extra 105 million bottles of Coke a day. In this period, staff turnover fell by 25 percent, and the company reported what external researchers called unprecedented increases in employee engagement for an organization of this size.

Leaders who need to give their employees more of a sense of direction can still leverage the lottery-ticket insight by augmenting their telling of the story with asking about the story. David Farr, chairman and CEO of Emerson Electric, for example, is known for asking virtually everyone he encounters in the organization four questions: (1) how do you make a difference? (testing for alignment with the company's direction); (2) what improvement idea are you working on? (emphasizing continuous improvement); (3) when did you last get coaching from your boss? (emphasizing the importance of people

development); and (4) who is the enemy? (emphasizing the importance of "One Emerson" and no silos, as well as directing the staff's energy toward the external threat). The motivational effect of this approach has been widely noted by Emerson employees.

## Strategy #3: Use small, unexpected rewards to motivate

US author Upton Sinclair once wrote, "It is difficult to get a man to understand something when his salary depends upon his not understanding it." The flip side, however, isn't true. When business objectives are linked to compensation, the motivation to drive for results is rarely enhanced meaningfully.

The reason is as practical as psychological. Most annual-compensation plans of executives are so full of key performance indicators that the weighting of any one objective becomes largely meaningless in the grand scheme of things. Furthermore, most compensation plans typically emphasize financial metrics whose results depend on myriad variables, many beyond individual control. On top of that, most companies don't have deep enough pockets to make compensation a significant driver of MQ in the workplace.

Leaders of organizations that successfully instill meaning understand the power of other methods. Terry Burnham and Jay Phelan's book, *Mean Genes*,[7] describes an experiment in which 50 percent of a group of people using a photocopier found a dime in the coin-return slot. When all were asked to rate their satisfaction level, those who got the dime scored an average of 6.5 on a scale of 1 to 7, while those who didn't scored just 5.6. The lesson here is that when we aren't expecting a reward, even a small one can have a disproportionate effect on our state of mind. And that's also true of employees in the workplace.

At ANZ Bank, John McFarlane gave all employees a bottle of champagne for Christmas, with a card thanking them for their work on a major change program. The CEO of Wells Fargo, John Stumpf,

[7] Terry Burnham and Jay Phelan, *Mean Genes: From Sex to Money to Food: Taming Our Primal Instincts*, first edition, New York, NY: Perseus Publishing, 2000.

marked the first anniversary of its change program by sending out personal thank-you notes to all the employees who had been involved, with specific messages related to the impact of their individual work. Indra Nooyi, CEO of PepsiCo, sends the spouses of her top team handwritten thank-you letters. After seeing the impact of her own success on her mother during a visit to India, she began sending letters to the parents of her top team, too.

Some managers might dismiss these as token gestures—but employees often tell us that the resulting boost in motivation and in connection to the leader and the company can last for months if not years. As Sam Walton, founder of Wal-Mart Stores, put it, "Nothing else can quite substitute for a few well-chosen, well-timed, sincere words of praise. They're absolutely free—and worth a fortune."

Of the three *Q*s that characterize a workplace likely to generate flow and inspire peak performance, we frequently hear from business leaders that MQ is the hardest to get right. Given the size of the prize for injecting meaning into people's work lives, taking the time to implement strategies of the kind described here is surely among the most important investments a leader can make.

**Susie Cranston** is a senior expert in McKinsey's San Francisco office, and **Scott Keller** is a director in the Southern California office.

## Picture This

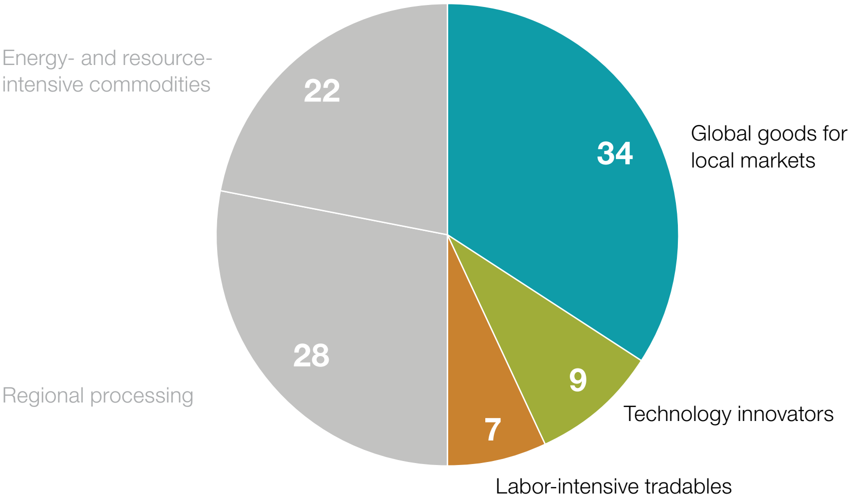
# Parsing global manufacturing

James Manyika, Jan Mischke, and Louis Rassey

Making physical products contributes disproportionately to productivity growth, trade, and innovation in advanced economies and provides a path to higher living standards in developing ones. A decade into the 21st century, agile, networked enterprises are using data as skillfully as talent and machinery to deliver products and services around the globe. The industries in which these enterprises compete can be divided into five broad segments that vary by the degree to which they rely on labor, knowledge, or resources and their proximity to customers. In many of these segments, the distinctions between manufacturing and services are blurring. And all of them are evolving in response to changes in technology and global trends, often in ways that defy conventional wisdom.

**Manufacturing gross value added by segment,** 2010, %

**100% = $10.5 trillion**



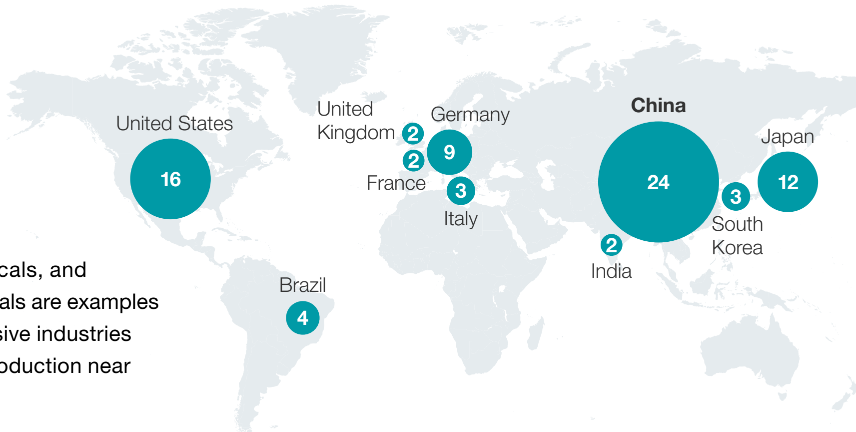

For more on all five manufacturing segments, see *Manufacturing the future: The next era of global growth and innovation*, on mckinsey.com.

Source: IHS Global Insight, May 2012 forecast; McKinsey Global Institute analysis

**James Manyika** is a director of the McKinsey Global Institute and a director in McKinsey's San Francisco office, **Jan Mischke** is a senior expert in the Zurich office, and **Louis Rassey** is a principal in the Chicago office.

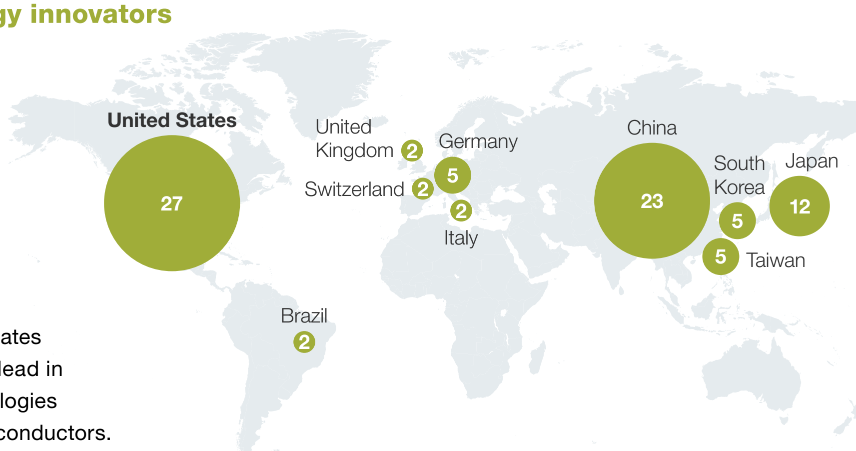
**Global market share of top ten countries** (by gross value added),[1] 2010, %

## Global goods for local markets



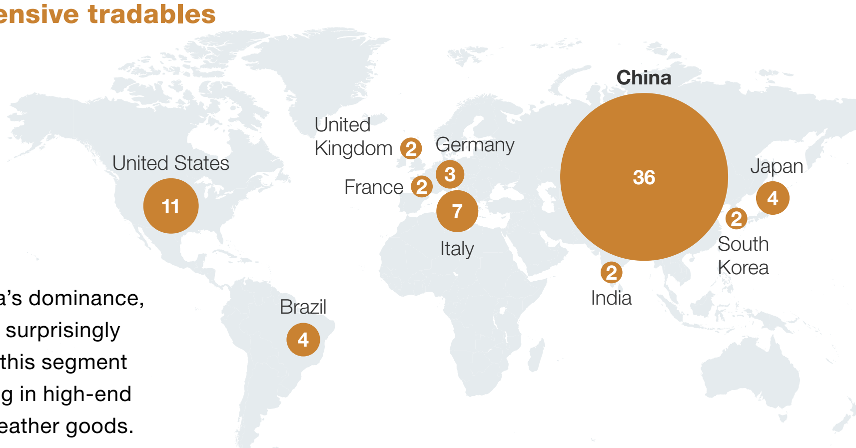

Autos, chemicals, and pharmaceuticals are examples of R&D-intensive industries that locate production near end markets.

## Technology innovators



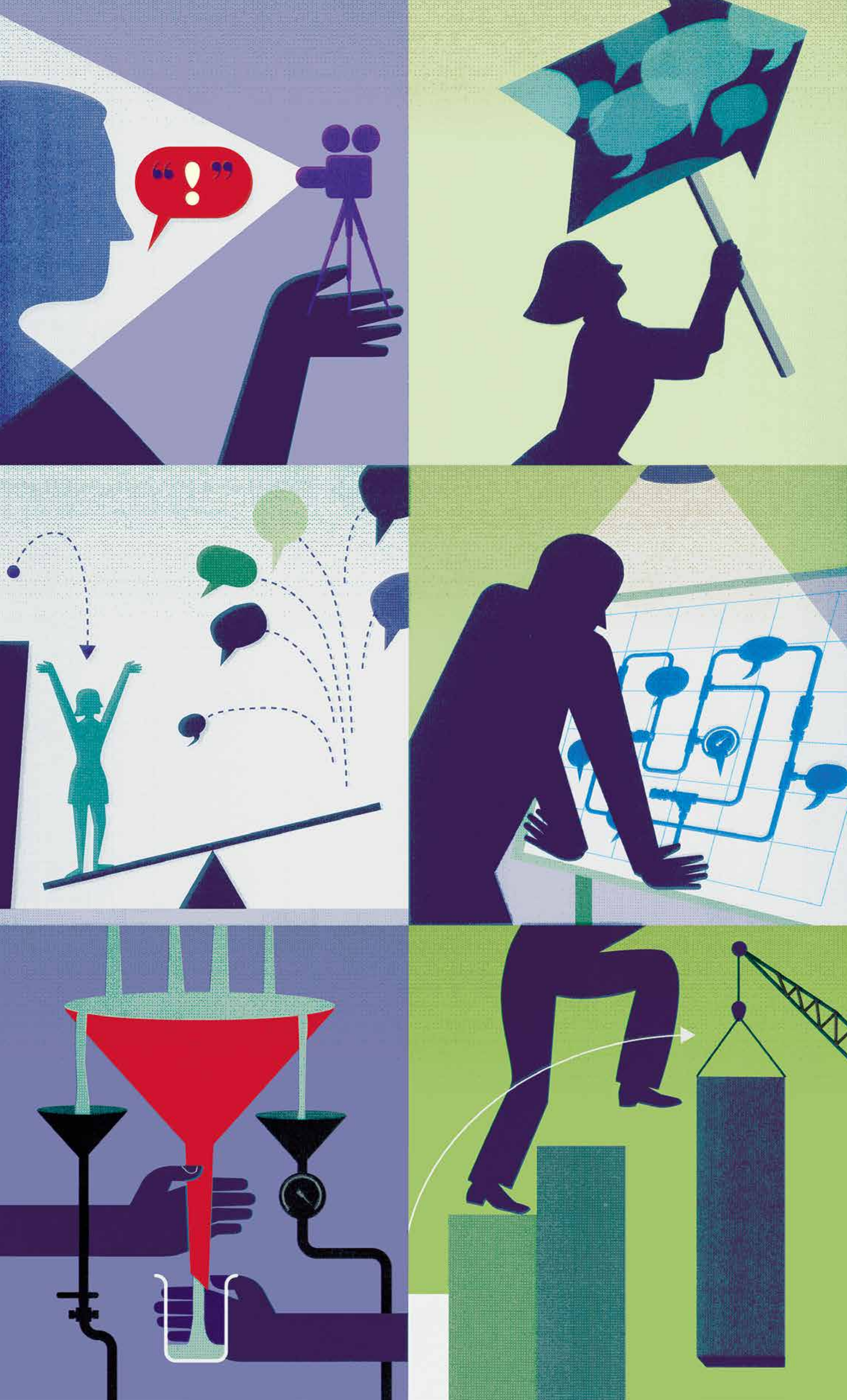

The United States continues to lead in global technologies such as semiconductors.

## Labor-intensive tradables




Despite China's dominance, Italy retains a surprisingly high share in this segment by specializing in high-end apparel and leather goods.

[1]Based on bottom-up calculations for manufacturing industries in 75 of the largest economies (28 developed and 47 developing); includes all 2-digit manufacturing industries in the ISIC, except recycling.



# Six social-media skills

## every leader needs

**Roland Deiser and Sylvain Newton**

Organizational social-media literacy is fast becoming a source of competitive advantage. Learn, through the lens of executives at General Electric, how you and your leaders can keep up.

**The problem**

Even as individuals increasingly embrace social technologies, many leaders fear the risks of unbridled information and see difficulties meshing the open dynamics of social media with existing communications processes.

**Why it matters**

When leaders shy away from social media, they inhibit collaboration, knowledge sharing, and the tapping of employee capabilities that collectively can create a competitive advantage.

**What to do about it**

Leaders need to develop new social-media skills and help their organizations do the same.

At the personal level, leaders must be able to produce compelling, authentic content; master the new distribution dynamics; and navigate information overload.

At the organizational level, leaders should encourage usage through thoughtful orchestration and role modeling, become architects of a social-media-friendly infrastructure, and stay ahead of rapid technology shifts.

For more on this topic, see "Social technologies: Crossing the next threshold," on page 76.

Illustrations by Andrew Baker

**Few domains in business and society** have been untouched by the emerging social-media revolution—one that is not even a decade old. Many organizations have been responding to that new reality, realizing the power and the potential of this technology for corporate life: wikis enable more efficient virtual collaboration in cross-functional projects; internal blogs, discussion boards, and YouTube channels encourage global conversations and knowledge sharing; sophisticated viral media campaigns engage customers and create brand loyalty; next-generation products are codeveloped in open-innovation processes; and corporate leaders work on shaping their enterprise 2.0 strategy.

This radical change has created a dilemma for senior executives: while the potential of social media seems immense, the inherent risks create uncertainty and unease. By nature unbridled, these new communications media can let internal and privileged information suddenly go public virally. What's more, there's a mismatch between the logic of participatory media and the still-reigning 20th-century model of management and organizations, with its emphasis on linear processes and control. Social media encourages horizontal collaboration and unscripted conversations that travel in random paths across management hierarchies. It thereby short-circuits established power dynamics and traditional lines of communication.

We believe that capitalizing on the transformational power of social media while mitigating its risks calls for a new type of leader. The dynamics of social media amplify the need for qualities that have long been a staple of effective leadership, such as strategic creativity, authentic communication, and the ability to deal with a corporation's social and political dynamics and to design an agile and responsive organization.

Social media also adds new dimensions to these traits. For example, it requires the ability to create compelling, engaging multimedia content. Leaders need to excel at cocreation and collaboration—the currencies of the social-media world. Executives must understand the nature of different social-media tools and the unruly forces they can unleash.

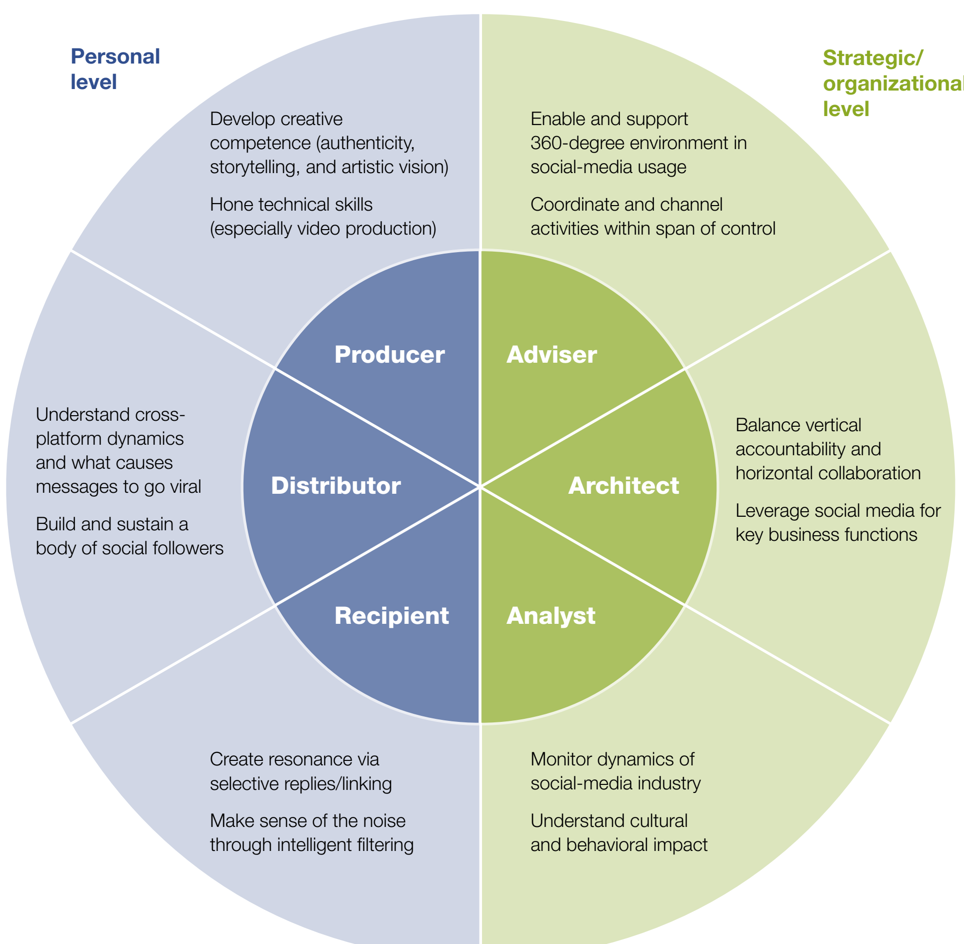
Equally important, there's an organizational dimension: leaders must cultivate a new, technologically linked social infrastructure that by design promotes constant interaction across physical and geographical boundaries, as well as self-organized discourse and exchange.

We call this interplay of leadership skills and related organizational-design principles organizational media literacy, which we define along six dimensions that are interdependent and feed on one another (exhibit).

Our clearest window on the development of these new forms of literacy is General Electric, where one of us is responsible for leadership development. Witnessing GE through this lens is

Exhibit

**The six dimensions of social-media-literate leadership.**



particularly interesting; unlike Google or Amazon, GE isn't a digital native, and its 130-year tradition of reinventing businesses and itself makes it worth watching. So does GE's status as a "leadership factory."

GE's commitment to social media is perhaps most visible through its digital platform GE Colab, designed by GE employees for GE employees to facilitate global teamwork and collaboration. GE Colab combines the capabilities of Facebook, Twitter, and other social applications, allowing easy networking, information sharing, instant communication, advanced search, blogging, videoblogs, and more. Launched in 2012, the platform has already attracted more than 115,000 users.[1]

To get a sense of how executives deal with these new realities, we interviewed GE officers of various businesses and regions. These leaders and their organizations are at different mileposts along the journey to social-media literacy, just as different companies are. In aggregate, though, they described a rich range of efforts to build personal skills, experiment with technologies, invest in new tools, expand employee participation, and shape organizational structures and governance to capture emerging social opportunities. We drew on those experiences to illustrate the six-dimensional set of skills and organizational capabilities leaders must build to create an enterprise level of media literacy—capabilities that will soon be a critical source of competitive advantage.

## 1. The leader as producer: Creating compelling content

With video cameras achieving near ubiquity and film clips uploading in the blink of an eye to YouTube or other platforms, the tools for producing and sharing rich media are in everyone's hands. GE's Video Central now houses thousands of videos, many created by top leaders. More than a few executives have started to incorporate video streams into their blogs. As video communication rises in importance, effective leadership will increasingly require the kind of

[1] See Ron Utterbeck, interview by Robert Berkman, "GE's Colab brings good things to the company," *MIT Sloan Management Review*, sloanreview.mit.edu, November 7, 2012.

GE Colab combines the capabilities of Facebook, Twitter, and other social applications, allowing easy networking, information sharing, instant communication, advanced search, blogging, videoblogs, and more.

creative skills we know from the world of "auteur" filmmaking—an authentic voice, imagination, and the ability to craft compelling stories and to turn them into media products that make people take note and "lean forward." To engage in real time on a personal level, executives will also need the technical skills to master the basics of digital-multimedia production, including how to shoot and, if necessary, edit videos.

Mark Begor, who runs GE Capital's real-estate business, was nervous when he shot his first "unplugged" video message. "I was used to a studio environment where I could do several takes and have editors polish what I wanted to say." That unease soon vanished with practice. He now routinely produces a weekly five- to ten-minute video for his division. "I talk about what I learned during the week, about a great deal we've closed, and the status of the business. I also add comments about employees that I want to recognize." Begor says that this routine forces him to crystallize his thinking and that creating short stories people can relate to makes him more aware of his strategy and communication.

As Begor and others have discovered in this process, the logic of participatory media is strikingly different from that of traditional corporate broadcast media, where each and every piece of communication gets perfectly crafted. Too much perfection is actually a barrier to collaboration and cocreation, as it disinvites participation. To thrive in the world of social media, leaders need to acquire a mind-set of openness and imperfection, and they must have the courage to appear "raw" and unpolished—traits that may be as challenging for them as developing the creative and technical-production skills.

## 2. The leader as distributor: Leveraging dissemination dynamics

Business leaders have traditionally disseminated information along a controlled, linear chain that begins after the development of a formal meaning-creation process—think of how your company creates and distributes memos explaining new initiatives. While traditional distribution pathways won't disappear, social media revolutionizes the standard information process by reversing it. Social communication makes distribution the starting point and then invites company audiences to cocreate and contextualize content to create new meaning. Messages are rebroadcast and repurposed at will by recipients who repost videos, retweet and comment on blogs, and use fragments of other people's content to create their own mash-ups.

As the (vertical) broadcast media and the (horizontal) participatory media converge, leaders need to master the interplay of two fundamentally different paradigms: those of the traditional channels, which follow the logic of control, and of the new channels, where it is essential to let the system's dynamics work without too much direct intervention. Since executives won't be able to govern or control a message once it enters the system, they must understand what might cause it to go viral and how it may be changed and annotated while spreading through the network. Distribution competence—the ability to influence the way messages move through complex organizations—becomes as important as the ability to create compelling content.

Equally important is the skill of creating and sustaining a body of social followers who help to spread and reinforce the message. It becomes critical to know who an organization's key—and often informal—influencers are and to leverage their authority to push content through the right channels. Finally, leaders must recognize their role as redistributors of the content they receive, so they can leverage the communication continuously happening around them.

Lorraine Bolsinger, vice president and general manager of GE Aviation Systems, acquired these skills through experimentation. She began blogging a few years ago but initially didn't get much response. "It took time to get my audience actively involved," she recalls. "I had to find my voice and become more conversational, more easygoing." To increase the allure and sustainability of the dialogue, she eventually created a "360 blog," where all her direct reports blog with her on the same platform. This networked blog, with 12 regular contributors, provides additional points of view on issues, promotes more frequent communication, and attracts broader participation. Bolsinger says that the quality of her group's dialogue about strategy and operations has improved thanks to these efforts.

## 3. The leader as recipient: Managing communication overflow

Social media has created an ocean of information. We are drowning in a never-ending flood of e-mails, tweets, Facebook updates, RSS feeds, and more that's often hard to navigate. "There is too much noise out there," says Stuart Dean, CEO of GE ASEAN,[2] who is an active blogger and tweets regularly about issues in his market space. "I'd use Twitter much more as a source of information if I could get exactly what I need."

Dean's sentiment is echoed by most executives we know—many of them barely find time to catch up with their daily e-mail load. What to do? As a first step, leaders must become proficient at using the software tools and settings that help users filter the important stuff from the unimportant. But playing in today's turbulent environment requires more than just filtering skills.

In traditional corporate communications, consumption is a mostly passive act: you are pretty much left alone to make sense of messages and to assess their authenticity and credibility. In the social-media realm, information gets shared and commented on within seconds, and executives must decide when (and when not)

[2]Association of Southeast Asian Nations.

to reply, what messages should be linked to their blogs, when to copy material and mash it up with their own, and what to share with their various communities. The creation of meaning becomes a collaborative process in which leaders have to play a thoughtful part, as this is the very place where acceptance of or resistance to messages will be built.

"You have to see the entire communication universe, the interplay of traditional and social media," says Bill Ruh, head of GE's Software and Analytics Center. Just as leaders suffer from overflow, so do their people. "As a leader," says Ruh, "you have to develop empathy for the various channels and the way people consume information."

## 4. The leader as adviser and orchestrator: Driving strategic social-media utilization

In most companies, social-media literacy is in its infancy. Excitement often runs high for the technology's potential to span functional and divisional silos. But without guidance and coordination, and without the capabilities we discuss here, social-media enthusiasm can backfire and cause severe damage.

To harvest the potential of social media, leaders must play a proactive role in raising the media literacy of their immediate reports and stakeholders. Within this 360-degree span, executives should become trusted advisers, enabling and supporting their environment in the use of social tools, while ensuring that a culture of learning and reflection takes hold. As a new and media-savvy generation enters the workplace, smart leaders can accelerate organizational change by harnessing these digital natives' expertise through "reverse mentoring" systems (see later in this article).

Steve Sargent, president and CEO of GE Australia and New Zealand, believes that social media is reshaping the leadership culture by pushing executives to span geographic boundaries, engage more closely with stakeholders, and amplify the impact of employees at the periphery. Over the past five years, as proof of concept, Sargent has established a mining-industry network that cuts across GE's businesses and regions, linking informal teams that use social platforms to collaborate on solving customer needs. GE employees in

Brazil, for instance, now work with colleagues in Australia to develop products and services for customers doing business in both countries. The network's success led the company to elevate it to the status of a full-fledged GE mining business. "Markets today are complex and multidimensional, and leadership isn't about control but about enabling and empowering networks," Sargent says. "The type of leadership we need finds its full expression in the DNA of collaborative technology, and I am determined to leverage this DNA as much as I can."

To achieve this goal, leaders must become tutors and strategic orchestrators of all social-media activities within their control, including the establishment of new roles that support the logic of networked communication—for instance, community mentors, content curators, network analysts, and social entrepreneurs. Organizational units that leverage the new technologies in a coordinated and strategically aligned way will become more visible and gain influence in a corporation's overall power dynamics.

## 5. The leader as architect: Creating an enabling organizational infrastructure

Leaders who have steeped themselves in new media will testify that it requires them to navigate between potentially conflicting goals: they must strive to establish an organizational and technical infrastructure that encourages free exchange but also enforce controls that mitigate the risks of irresponsible use. This is a tough organizational-design challenge.

Most companies have a defined formal organization, with explicit vertical systems of accountability. But below the surface of org charts and process manuals we find an implicit, less manageable "informal organization," which has always been important and now gets amplified through social media. The leader's task is to marry vertical accountability with networked horizontal collaboration in a way that is not mutually destructive.

This challenge is reflected in GE's policies, which embrace the value of sharing expertise and perspectives with family, friends, colleagues, customers, and other stakeholders around the world.

Tools for producing and sharing videos are now in the hands of many executives, who can upload recordings of meetings (such as this one) to an internal server that employees can access.



With this openness comes a shared responsibility: employees must observe GE standards of transparency and integrity, refrain from speaking on behalf of the company without authorization, and be clear in their social messaging that their views are personal.

In this spirit, creating a social architecture that provides a meaningful space for internal and external interactions has been an ongoing mission for Andrew Way, vice president of GE's Oil & Gas Drilling & Surface Division. "I love the social-media stuff," he says, "so I surround myself with an organization that supports it."

In Way's last role in the division, he and his team launched a video project about the history and current timeline of the business. Since the videos are shared with customers, team members must make choices about which content can cross external boundaries. "It's an evolving thing. Every quarter, the team adds a new segment that features important things that happened in the last three months. It has resulted in a continuing story, and people look forward to every new version."

Way says that the videos have united division members around common goals, helping to bring new employees on board and making everyone more proficient in using new media. "Three years ago, an effort like this would have used PowerPoint with a standardized font. It clearly has created a new culture." Boosting engagement with stakeholders such as customers is an added benefit, since videos often include them in segments to help tell stories.

## 6. The leader as analyst: Staying ahead of the curve

As companies start to digest the consequences of the Web 2.0 revolution, the next paradigm shift is already knocking on the door. The next generation of connectivity—the Internet of Things—will link together appliances, cars, and all kinds of objects. As a result, there will be about 50 billion connected devices by the year 2020.[3] This transformation will open new opportunities, spawn new business models, and herald yet another major inflection point that leaders must manage.

It's imperative to keep abreast of such emerging trends and innovations—not just their competitive and marketplace implications, but also what they mean for communications technologies, which are fundamental for creating an agile, responsive organization. Executives who monitor weak signals and experiment with new technologies and devices will be able to act more quickly and capture the advantages of early adoption.

GE's leadership university, Crotonville, is leading a number of initiatives to help top executives stay ahead of those changes. One example is a program called Leadership Explorations, launched in 2011 to support continuous learning for top executives and orga-

[3] See Michael Chui, Markus Löffler, and Roger Roberts, "The Internet of Things," mckinseyquarterly.com, March 2010.

## The next generation of connectivity will link together appliances, cars, and all kinds of objects. This transformation will open new opportunities, spawn new business models, and herald yet another major inflection point that leaders must manage.

nized in locales connected with a specific strategic-leadership theme. In Silicon Valley, leaders are immersed in a range of cutting-edge technologies. Part of the program there involves "reverse mentoring," which connects media-savvy millennials with senior GE leaders to discuss the latest tech buzz and practice. Many participants continue to exchange insights long after the formal session is over. Exposing seasoned leaders to the millennial mind-set encourages them to experiment with new technologies—which, in turn, helps them better engage with up and comers.

• • •

Clearly, these are early days. Most companies recognize social media as a disruptive force that will gather strength rather than attenuate. But social-media literacy as we define it here is not yet an element of leadership-competency models or of performance reviews and reward systems. Equally, it has not yet found its way into the curricula of business schools and leadership-development programs.

This needs to change. We are convinced that organizations that develop a critical mass of leaders who master the six dimensions of organizational media literacy will have a brighter future. They will be more creative, innovative, and agile. They will attract and retain better talent, as well as tap deeper into the capabilities and ideas of their employees and stakeholders. They will be more effective in collaborating across internal and external boundaries and enjoy a higher degree of global integration. They will benefit from tighter and more loyal customer relationships and from the brand equity that comes with them. They will be more likely to play leading roles in their industries by better leveraging the capabilities of their partners and alliances in cocreation, codevelopment, and overall industry collaboration. And they will be more likely to create new business models that capitalize on the potential of evolving communications technologies.

It takes guts to innovate radically in leadership and organization, for legacy systems, cultures, and attitudes are powerful forces of inertia. Fortunately, the inherent quality of social media is a powerful transformational force. Social-media engagement will confront leaders with the shortcomings of traditional organizational designs. Leaders who address these shortcomings will learn how to develop the enabling infrastructure that fosters the truly strategic use of social technologies. When organizations and their leaders embrace the call to social-media literacy, they will initiate a positive loop allowing them to capitalize on the opportunities and disruptions that come with the new connectivity of a networked society. And they will be rewarded with a new type of competitive advantage.

**Roland Deiser** is a senior fellow at the Peter F. Drucker and Masatoshi Ito Graduate School of Management at Claremont Graduate University and author of *Designing the Smart Organization: How Breakthrough Corporate Learning Initiatives Drive Strategic Change and Innovation* (John Wiley & Sons, October 2009). **Sylvain Newton** is the GE Crotonville Leadership Senior Leader for Business and Regions.

# Social technologies:
## Crossing the next threshold

**Jacques Bughin and Michael Chui**

Adoption by companies is high, and the executives who responded to a recent McKinsey survey expect organizational changes that could spur further benefits.

**Over a surprisingly brief period,** social technologies have grown from limited experiments at the edge of corporate practice to what's now the mainstream. But after this strong initial uptake, many companies find themselves at a crossroads: if they want to capture a new wave of benefits, they'll need to change the ways they manage and organize themselves, according to our sixth annual survey of global executives on the business use of these technologies.[1] A remarkable 83 percent of respondents report that their companies are using at least one social technology. More than half of those surveyed now themselves use social networks—almost twice the level of 2009. Four in ten companies use blogs and video-sharing sites, while a quarter have adopted wikis, podcasts, and microblogs (such as Twitter) to facilitate communication.

Ninety percent of the executives report that their companies get measurable benefits from social tools. Over 70 percent say that these technologies speed access to knowledge, and nearly half that expertise is more accessible. Employee satisfaction has improved. What's more, a small yet growing number of companies—the most skilled and intensive technology users—are racking up outsized benefits. The ranks of these fully networked enterprises have jumped from only 3 percent of respondents in 2011 to about 10 percent in 2012 (exhibit).

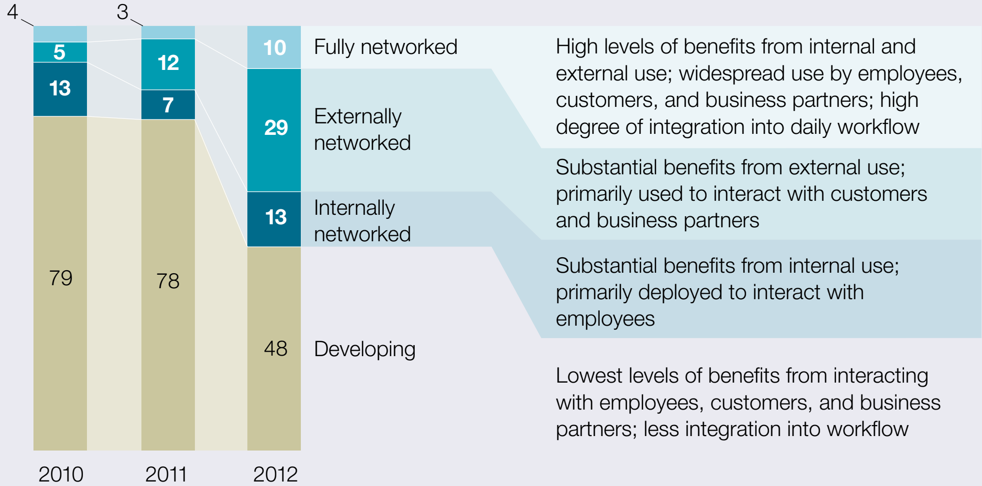
In aggregate, though, the reported benefits have hit a plateau in many cases, suggesting that after the first wave of adoption, benefits are harder to come by for companies. Executives are optimistic but sober about the next leg of the social-technology pathway. They recognize the new open environment's risks, particularly the leakage of confidential information and intellectual property, staff postings that reflect negatively on companies, and everyday distractions from employees' core tasks.

Exhibit

**The research identified 4 types of organizations . . .**

**. . . defined by the extent of Web 2.0 benefits they reported.**

Distribution by type, % of respondents[1]




[1]Number of executives surveyed: 2010 = 2,174; 2011 = 3,103; 2012 = 2,560. Figures for 2010 do not sum to 100%, because of rounding.

Nonetheless, 60 percent of the respondents say the potential benefits outweigh the risks. That sentiment was underscored when we asked executives to peer ahead and envisage organizational changes likely to happen as internal barriers to the use of these technologies fall and companies become increasingly networked. About half of the respondents at companies with no barriers expect new processes for scanning the competitive environment and finding new ideas. Three in ten respondents from such companies believe that internal processes will evolve, with implications for how companies manage projects and develop strategic plans. To accelerate these changes and make them stick, a growing number of leaders have begun to stress the importance of driving social-media skills throughout the organization (see "Six social-media skills every leader needs," on page 62). It's these networked organizations that are the most likely to realize competitive gains. o

[1]We surveyed more than 3,500 executives around the world, representing a full range of industries, company sizes, and functions. A complete discussion of the findings will appear in the forthcoming article "Evolution of the networked enterprise: McKinsey Global Survey results," on mckinseyquarterly.com. For more on company use of social technologies, see Jacques Bughin, Michael Chui, and James Manyika, "Capturing business value with social technologies," mckinseyquarterly.com, November 2012.

**Jacques Bughin** is a director in McKinsey's Brussels office; **Michael Chui** is a principal at the McKinsey Global Institute and is based in the San Francisco office.

Improving performance through better

# board engagement



Illustration by Keith Negley

The independent perspective, long-term focus, and experience-fueled wisdom of board members represent invaluable corporate assets that are frequently underutilized. In this package, McKinsey experts highlight ways that boards and senior executives can engage more effectively on critical business issues, including strategy setting, technology, marketing, and M&A. To set the stage, former Medtronic CEO William George recounts his experiences as board chair, CEO, chairman and CEO, and independent director—and suggests ways to work more effectively in any of these roles, regardless of your perspective on the ongoing debates surrounding corporate-governance reform.

# Board governance depends on where you sit

**William George**

William George, former CEO of Medtronic and a veteran of ten corporate boards, reflects on common governance pitfalls and how to overcome them.

**Board governance** is frequently discussed and often misunderstood. In this article, I offer an insider's perspective on the topic. Over the years, I have had the privilege of serving on ten corporate boards, as well as being chairman and CEO of Medtronic, chairman only, and CEO only. I have also observed dozens of boards from outside the boardroom and engaged in numerous confidential conversations with members of these boards about the challenges they faced and how they handled them.

What I have learned from these experiences is that one's perspective about a board's governance is strongly influenced by the seat one holds—independent director, chair and CEO, CEO only, or chair only. That's why it is essential to look at corporate governance through the eyes of each of these positions.

In surveying governance through the lens of different roles, I hope to address a problem in the prevailing dialogue: many of the governance experts exerting power over boards through shareholder proposals, media articles, and legislative actions have never participated in an executive session of a major board. It's no surprise, therefore, that their proposals deal almost entirely with formal board processes and "check the box" criteria that generally have little to do with the substance of how boards operate.

I worry, in fact, that many of these proposals could weaken the performance of boards by burdening them with an excessive amount of ministerial details. That would be a shame, because corporate boards have made progress since the scandals of recent years, with a new generation of CEOs sharing with boards more openly, listening to them more closely, and working to achieve a healthier balance of power with independent directors.

Role #1

## The independent director

The combination of new governance regulations and rising expectations makes serving as an independent director much more important—and difficult—than it was in years past. The greatest challenge these directors face is to stay fully informed about the companies on whose boards they serve.

Information asymmetry is often at the root of this challenge. When directors are truly independent of the companies they serve, they generally lack the wealth of knowledge about the industry or business that their senior-executive counterparts have. Moreover, independent directors typically have limited engagement with the company and its board, meeting perhaps six to eight times a year. Consequently, management has far more information than independent directors can ever absorb. I recall this challenge well: of the nine boards I served on as an independent director—across a range of industries—I had industry-specific knowledge in exactly none of them.

In one instance, I recall asking why a company wanted to implement an aggressive stock-buyback program when it might be better to preserve cash to take advantage of opportunities or to use as a cushion if cash flow turned negative. My question was not well received. The CFO argued that the company had always been able to raise cash when it was needed and had never passed up an opportunity for lack of cash. A fellow director told me that I simply didn't understand the industry and that stock buybacks were routine. So I backed off.

However, a year later the company became so concerned about volatility in financial markets that it suspended all stock buybacks and began an aggressive program of increasing its liquidity. That was a good thing, because the following year the markets completely shut down when the credit and liquidity crunch occurred. Had the firm not had a large cash reserve, it might have wound up insolvent, like many of its competitors.

Whether or not my questions a year earlier helped nudge management in this direction, I strongly believe that independent directors can provide leadership and contribute to the companies they serve in ways that go beyond meeting the basic legal requirements and fiduciary responsibilities inherent in board service. In addition to asking tough questions, three opportunities stand out.

## Be an advocate for sound governance

Independent directors should be advocates—and enforcers—of sound governance principles. This is especially important in challenging times or when the company is in crisis. Too many directors accept board governance as it is, without suggesting the kinds of process improvements that would make a difference; some directors even resist them.

Yet process matters hugely in the boardroom, and not just to make sure a company abides by governance rules. Process steps help to keep board members engaged and able to fulfill their responsibilities and, more important, establish the proper balance of power between management and the board.

Perhaps the most useful aspect of the governance rules passed a decade ago in the United States is the requirement that independent directors meet in executive session without the CEO present. These sessions give directors the opportunity to share concerns about the company and to ask for improved governance steps or additional reviews. They are also a time to discuss privately any concerns that directors have about management and to ensure that directors are fully informed. Finally, the sessions are useful in building chemistry among the independent directors.

Good chemistry is important. The director of a major European company shared with me his frustration when he challenged its CEO and the direction in which the chief executive was moving the company, but received no support—just silence—from his fellow directors. Later, when the board went into executive session without the CEO in the room, the directors around the table unanimously agreed with this director, saying that the CEO was not providing the right leadership or taking the company in a sound direction.

## Leadership succession

Nearly all independent directors say that selecting the right leadership for a firm is their most important role. Yet in my experience, the time spent on succession is far too limited and the discussion not nearly candid enough. All too often, board members settle for a "hit by a bus" contingency plan. Such plans are crucial, of course, even if just for an interim period. Yet oftentimes the person ultimately identified to lead is just the most obvious interim leader, not the best long-term successor.

To better prepare for succession, boards should have multiple discussions each year to identify the company's next generation of leaders. They need to create ways to get to know these candidates personally and observe them in crises and under pressure. The board should also create a series of assignments to prepare prospective CEOs and other senior-executive candidates.

If succession isn't taken seriously, directors may find that when the time comes, they do not have confidence in the internal candidates. Faced with this situation, directors may react—or overreact—by immediately initiating an external search, which bears substantial risks of its own. Outside hires may look good on paper and have been successful elsewhere, but it is not uncommon to find they do not understand the company's culture and values and do not take the time to identify the people who make the organization run successfully.

The board should instead conduct detailed leadership-succession-planning sessions to review candidates and their progression, ensuring that they have the necessary experiences to get them ready for the top jobs. In these reviews, the age of the potential top leaders matters. They should not be so close in age to the CEO that they would be unable to have a sufficiently long tenure as CEO prior to reaching mandatory retirement, nor can they be so young that there simply isn't time for them to have the experiences they need for such a major task. Thus, the process of identifying candidates for top roles must start early—typically, with leaders who are barely 30 years old.

On one board on which I served, the long-time CEO, who was doing an excellent job, steadfastly resisted the board's insistence that he develop potential successors. Frustrated by his inaction, the compensation committee (of which I was not a member) voted to provide him with a special bonus for grooming a prospective successor. He then reluctantly initiated an external search for a chief operating officer.

However, before any candidates were identified, he set up an off-site meeting with the independent directors to recommend that the external search be canceled because "it was causing too much disruption." Instead, he proposed to the board that he would develop some much younger candidates who not only were several years away from being viable successors but also, in some cases, seemed unlikely ever to make effective CEOs.

That was enough for me. I decided to resign rather than remain part of what I viewed as a charade. The CEO stayed for many more years, eventually stepping down after two decades in the job. Even then, he continued to occupy his CEO office at company headquarters. His successor, who was quite junior to him in age, found that managers routinely took problems and opportunities to the old CEO, thereby undermining the new CEO's authority.

## Leading in crisis

The real test of a board of directors comes when the company is in crisis. Independent directors, in particular, are counted upon to step up to their responsibilities in difficult times. Their accumulated wisdom and judgment are crucial to make sound decisions under the pressure of time and media attention.

The overarching lesson I have distilled from the crises I've experienced (among them, the termination or resignation of CEOs, external financial crises such as the 2008 financial-market meltdown, major governmental action against the firm, and an unexpected takeover attempt) is that board members need to understand and trust each other. Only when they can have candid conversations will they ultimately reach a consensus that has positive and far-reaching implications for the company. Trust becomes even more important when meetings are conducted by telephone, which is often the case in crises.

The bottom line for independent directors is that their responsibilities and obligations are so great these days that they cannot serve on a board and expect to preside while fulfilling only the minimum requirements. Rather, independent directors must be fully engaged, do their best to learn the business, and stay connected between meetings. Otherwise, they won't be prepared to lead when a crisis hits. For many independent directors, this will mean not serving on as many boards as they did in the past—a change that's appropriate given the time it takes to be an effective board member.

Role #2

## CEO with nonexecutive chair

In 1991, I became CEO of Medtronic, two years after joining the company as president and chief operating officer. My predecessor, who had just turned 65, continued as chair of the board. I was quite satisfied with this arrangement. His wealth of experience and wisdom were valuable to me as CEO, and he had the board's full confidence. He was also more than willing to take on difficult assignments at my request regarding delicate government and legal issues.

This dual structure—the standard model in Europe—is preferred by most governance experts and some regulators. The split clearly distinguishes the role of management (to lead the company) from that of the board chair (to take responsibility for the board and governance).

Yet as obvious as the structure seems in principle, I have seen no evidence or research to demonstrate that split roles create superior performance or even provide greater stability at the top. Anecdotally, the opposite is often the case.

In practice, the model's effectiveness depends on the relationship between the two individuals in these roles. If they are not squarely in agreement about the direction, leadership, and strategy of the company, an unhealthy separation may emerge within the board, and between management and the board. The result can be a lack of clear direction for the company—a state of affairs that leads to malaise or confusion within the employee ranks and, ultimately, to dissatisfied customers and shareholders. In the worst case, the two leaders engage in a power struggle that paralyzes both management and the board, thus preventing the company from making important decisions and responding quickly to changing conditions.

As much as I initially supported the separation of roles when I became CEO, over time the arrangement became more difficult. For example, some board members seemed confused about whom they should look to for strategic direction, especially in the case of acquisitions. In addition, the chair felt he should be “the eyes and ears of the board” in the company. Over time, this led to some confusion within management about his role. The board was also somewhat confused about whether I reported to him or to the board as a whole, an issue that was never fully clarified. Quite naturally, I felt that I reported to the board as a whole and that my responsibility and authority to lead the company depended on those relationships.

Tension also developed because board members seemed hesitant to give me direct feedback or to talk openly about their concerns. When I became board chair as well as CEO, this tension evaporated quickly, and I found myself spending far less time on board governance. In part, this happened because communication lines opened up and were more direct. By contrast, when the roles had been separate, I found I had to spend more time than I had expected involved in board governance and in responding to issues raised by the board.

Role #3

## The dual mandate

North American CEOs strongly prefer the dual mandate of being board chair and CEO, as it puts them squarely in charge and avoids the likelihood of conflicts or power struggles within the boardroom. The downside of this model is that in the past it often encouraged complacency by boards and discouraged them from getting deeply involved in issues until it was too late.

In practical terms, a leader is most effective in dual-mandate roles when he or she starts by keeping independent directors well informed through a combination of telephone updates, monthly progress reports, and candid comments in executive sessions with the independent directors about the real-time issues facing the company. The leader must be responsive to the independent directors’ concerns and either take action on them or put them on the board agenda for discussion by the full board.

Such a leader also must learn to perform a delicate balancing act: facilitating open discussions on the board while at the same time representing management's position to it. If this individual argues his or her case too strenuously, he or she may shut down thoughtful comments from the independent directors. On the other hand, if the individual acts solely as a facilitator of these discussions, the directors won't get the full benefit of management's thinking and rationale.

Having served on several boards with a single leader in the combined roles of chair and CEO, I have learned that a board is most effective when the leader clearly understands the difference between these two roles and bends over backward to respect the board's independence. This independence extends to the directors' need to have open discussions without the CEO present, to ensure that important issues are addressed privately.

Similarly, when I had this dual role, I did whatever I could to open up meaningful discussions within the board, especially by drawing out the opinions of its quieter members. This was particularly challenging when the board was discussing important strategic issues or acquisitions and needed the benefit of my judgments and insights. I had to learn to withhold my opinions until others had the opportunity to offer theirs and then work them into the context of my conclusions. Frequently, this meant delaying decisions until the board had time to digest the ideas or management could undertake additional analyses.

One of the benefits the board and I had was an active, capable lead director with whom I could work closely. He did a superb job in guiding the issues of the independent directors and in keeping me fully informed of any concerns and issues the board might have. When it came time to select my successor, he developed a sound process that we both agreed upon and led the board through it.

The rise of the role of lead director, elected by the independent directors, is contributing to a better separation of governance from management. To make the position work effectively, it is essential that this role have a separate job description that is publicly available and respected by the chair and CEO. The most effective lead directors view themselves as "first among equals" and can coordinate the opinions of all directors and facilitate open discussion among them.

Role #4

## Non-CEO chair

The role played by a non-CEO board chair will depend heavily on the experience that person brings to the position. If this individual was the previous CEO—a common situation—he or she will bring a wealth of experience, a keen knowledge of the other directors, some strong opinions about what the company needs, and oftentimes a legacy to nourish or at least maintain. Therein lies the difficulty: no matter how hard old CEOs try to restrain themselves, they may have a tendency to overshadow or, worse, override new CEOs.

This problem is exacerbated by independent directors who still rely heavily on the ex-CEO's opinions and may trust his or her recommendations more than they do those of the current CEO. Still, when former CEOs can restrain themselves, recognize that it is time to let go, and do everything they can to support their successors, they can be very effective in the role of board chair.

In my case at Medtronic, I was committed to a seamless transition with my successor and to ensuring his success and the company's. Also, the board and I had agreed upon a timetable of just one year for me to serve as chair, so I was clearly in a transitional mode. I was still in my 50s and looking forward to turning my attention to other interests.

Nevertheless, it didn't take long before I faced a board-level challenge. It came at an off-site board meeting just a month after the CEO transition. For 15 years, dating back to my predecessor's tenure, Medtronic had pursued publicly announced goals of 15 percent per annum growth in both revenues and profits, compounded over any five-year period. These aggressive goals provided discipline within the company and a consistent benchmark for shareholders. We had been successful in exceeding these goals, but not without risks and challenges.

At a board meeting, however, one of the independent directors argued forcefully that given the company's larger size, it would be impossible to continue to achieve such high rates of growth. Although I was tempted to jump into the discussion and defend the importance of the goals, I held my fire. My successor held firm, and the company stayed the course.

Many people make a strong case that a former CEO is not the right person to serve as board chair and that he or she should leave the board immediately. An alternate choice could be one of the existing directors.

Many people make a strong case that a former CEO is not the right person to serve as board chair and that he or she should leave the board immediately. An alternate choice could be one of the existing directors, provided there is a well-qualified candidate available. An equally good choice is to appoint someone who has served as chair, CEO, or both at another company. In some countries, the board chair may be an independent attorney or financial expert, but this approach risks ending up with a candidate who has insufficient knowledge of the company, its business, and what it takes to lead it. Regardless of who holds the position, it must have a well-defined job description to keep accountability strong. A nonexecutive chair should be formally evaluated at least annually by fellow board members. Finally, the position should have a defined term of office, after which a new nonexecutive chair is elected or the existing chair is formally reelected.

## Reflections

The diversity of perspectives that board members bring to the role can be a considerable strength for the companies they serve. How can organizations make the most of it? Here are three suggestions.

- The board should acknowledge that no single structure works in all cases. Boards must be pragmatic enough to adapt to the individuals involved rather than put a rigid structure in place.

- All parties, but especially CEOs, should acknowledge different points of view and work to minimize the conflicts that inevitably arise from them. This requires high-level listening skills, the ability to see situations from the other person's perspective, and the wisdom to understand the basis for the different points of view.

- All directors, but especially CEOs, can benefit from holding different positions, either within the company or on other companies' boards. Nominating committees should seek out prospective board members with diverse experiences. Boards should also encourage CEOs to serve on at least one outside board to give them the experience of being an independent director and seeing firsthand the challenges outside directors face.

If these basic guidelines are followed, I believe that board governance will improve markedly. As a result, companies will have a steady hand in the boardroom to sustain their achievements through successive generations of leadership and board membership.

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# Tapping the strategic potential of boards

**Chinta Bhagat, Martin Hirt, and Conor Kehoe**

Too many boards just review and approve strategy. Three questions can help them—and executives—begin to do better.

**It's late afternoon** in the boardroom, and the head of a major global infrastructure company's construction business is in the hot seat. A director with a background in the industry is questioning an assumption underlying the executive's return-on-invested-capital (ROIC) forecast: that the industry's ratio of leased (versus owned) equipment will remain relatively constant. The business leader appears confident about the assumption of stability, which has implications for both the competitive environment and for financial results. But the director isn't convinced: "In my experience, the ratio changes continuously with the economic cycle," he says, "and I'd feel a whole lot better about these estimates if you had some facts to prove that this has changed."

An uneasy silence settles over the room: the board member's point appears quite relevant but requires a familiarity with the industry's behavior and economics, and the rest of the board doesn't have it. Finally, the chairman intervenes: "The question John is raising is critical and not just for our construction business but for our entire strategy. We're not going to resolve this today, but let's make sure it's covered thoroughly during our strategy off-site. And Paul," says the chairman to the CEO, "let's have some good staff work in place to inform the discussion."

If the preceding exchange sounds familiar, it should: in the wake of the financial crisis, we find that uncomfortable conversations such as this one[1] are increasingly common in boardrooms around the world as corporate directors and executives come to grips with a changed environment. Ensuring that a company has a great strategy is among a board's most important functions and the ultimate measure of its stewardship. Yet even as new governance responsibilities and faster competitive shifts require much more—and much better—board engagement on strategy, a great number of boards remain hamstrung by familiar challenges.

## The strategy challenge for boards

For starters, there's the problem of time: most boards have about six to eight meetings a year and are often hard pressed to get beyond compliance-related topics to secure the breathing space needed for developing strategy. When we recently surveyed board members to learn where they'd most like to spend additional time, two out of three picked strategy. A related finding was that 44 percent of directors said their boards simply reviewed and approved management's proposed strategies.

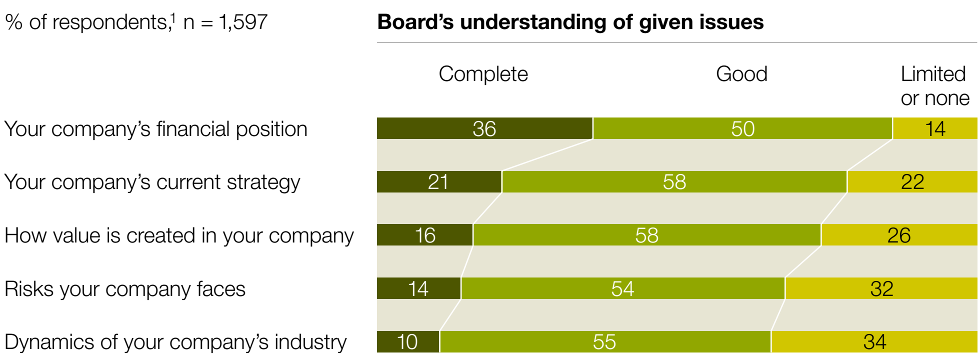
Why such limited engagement? One likely reason is an expertise gap: only 10 percent of the directors we surveyed felt that they fully understood the industry dynamics in which their companies operated. As a result, only 21 percent of them claimed to have a complete understanding of the current strategy (exhibit).

What's more, there's often a mismatch between the time horizons of board members (longer) and of top executives (shorter), and that lack of alignment can diminish a board's ability to engage in well-informed give-and-take about strategic trade-offs. "The chairman of my company has effectively been given a decade," says the CEO of a steelmaker in Asia, "and I have three years—tops—to make my mark. If I come up with a strategy that looks beyond the current cycle, I can never deliver the results expected from me. Yet I am supposed to work with him to create long-term shareholder value. How am I supposed to make this work?" It's a fair question, particularly since recent McKinsey research shows that major strategic moves

[1] This conversation is drawn from real events, though we have changed the names of those involved.

Exhibit

**Board members said they understand their company's financial position significantly better than its risks or industry dynamics.**




[1] Respondents who answered "don't know" are not shown; figures may not sum to 100%, because of rounding.
Source: June 2011 McKinsey survey of 1,597 corporate directors on governance

involving active capital reallocation deliver higher shareholder returns than more passive approaches over the long haul, but lower returns over time frames of less than three years.[2]

Compounding these challenges is the increased economic volatility prompting many companies to rethink their strategic rhythm, so that it becomes less calendar driven and formulaic and more a journey involving frequent and regular dialogue among a broader group of executives.[3] To remain relevant, boards must join management on this journey, and management in turn must bring the board along—all while ensuring that strategic cocreation doesn't become confusion or, worse, shadow management.

## Three questions to spur high-quality engagement

While no one-size-fits-all solution can guide companies as they set out, we suggest that board members and senior managers ask themselves three simple questions as they approach the development

[2] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," mckinseyquarterly.com, March 2012.

[3] See Chris Bradley, Lowell Bryan, and Sven Smit, "Managing the strategy journey," mckinseyquarterly.com, July 2012.

of strategy. Using them should raise the quality of engagement and help determine the practical steps each group must take to get there.

To illustrate what this looks like, we return to the infrastructure company we mentioned at the beginning of this article. The company had three key business units—construction, cement manufacturing, and the ownership and operation of infrastructure projects (primarily power plants)—as well as a fledgling real-estate business. It had expanded aggressively in emerging markets in the mid-to-late 1990s, until the Asian currency crisis forced it to sell off some of its more adventurous purchases and precipitated an equity investment by a large institutional investor with long-term interests in infrastructure. The investor appointed a new chairman, who in turn brought in a new CEO. After a few years of strong success and continued volatility (punctuated by the global financial crisis), the company's growth hit a plateau, triggering a thorough review of the strategy by the board.

When the chairman discussed the matter with the CEO, they agreed that the company had to take a different approach. Some of the board members were new and grappling with the problems of stewarding a complex multinational and multibusiness corporation. What's more, several fundamental questions were on the table that could conceivably lead to a full-blown restructuring and transformation involving the spin-off of divisions and the reallocation of capital to new areas.

The usual annual strategic refresh was unlikely to provide the board with an appreciation of the context it would need to address these questions fully, let alone to generate fresh insights in response. Such dissatisfaction with mechanistic annual board-level strategy processes is widespread, in our experience. The answer for this board (and several others we know) was to throw out the annual process and replace it with a much more intense but less frequent form of engagement—roughly every three years in this case—while still devoting some time at *every board meeting* to pressure-testing the strategy in light of its progress and changes in critical variables.

Pushing to answer the questions below, as the infrastructure company did, can help organizations enhance the quality of board engagement on strategy, both when that engagement must be deep and during the regular course of business.

## 1. Does the board understand the industry's dynamics well enough?

Most boards spend most of their strategic time reviewing plans, yet as we've noted, relatively few directors feel they have a complete understanding of the dynamics of the industries their companies operate in or even of how those companies create value. To remedy this problem and to avoid the superficiality it can engender, boards need time—some without management present—so they can more fully understand the structure and economics of the business, as well as how it creates value. They should use this time to get ahead of issues rather than always feeling a step behind during conversations on strategy or accepting management biases or ingrained habits of thought.

Board members at the infrastructure company began by studying its performance, focusing solely on ROIC across economic cycles. The board then studied all value drivers that affected ROIC. Revenue growth and earnings before interest and taxes, on which management spent most of its time, were two important but only partial explanations of the company's overall performance. Through a combination of independent sessions and two formal discussions with the CEO, the board established a much stronger foundation for a subsequent dialogue with management about strategy.

It turned out, for example, that the board member who had expressed concerns about the construction business's assumptions for leased-versus-owned equipment was right—not just for that unit, but also for most of the company's operations. One implication was that the forward-looking returns from the construction business were higher and more stable than those from the cement business, which, on the face of it, had higher margins and was better known and larger overall. This observation led the board to a closer look at both of these units and to a fuller appreciation of the construction business's strong project-management talent bench, which was well positioned to help counteract its "lumpier" risk profile.

## 2. Has there been enough board–management debate before a specific strategy is discussed?

Armed with a foundational view based on a clearer understanding of industry and company economics, boards are in a better position to have the kinds of informed dialogue with senior managers that ultimately help them prepare smarter and more refined strategic options for consideration. Board members should approach these discussions with an owner's mind-set and with the goal of helping management to broaden its thinking by considering new, even unexpected, perspectives.

At the infrastructure company, such discussions were triggered by the chairman, who remarked, "I've found this process of assessing the industry and company economics very enlightening so far. It makes me wonder: if a private-equity firm were to take over this company right now, what would they do with it?" The question's disruptive nature changed the frame of the discussion from "What more can we do with this business?" to "Should we be in this business at all?" It led to the recognition that the cement unit required a level of scale and competitiveness the corporation didn't have and was unlikely to achieve organically. That realization ultimately led the infrastructure company to spin off the business.

During such debates, management's role is to introduce key pieces of content: a detailed review of competitors, key external trends likely to affect the business, and a view of the specific capabilities the company can use to differentiate itself. The goal of the dialogue is to develop a stronger, shared understanding of the skills and resources the company can use to produce strong returns, as opposed to merely moving with the tide.[4]

It's important, however, that this dialogue should stop short of deciding on a strategy, which comes next.

## 3. Have the board and management discussed all strategic options and wrestled them to the ground?

Very often, the energizing discussions between the board and management about the business, its economics, and the competition represent the end of the debate. Afterward, the CEO and top team go off to develop a plan that is then presented to the board for approval.

Instead, what's needed at this point is for management to take some time—mostly spent alone—to formulate a robust set of strategic options, each followed through to its logical end state, including the implications for the allocation of people, capital, and other resources.

[4]Determining whether a strategy will beat the market is one of ten crucial tests that boards can apply to determine the quality and strength of business-unit strategies. For more, see Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," mckinseyquarterly.com, January 2011.

These strategic options can then be brought back to the board for discussion and decision making.

At the infrastructure company, the actual off-site strategy meeting, held during two days to ensure adequate time, focused entirely on debating and deciding between strategic options and then working through the resource-allocation implications of the decisions. Among the various debates, two stood out. One was whether to double down on the company's highest-potential business—construction services—by allocating additional talent and capital for an M&A-led consolidation initiative in two high-potential markets. The other was whether to exit the company's real-estate business. Forcing an explicit conversation about it proved to be a relief for both the board and the management team, who agreed that these issues had been an unstated source of unease for quite some time.

An important caveat: forcing meaningful, high-quality conversations like these is challenging, particularly when boards aren't used to having them, and places a premium on the board chair's ability to facilitate discussion. Creating a participative, collaborative dynamic while maintaining a healthy tension is critical. Also, the chair must neither monopolize the discussion nor fail to intervene strongly to shut down unproductive tangents.

In this case, the infrastructure company used some time on the last day of its off-site meeting to discuss how the board and management would monitor execution. This led to a healthy negotiation between the two on "what would get done by when." The company also created time for a final debate, on the allocation of resources, ensuring that no one was left behind in the decision making. The director with a background in the industry spent some time with

With a clearer understanding of industry and company economics, boards can have the kinds of informed dialogue with senior managers that ultimately help them prepare smarter options.

the CEO providing input on path dependencies, allocations of capital and people, and high-level time lines.

Extending the discussion of strategic options all the way to monitoring execution was a powerful—and unusual—step. Normally, this isn't necessary. But boards sometimes overlook how difficult it is for executives to reconcile the sweeping changes they and the board have committed themselves to with day-to-day operational realities that consume the executives' time. Sometimes, this is an unintended consequence of the timing of off-site strategy meetings. When they are held near the end of the financial year, there isn't enough time to flesh out plans and create linkages to key performance indicators before the budget must be approved.

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Developing strategy has always been complex—and becomes more so with a board's increased involvement, which introduces new voices and expertise to the debate and puts pressure on management teams and board members alike to find the best answers. Yet this form of strategy development, when done well, is invaluable. It not only leads to clearer strategies but also creates the alignment necessary to make bolder moves with more confidence and to follow through by committing resources to key decisions.

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# Elevating technology on the boardroom agenda

**Michael Bloch, Brad Brown, and Johnson Sikes**

In this age of rapid technological change, boards can do more to help management ask the right questions about promising opportunities and looming threats.

**Business is becoming** increasingly digital as technology trends such as big data, cloud computing, enterprise mobility, and social media spawn new marketing and operational capabilities. Technology has therefore become too embedded in the fabric of business—and too critical for competitive performance—to be left to the IT function alone. In response, forward-looking boards have started asking questions to ensure that executives focus on the right technology issues.

Yet in a McKinsey survey of corporate directors, more than half said their boards had at most one technology-related discussion a year, and almost half said that this level of attention was insufficient. In addition, a separate McKinsey survey suggested that there's a significant gap between what boards actually discuss and what they should. For example, more than half of the respondents said their boards needed to discuss forward-looking views of technology's impact on their companies' industries, yet less than 30 percent said that their boards did so. The problem, as former Kraft Foods CEO Betsy Holden has noted, is that "board-level conversations about technology need to be strategic and connected to key business drivers rather than focused on the tactical, as is often the case."

As senior-executive teams become increasingly involved in technology issues, boards must think strategically about how technology trends are shaping the future of their companies. The rewards are significant: deeper board involvement can cut through company politics and achieve endorsement for larger, integrated technology investments; increase the positive impact of mergers and acquisitions, since about half of the synergies depend on IT[1]; ensure that a company has given sufficient thought to potential technology-driven disruptions; and help address the risk of crippling cyberattacks.[2] We have identified four measures boards can take to better engage management on technology issues.

**Sponsor periodic reviews of technology's long-term role.** Some boards are engaging in forward-looking conversations about how technology affects their industries and its implications for their current and future strategies. Given the rapid pace of change, such big-picture discussions should take place every 12 to 18 months—or more frequently if necessary.

For example, when the CIO of one financial institution requested a substantial investment to modernize legacy software platforms and develop new capabilities in advanced risk analytics, the board sought a broader perspective. Analysis rooted in the company's industry context found that while a new type of player—large, highly tech-enabled and data-driven companies—was emerging in the market, there would still be room for a sizable number of smaller players with varying technology capabilities. It also identified leading practices other companies applied, as well as the use, in other sectors, of data and analytics to improve customer segmentation and risk assessment. Armed with a better understanding of the company's business-technology gaps and the investments required to close the most critical ones, the board approved the CIO's funding request.

**Establish board reviews of the IT portfolio.** Some boards are introducing an annual "state of the union" report that reviews the alignment of a company's entire IT portfolio with corporate and business-unit strategy. Such a review should feature joint presentations by IT executives and corporate and business-unit managers. It should address major IT systems and components, such as enterprise-resource-planning and customer-relationship-

[1] For more information, see Hugo Sarrazin and Andy West, "Understanding the strategic value of IT in M&A," mckinseyquarterly.com, January 2011.

[2] For more information, see James Kaplan, Shantnu Sharma, and Allen Weinberg, "Meeting the cybersecurity challenge," mckinseyquarterly.com, June 2011.

management systems, as well as IT's operating model, resource strategy, and cybersecurity plans and preparedness, and review top-level IT talent and the company's CIO-succession plans.

Boards should also more frequently review major business projects that have a significant technology component. At one company rolling out a massive systems-transformation project estimated to cost several hundred million dollars, for example, the board conducts regular progress reviews with the project leader, the CIO, and the business-area chief.

Critically, to have successful discussions, the CIO and his or her staff must engage at the board level. When they do, they should leave the IT jargon behind and relate the company's IT strategy to the business strategy. Too often, IT leaders and board members don't speak the same language, so there is a risk that the full potential of IT investments will not be realized.

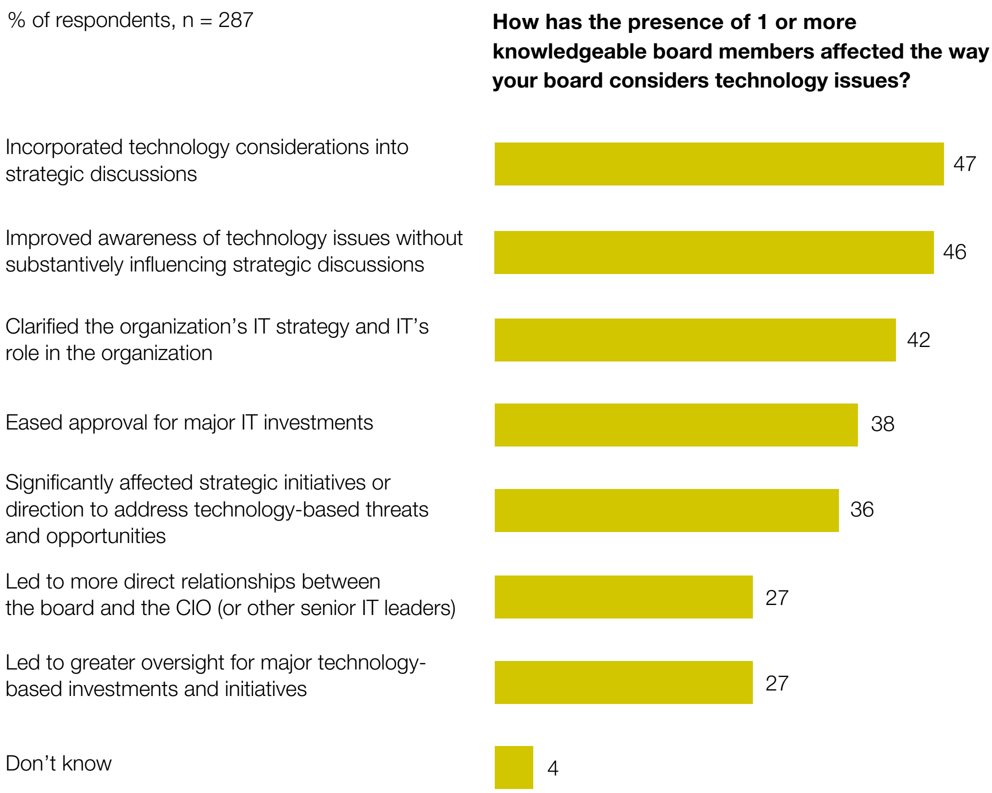
**Leverage technology-savvy board members.** Greater board involvement in technology matters means that corporate directors need to build expertise that enables them to have constructive dialogues with IT leaders. One approach is to bring in more directors with technology backgrounds, who can help start these conversations organically during board meetings. A recent report from Spencer Stuart[3] indicated that 20 percent of boards are actively looking for directors who have this expertise. Our experience and survey results show that finding such board members can pay significant dividends (exhibit). In addition, some boards are considering "technology boot camp" training sessions similar to the risk or accounting training that some boards conduct for members of the relevant committees. Although this will not turn directors into experts, it can make them more familiar with the core issues.

Another option is to create a technology advisory panel similar to the scientific advisory boards many pharmaceutical companies use. By integrating a mix of advisers, including both industry experts and cutting-edge technologists, companies could have more eyes looking at their existing portfolios and at trends they should be considering.

[3] "US Board Index 2011," Spencer Stuart, November 2011, p. 13.

Exhibit

**Technology-focused discussions are richer when boards have at least one IT-savvy member.**




Source: Dec 2011 McKinsey survey of executives

**Strengthen the technology-governance structure.** While boards often need to improve their technology expertise, structural steps can make them more effective stewards. Some 22 percent of survey respondents reported that their companies' boards had created a specific committee responsible for technology oversight, although delegating this work to a committee does not relieve the full board of its broader responsibilities, such as discussing technology trends and their strategic impact. Another way to strengthen technology governance is to delegate risk-related technology issues to the board committee that oversees corporate risk. Many boards already consider some technology topics in their internal audits. Reviewing the operational risks associated with technology-dependent business processes is often a valuable means of expanding oversight.

Boards also can review how data are used and safeguarded, as well as discuss concerns about broader cybersecurity issues. The audit committee of the board of one UK group, for example, oversees technology risks. The group COO reports regularly to the committee, which also asks the company's internal-audit department to examine the IT-security strategy and report on its findings. The committee then mandates the group COO to report on the measures being taken to fill existing gaps.

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Technology is increasingly integral to strategy, and boards have a crucial role to play as trusted advisers. Every board should constantly engage in discussions about technology trends and the company's technology portfolio, while building the expertise of corporate directors and creating structures that strengthen IT governance. Now is the time to act.

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The full version of this article is available on mckinseyquarterly.com.

# Engaging boards on the future of marketing

**Jean-Baptiste Coumau, Ben Fletcher, and Tom French**

At many companies, the whole organization is becoming more responsible for customer engagement. A few are extending this thinking to the boardroom.

**As trends such as social media,** the mobile Web, and proliferating data streams rapidly redefine what it means to be on the cutting edge of marketing, the organization as a whole is becoming more responsible for customer engagement. In previous articles, we've described how an organization-wide commitment helps companies ensure access to the steady diet of wide-ranging inputs they need to stay ahead of the curve.[1] Some companies are extending this thinking to the boardroom. While it's still early days, and the dynamics will of course differ by industry and company, a closer look at what a handful of organizations are doing provides food for thought about the benefits of having boards engage with the fast-paced evolution of marketing.

## Bringing the board into marketing

When a new CEO took the directors on a tour to visit innovators and peer companies in the United States and (later) Europe, one Asian technology-services company began to discover the value a board can bring to marketing. The CEO's intent was to instill among board members a shared sense of the need for fundamental changes in the company's growth goals and to build enthusiasm for a major efficiency drive.

[1] See Tom French, Laura LaBerge, and Paul Magill, "We're all marketers now," mckinseyquarterly.com, July 2011; and "Five 'no regrets' moves for superior customer engagement," mckinseyquarterly.com, July 2012.

In addition to accomplishing those goals, the visits created a new sense of urgency about the company's need to diversify both the range of channels it used to interact with customers and the points in the customer relationship where it would emphasize deep engagement. The board's commitment helped overcome internal opposition, and the company embarked on a dual program of restructuring its channels and acquiring or partnering with third-party providers whose services could help enrich its offerings at various points in the customer life cycle.

The results thus far have been impressive—customer satisfaction has increased by 20 percentage points, market share in core services by nearly 10, and profitability has increased correspondingly. Meanwhile, the company has continued sending its corporate directors on fact-finding trips in a variety of geographies, with the intention of shaking up the directors' thinking and encouraging them to spot overlooked opportunities.

Such board missions can deliver unexpected insights thanks in no small part to the diversity of experiences and perspectives that well-chosen boards can bring to bear. When a large distribution business concluded that it needed to change its way of engaging with customers, it enlisted the board in the problem-solving process. The company paired off board members and senior managers with complementary skills and flew them to different locations, where they visited company sales offices and customers before later reconvening at an offsite strategy meeting. When the full group debriefed, its members' collective experiences yielded new insights about customer needs and the value proposition the company was (and wasn't) offering, all of which had implications for its sales and distribution approach.

The changing marketing environment also elevates to board agendas items that previously might not have made it there. One example is corporate brand management, long the domain of chief marketing officers and public-relations departments. Yet against a backdrop of social media, viral video, and the reputational threats posed by "citizen bloggers," the CEO of one North American manufacturer recently placed the potential for brand-changing events on the board's agenda. This move led to a good discussion about ways to cope. The conversation transcended traditional marketing communications and touched on the company's overall strategy, as well as its approach to crisis response.

Boards can also serve a valuable role in helping management to identify and initiate beneficial marketing-strategy or organizational changes that would have been difficult for managers to envision on their own, given their focus on day-to-day concerns. At a global luxury group, for example, a board member helped management to see the importance of dramatically increasing a key brand's online presence. The additional focus highlighted the need for big changes—including new functional skills, organizational capabilities, and processes—that culminated in the creation of an internal "brand studio" tasked with "insourcing" a wide range of the brand's digital activities.

## Three tips for improving engagement

As these examples suggest, it's too early to draw a definitive road map for board involvement in marketing, just as it's not yet possible to draw a universal blueprint for creating superior customer engagement. Still, our experience suggests a few ideas worth considering.

First, much as most boards now include a strategy day in their calendar of meetings, we think it's worth considering a customer-engagement day to take stock of the broadest strategic implications of changes in the marketing environment and of the company's position with customers. On such a day, the directors of another Asia-based services company took decisive action to rethink its premium-pricing strategy after coming to grips with big changes under way in the customer base.

Second, it's important to be mindful of the board's composition, given the fast-changing nature of marketing. For example, including more board members with public-sector experience—including political-campaign skills—can provide valuable counsel to today's ever-more-exposed CEOs.

Third, it's important to keep board involvement strategic in nature and clearly aimed at governance issues and *not* the day-to-day management of marketing activities. To be sure, it can be valuable for board members with specialized expertise to provide it fairly regularly; we know of one company that's asked an innovation guru on the board to work closely, between meetings, with the head of R&D. Yet any such involvement must ultimately connect back to the board; otherwise, there's a risk of creating a cadre of shadow managers. In this case, the R&D director and board member jointly update the board on innovation efforts to ensure that it remains plugged in.

This last example shows how CEOs are finding value in individual board members. In this case, the value was in R&D, the lifeblood of that company. In others, it might be in understanding new technologies shaking up consumer behavior or new geographies emerging as priority markets. As the digital-marketing revolution continues to unfold, senior leaders will need all the help they can get to keep their companies on the leading edge.

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# Modernizing the board's role in M&A

**Chinta Bhagat and Bill Huyett**

Active involvement can help companies capture more value—and develop a competitive advantage in deal making.

**In many conversations** with senior executives and corporate directors, we've heard variations on the theme that deep board involvement in M&A encroaches on the line that separates governance from management. That line is critical. Yet our experience suggests that when it comes to M&A, many boards and management teams are drawing it in the wrong place.

Consider the stakes: many large corporations depend on M&A[1] for growth, and by executing it well they can significantly boost the value those deals create. But poorly executed M&A can saddle investors with weak returns on capital for decades. What's more, the margin between success and failure is slim. In most transactions, the net value creation to the buyer is usually a small fraction of the deal's value and therefore easy to wipe out with indifferent execution or ill-informed economic assumptions.

Many boards, reluctant to cross the line between governance and management, miss opportunities to help senior executives win at M&A. Boards are well placed to take a long-term view of a deal's value: the CEO or the business-unit leader may have tenures shorter than the time needed to realize it fully. Boards are also well positioned to challenge the biases that often cloud M&A decision making and goal setting. Furthermore, the diverse experiences of board members with long leadership careers in different corporate

[1] In this article, M&A refers to mergers, acquisitions, joint ventures, and divestitures; it does not include sales of companies, leveraged buyouts, or other recapitalization events.

settings can shed useful light on common organizational risks in deals. Finally, boards can embolden senior management to pursue promising deals that may seem unfashionable or likely to be unpopular with investors initially.

Of course, a board cannot substitute for an effective management team. Yet it can play roles that go beyond the legal, regulatory, and fiduciary obligations that virtually every board fulfills on M&A—thereby helping executive teams to pursue deals and manage the associated risks in ways that create more value. In this article, we describe three such roles: challenging value-creation possibilities, testing merger-integration plans, and helping managers to create a corporate competitive advantage in M&A.

This final role is crucial because M&A is central to the strategy of many value-creating companies. Active M&A programs offer a window on the external world—product innovations, talent, new business models—and a way to bring fresh skills and ideas to the development of new products and geographies. They also help leaders keep corporate portfolios vibrant by training resources on the most attractive businesses and avoiding inertia in the allocation of cash and talent. In short, the benefits of M&A often transcend those of individual deals, making boards that engage with it better able to fulfill their broader stewardship functions.

## Challenging value-creation potential

To understand how boards can help to create value, consider the example of one we know that's created a subcommittee to challenge the thinking of executives on potential transactions. That subcommittee is in constant touch with the company's M&A strategy, the pipeline of potential targets, and emerging deals. Its involvement allows the full board to feel more confident about (and to move much faster than other possible buyers on) large-scale transactions—even company-shaping ones, with all their accompanying risks—because the board is always current on how specific deals create value. This approach isn't common, but it's the right idea.

Providing such a challenge lies at the heart of the value boards can offer in M&A: helping managers to exploit its impact on performance while avoiding its traps. Why the board? Because without its input, ways of working that serve corporations well for ongoing business operations can work against consistent value creation through M&A. The board's independence from daily operations and its long-term perspective enable it to challenge the tendency of management to emphasize income statements over balance sheets; to adhere, sometimes slavishly, to budget targets obscuring the potential of transactions; or to behave in risk-averse ways that inhibit the consideration of aggressive deals and prevent managers from discussing any but the most certain synergies. Specifically, boards can enhance decision making in M&A by closely challenging the following.

## The strategic fit

While opportunistic transactions can succeed, recent analysis by our McKinsey colleagues has underscored the importance of strategic fit: deals driven by strategy succeed more often when they are part of a stream of similar transactions supporting that strategy.[2] Boards should push to clarify the relationship between a potential transaction and corporate strategy: how the deal will support organic-growth efforts in target markets and provide complementary sources of value creation, for example. Above all, why is the company a "better owner" than competing buyers?

## The pro forma

In reviewing pro forma financial statements prepared for a transaction, a board should test the assumptions used to justify a deal, not just make decisions based on estimates of net present value or internal rates of return. Many boards place too much emphasis on, for example, whether a transaction is accretive or dilutive of the acquirer's earnings per share or on basing the outlay for deals on price-to-earnings multiples. Instead, they should demand clarity—using discounted-cash-flow methods—about the value created by various growth, asset, and cost synergies compared with the value-creation potential other bidders would bring to the deal. Are the forecast growth rates and return-on-invested-capital (ROIC) estimates consistent with industry norms and the long-run tendency of these metrics to converge? What business-model or product disruptions may lie on the horizon? Does the pro forma account for a competitive response? Are its price assumptions consistent with its assumptions about market-share capture? Is there enough new spending to support growth projections?

[2] Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," mckinseyquarterly.com, January 2012.

### The risks and rewards

Frequently, best case/worst case risk analyses that a board sees reflect a heavily negotiated pro forma that barely meets the minimum financial threshold to secure approval for a deal. These analyses may fail to highlight important risks or upside opportunities. Boards must indicate clearly that it's OK to acknowledge uncertainties in pro formas; what matters is management's ability to assess both those risks and the upside realistically and to develop plans that address them. For example, boards should explore the correlation between different types of risks inherent in a transaction and understand the impact they might have on future growth or returns. Similarly, boards shouldn't miss a chance to push companies to capture cost or revenue synergies more quickly. Setting high expectations for management—and rewarding it accordingly—boost the odds of creating value.

## Testing the merger-integration plan

Important as it is to scrutinize a deal's value-creation potential, one board we know has decided that postmerger-integration (PMI) oversight, not a challenge to a deal's pro forma, represents its primary opportunity. In that company's industry, acquirers must typically rationalize costs and accelerate growth in the new entity—a tricky combination—to create value through deals. The board pressure-tests the PMI plan's specifics against stretch-growth and cost goals before and after a deal's announcement.

Boards should examine a transaction's PMI plan in as much detail as they do pro forma statements. While this might seem to verge on meddling in management, our experience suggests otherwise. We see more variation in the quality of postmerger plans than in the financial analysis and pricing of transactions. We've also seen effective PMI plans boost net value creation for the buyer by as much as two to three times the net value created through ineffective PMI plans. Boards can help realize these opportunities without micromanaging, by asking questions such as the following:

- Is the PMI designed to capture maximum value? A surprising number of PMIs and associated management incentives are designed, implicitly, just to integrate transactions smoothly and to meet, not beat, the value-creation pro forma approved by boards. Unfortunately, PMIs are inherently messy; the priority should be finding and exploiting every source of value, not merely keeping things orderly. The PMI plan also must be adaptable enough to accommodate new value-creation opportunities and risks uncovered in the early weeks of integration.

- Is the PMI leader well equipped to realize the deal's value? Particularly for large transactions, it's often important to appoint fairly senior integration managers. In a world of scarce senior talent, a board should make sure that when a complex transaction is under consideration, PMI leadership is on the table. Is a senior leader available with the skill and independence to manage what is often a tricky and high-stakes role?

- Can we launch the PMI on the day the deal is announced and complete it rapidly? If the answer is no, value leakage is inevitable. Our experience suggests that lost value is difficult to recover—and is rarely captured at all if a board accepts a strategy of "we'll integrate the business later."

## Creating a competitive advantage in M&A

The third arena of board involvement is unrelated to a transaction's deadline; it is the decision to create a competitive advantage through M&A skills—a corporate asset that can be difficult for competitors to copy. Boards can help management along three dimensions.

### M&A strategy

As part of a board's corporate-strategy oversight, the board and management must agree on the role M&A plays in creating value for shareholders—how material is that role, which of course varies across companies, and what critical sources of value can M&A provide? The dialogue between management and the board about sources of value must be quite specific, and the board should know how those sources fit in with the prospective deal pipeline, whose size, flow, and quality help determine the performance of M&A. While active involvement in the pipeline by the full board is rarely feasible or desirable, the board should periodically review it.

## M&A leadership

Even if a company doesn't appoint a single executive to oversee M&A, it must have clear organizational-structure and process linkages between the creation of a healthy pipeline, the closing of deals, and their integration. The board can help the CEO and CFO become more explicit about the roles of the corporate center and business units in M&A and a permanent M&A organization's ideal scale and scope. Moreover, the executives leading various elements of M&A can significantly affect the creation of value. It's often harder to provide mentorship for these roles and to develop in them. They deserve the same attention from the board as do, for example, business-unit leadership roles.

## M&A processes

Directors should read and challenge their company's M&A playbook—its guide for the types of deals it pursues. The playbook typically covers topics ranging from capturing cost synergies to integrating IT to jump-starting growth, and translates M&A strategy into specifics for delivering value. With the playbook in mind, a board can also help make M&A decision making more effective. The board should ensure that the company structures each phase of decision making to counter risks ranging from risk aversion in the early stages to biases in financial analysis to deal advocacy in the final stages. Once a deal is complete, boards can ensure that its performance is transparent, with incentives tied to realizing its full value.

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This level of engagement will be outside the comfort zone for some executives and directors—but need not cause friction between them. In fact, it can align the board and management on the need for bolder transactions with more upside potential. The risks will be clearer all around, while management will be able to focus on capturing value instead of securing the board's approval. Above all, greater engagement can convert what is typically a sequence of discrete deals into a set of ongoing deal processes and dialogues to deliver value from M&A. ○

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# Applied Insight

Tools, techniques, and
frameworks for managers



Illustration by Neil Webb

# Leadership and the art of plate spinning

**Colin Price**

*Senior executives will better balance people and priorities by embracing the paradoxes of organizational life.*

I often ask business leaders three simple questions. What are your company's ten most exciting value-creation opportunities? Who are your ten best people? How many of your ten best people are working on your ten most exciting opportunities? It's a rough and ready exercise, to be sure. But the answer to the last question—typically, no more than six—is usually expressed with ill-disguised frustration that demonstrates how difficult it is for senior executives to achieve organizational alignment.

What makes this problem particularly challenging is a number of paradoxes, many of them rooted in the eccentricity and unpredictability of human behavior, about how organizations really tick. Appealing as it is to believe that the workplace is economically rational, in reality it is not. As my colleague Scott Keller and I explained in our 2011 book, *Beyond Performance*,[1] a decade's worth of data derived from more than 700 companies strongly suggests that the rational way to achieve superior performance—focusing on its financial and operational manifestations by pursuing multiple short-term revenue-generating initiatives and meeting tough individual targets—may not be the most effective one.

Rather, our research shows that the most successful organizations, over the long term, consistently focus on "enabling" things (leadership, purpose, employee motivation) whose immediate benefits aren't always clear. These healthy organizations, as we call them, are internally aligned around a clear vision and strategy; can execute to a high quality thanks to strong capabilities, management processes, and employee motivation; and renew themselves more effectively than their rivals do. In short, health today drives performance tomorrow.

Many CEOs instinctively understand the paradox of performance and health, though few have expressed or acted upon it better than John Mackey, founder and CEO of Whole Foods. "We have not achieved our tremendous increase in shareholder value," he once observed, "by making shareholder value the only purpose of our business."

In this article, I want to focus on three other paradoxes that, in my experience, are both particularly striking and quite difficult to reconcile. The first is that change comes about more easily and more quickly in organizations that keep some things stable. The second is that organizations are more likely to succeed if they simultaneously control *and* empower their employees. And the third is that business cultures that rightly encourage consistency (say, in the quality of services and products) must also allow for the sort of variability—and even failure—that goes with innovation and experimentation.

Coming to grips with these paradoxes will be invaluable for executives trying to keep their people and priorities in balance at a time when cultural and leadership change sometimes seems an existential imperative. Just as a circus performer deftly spins plates or bowls to keep them moving and upright, so must senior executives constantly intervene to encourage the sorts of behavior that align an organization with its top priorities.

## Change and stability

Organizational change, obviously, is often imperative in response to emerging customer demands, new regulations, and fresh competitive threats. But constant or sudden change is unsettling and destabilizing for companies and individuals alike. Just as human beings tend to freeze when confronted with too many new things in their lives—a divorce, a house move, and a change of job, for example—so will organizations overwhelmed by change resist and frustrate transformation-minded chief executives set on radically overturning the established order. Burning platforms grab attention but do little to motivate creativity. Paradoxically, therefore, change leaders should try to promote a sense of stability at their company's core and, where possible, make changes seem relatively small, incremental, or even peripheral, while cumulatively achieving the transformation needed to drive high performance.

A large universal bank provides a case in point. Given the tumult in the financial-services sector in recent years, it needs to change, and change profoundly. But the cry of "let's change everything" will be counterproductive in an organization where staff members are mostly hard-working, committed people operating processes that involve millions of transactions per hour.

One large automotive company I'm familiar with, buffeted by three different owners and five different CEOs in the last decade, has recently embraced this paradox with a new management model dubbed "balance," a word loaded with meaning in the automotive industry because of its association with reducing drag and increasing speed. The simple idea behind the model is that any changes to a company's systems, structures, and processes should always be introduced in a consistent way, typically quarterly, as part of an explicit change package. If a proposed change isn't ready in time for one of these regular releases, it is either deferred to the next one or abandoned.

Previously, leaders of each of the company's functions had been inclined to introduce, on their own, changes they thought might generate value—for example, finance would launch a program to make costs variable, HR would announce an initiative to shake up performance management and compensation, and manufacturing would bring in new vendor-management systems. Hapless middle managers found themselves in a blizzard of change that made it difficult to focus on the organization's top priorities. Now, *before* change programs are rolled out more broadly, all of them are integrated, and the resulting complexities are addressed at the *top* of the organization.

In this way, the company's underlying operating model has remained more stable than it would otherwise have been, and more stable than it used to be when changes were announced in an uncoordinated fashion. Managers now understand and accept the rhythm of change, while managers and employees alike have gained new confidence that the different elements in the releases will be complementary and coherent.

The result is that a well-intentioned but disjointed flow of unending change has been converted into a well-structured one. Moreover, after years of lagging behind industry peers, the company has shortened its product-development cycles and increased the quality of its products. And it is running much more smoothly, with 20 percent fewer managers.

## Control and empowerment

All organizations need at least a thread of control to link those who own the business to those charged with implementing its objectives. Companies that neglect mechanisms that enforce discipline, common standards, or compliance with external regulation do so at their peril. The share price of one global energy group, for example, collapsed when it came to light that poor oversight had allowed internal analysts to develop metrics based on optimistic assumptions and to overstate the company's oil and gas reserves substantially.

Yet excessive control, paradoxically, tends to drive dysfunctional behavior, to undermine people's sense of purpose, and to harm motivation by hemming employees into a corporate straitjacket. The trick for the CEO-cum-plate-spinner is to get the balance right in light of shifting corporate and market contexts. In general, a company will probably need more control when it must actually change direction and more empowerment when it is set on the new course.

The story of how a major global technology company recovered from a crisis four years ago is instructive. Forced to write off more than $2 billion of unmanageable contracts—and facing insolvency—a new management team took drastic and decisive action to strip out costs, renegotiate old agreements, change established practices, and impose stringent new controls. The company (with more than 100,000 employees) was saved but in the process found that it had lost the ability to deliver on its top priority: creative new ideas that would fuel organic growth. That's because an unintended consequence of the much-needed cost reductions had been the emergence of a "parent–child" relationship between the company's top team and middle managers. These managers had become so used to being told what to do, and had been given so little room to maneuver, that they eventually lost the ability to experiment. The "tree" of top management had grown so large that nothing could grow in its shade.

This company's solution was to introduce an "envelope" leadership approach, which first involved defining a set of borders. Employees could not go beyond them, but within them there was almost complete freedom to innovate and grow. Other businesses have attempted to copy the envelope idea but few have had the success of this global technology company, whose approach had real teeth. The flame of empowerment was fanned by first identifying some 600 leaders with the best capabilities and then rotating them around different businesses, with a mandate to shake things up. Meanwhile, the company's purpose, vision, mission, and values were all rewritten and drilled into leaders. Its "signature processes" (five core ones, where it aspired to be truly differentiated) were fundamentally reimagined. And evaluation and reward mechanisms were dramatically tightened to reward stars and actively manage people who seemed to be struggling. As the company added a greater degree of empowerment to the stricter controls—plates both balanced and spinning—its performance improved. Sales are growing again, and fresh energy is palpable throughout the organization.

## Consistency and variability

Producing high-quality products and delivering them to customers on time and with the same level of consistency at every point in the value chain is critical to success in most industries. Variability is wasteful and time consuming, not to mention potentially alienating for customers. Most organizations therefore applaud behavior that attacks and eliminates it.

Yet in human terms, consistency too often hardens into rigid mind-sets characterized by fear of personal and organizational failure. It's been shown that we feel the pain of failure twice as much as we do the joy of success, so employees naturally tend to protect themselves and their teams, behavior that can inadvertently hamper innovation and calculated risk taking. After all, mistakes—from Edison's countless failed filaments to 3M's accidental creation of the adhesive behind Post-it notes—can sometimes be the mother of invention; as they say in the mountains, "If you're not falling, you're not skiing."

It's hard to think of a sector where it's more important to get the balance between consistency and variability right than it is in pharmaceuticals. Lives are at stake, and the development and launch costs of a new compound often run to billions of dollars. Faced with the approaching expiration of many licenses, one of the world's biggest pharma companies found that its tradition of reliability and consistency had become a limiting mind-set. Although it desperately needed to make new discoveries, a status quo bias took hold of the organization, which froze around a complex bundle of assurance, governance, and controls. Fear of failure and an obsession with getting these things right produced defensive 100-page PowerPoint presentations in abundance, but little meaningful product-development progress.

Behavioral problems didn't help, of course. An excessive "telling" rather than "listening" culture had degenerated into bullying; some senior executives literally shouted at their underlings. On one notorious "away day," a number of exercises revolved around cage fighting, a sport (dubbed "human cockfighting") that combines boxing, wrestling, and martial arts. The signal this sent from the top was that the culture really was dog eat dog.

Things came to a head when two scientists, frustrated by the time needed to get approvals, left to set up their own successful research business and were openly lauded by colleagues for breaking free of a stifling bureaucracy and dictatorial culture. The morale of those left behind suffered further, and energy drained out of the organization.

The solution the company devised combined building "slack" (additional people) into its resourcing—a bold move in austere times—with a direct attack on negative behavior. The worst offenders were removed, and it was made clear that cage-fighting attitudes were unacceptable.

Steps were taken to bump up the innovation rate by investing in smart people, but the top team went further. It set out fundamentally to alter what it called the organization's "social architecture" by building worldwide communities of scientists and encouraging exchanges between them across geographical boundaries and industry disciplines.

Successful experiments, to be sure, were more highly valued than failures, but both had their place in the company's culture. An emphasis in communications on "our wealth of ideas" promoted the simple notion that wealth (economic progress) arises from ideas (experimentation and innovation) and showed how carefully crafted language can help drive change. The result was an increase in the pipeline of products and, over time, a resumption of profit growth.

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Embracing the paradoxes described in this article can be uncomfortable: it's counterintuitive to stimulate change by grounding it in sources of reassuring stability or to focus on boundaries and control when a company wants to stir up new ideas. Yet the act of trying to reconcile these tensions helps leaders keep their eyes on all their spinning plates and identify when interventions are needed to keep the organization lined up with its top priorities. Last, this approach makes it possible to avoid the frustration of many executives I've encountered, who pick an extreme: either they try to stifle complex behavior by building powerful and rigid top-down structures, or they express puzzlement and disappointment when looser, more laissez-faire styles of management expose the messy realities of human endeavor. Far more centered and high performing, in my experience, are those leaders who welcome the inconvenient contradictions of organizational life.

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

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Illustration by Matthew Taylor

# Leadership lessons from the Royal Navy

**Andrew St. George**

*This branch of the British armed services consciously fosters cheerfulness and nourishes its collective memory. Business executives should take note.*

Britain's Royal Navy is a disciplined command-and-control organization that moves across 140 million square miles of the world's oceans. Although few environments are tougher than a ship or submarine, I've been struck, while conducting research on the Royal Navy, by the extent to which these engines of war run on "soft" leadership skills. For officers leading small teams in constrained quarters, there's no substitute for cheerfulness and effective storytelling. In fact, I'd go so far as to say that naval training is predicated on the notion that when two groups with equal resources attempt the same thing, the successful group will be the one whose leaders better understand how to use the softer skills to maintain effort and motivate.

I believe that the same principle holds true for business. In this article, I hope to translate for business leaders—like the ones I've gotten to know throughout my career as a business-school professor and communications adviser—some of what I learned while writing the Royal Navy's first new leadership handbook since 1963. That handbook,[1] published last year, is based on research of unprecedented length and breadth, as well as my own direct observation of officer training and life at sea.

Among the many softer leadership skills important to the Royal Navy, I highlight here the aforementioned cheerfulness and storytelling, which to me were both unexpected and broadly applicable. While the means of applying these lessons will, of course, differ by organization and individual, reflecting on them should stimulate fresh thinking by senior executives about the relationship between soft management skills and superior performance.

## Cheerfulness counts

No one follows a pessimist, and cheerfulness is a choice. It has long been understood to influence happiness at work and therefore productivity.[2] The cheerful leader in any environment broadcasts confidence and capability, and the Royal Navy instinctively understands this. It is the captain, invariably, who sets the mood of a vessel; a gloomy captain means a gloomy ship. And mood travels fast. Most ships' crews are either smaller than, or divided into, units of fewer than 150 members—near the upper end of Dunbar's Number, suggested by British anthropologist Robin Dunbar as the extent of a fully functioning social group.[3]

The Royal Navy assiduously records how cheerfulness counts in operations. For example, in 2002 one of its ships ran aground, triggering the largest and most dangerous flooding incident in recent years. The Royal Navy's investigating board of inquiry found that "morale remained high" throughout demanding hours of damage control and that "teams were cheerful and enthusiastic," focusing on their tasks; "sailors commented that the presence, leadership, and good humor of senior officers gave reassurance and confidence that the ship would survive."[4] Turning up and being cheerful, in other words, had a practical benefit.

How do you teach cheerfulness? The Royal Navy takes every informal opportunity to demonstrate its usefulness. To fill the dead time that invariably occurs during training exercises and other routine activities, for example, navy personnel routinely hold informal games or contests. These games, known as Dogwatch Sports (after the dogwatch periods of duty in the evening, when the entire ship's company is typically awake), are often trivial and nonsensical—passing a stick, for example, across an ever-widening divide. But besides cheerfulness, they encourage speed of thought, an outward-looking mind-set, and a willingness to talk. Cheerfulness in turn affects how people sit, stand, and gesticulate: you can see its absence when heads are buried in hands and eye contact is missing.

Royal Marine commanders understand particularly well that cheerfulness is fueled by humor: one I met required his whole company to "sing for their supper" by telling a joke—any joke—in front of their fellow marines prior to eating. That's part of a wider navy culture that expects everyone, from the top down to the newest and rawest sailor, to be able and willing to stand up and talk, in an impromptu fashion, about what they're doing. Such a skill is especially prized in an organization that moves people quickly and often (typically, every two years) and requires them, perhaps as a matter of life and death, to hit the ground running in their new posts.

The practice of "banter"—a peculiarly British form of playful, if gently mocking, communication—is also openly encouraged as an upbeat and informal way to regulate relationships and break down hierarchy. Banter occurs at all ranks and quite often between them. A Royal Navy driver will talk more readily to a second sea lord than the average corporate employee will engage his or her CEO in an elevator. Indeed, one CEO I know described the social awkwardness of riding one with his (clearly discomfited) colleagues by confiding: "Everyone acts as if they're dating my eldest daughter!"

Several times, I personally experienced the social cohesion that banter helps promote, most memorably on mountaintop exercises with the Royal Marines. News of my snoring had preceded me at nightfall, but embarrassment quickly gave way to a feeling of social inclusion in a group of people I had never previously met. Banter is always tempered by respect for others.

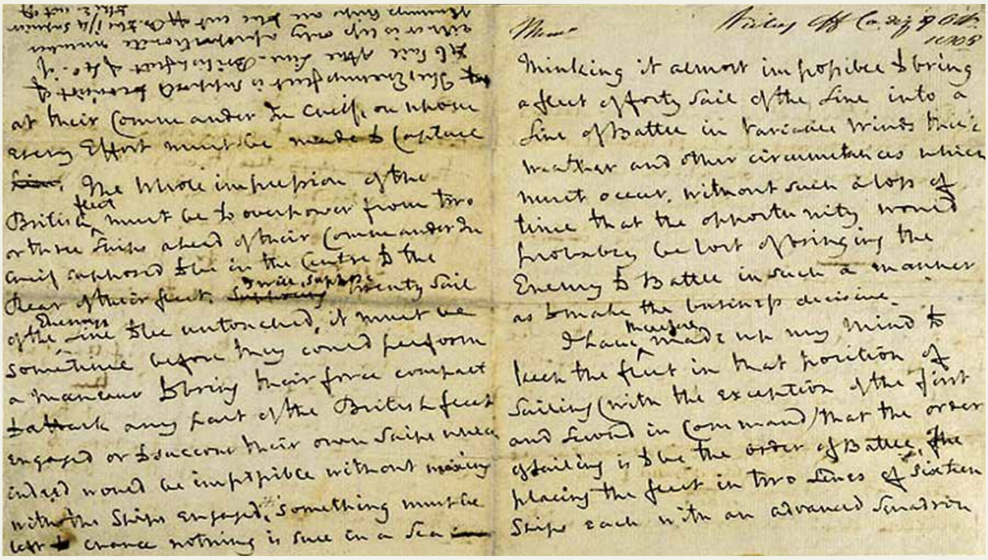
Conversely, empty optimism or false cheer can hurt morale. As one naval captain puts it, "Being able to make the uncertain certain is the secret to leadership. You have to understand, though, that if you are always über-optimistic, then the effect of your optimism, over time, is reduced."

The relevance of many of these techniques to the corporate workplace is obvious, not least in a world of rapid job rotation, team-based work, and short-term projects that are typically set up in response to sudden competitive challenges and require an equally fleet-footed response.

## Keep spinning 'dits'

The Royal Navy has a highly efficient *informal* internal network. Leadership information and stories known as dits are exchanged across it—between tiers of management, generations, practices (branches), and social groups. With the help of dits, the Royal Navy's collective consciousness assimilates new knowledge and insights while reinforcing established ones. Visitors to naval establishments or ships are often invited for a few dits; crews are encouraged to share theirs.

These dits are one way the Royal Navy fosters what a business would call its culture, or philosophy. Writing in 1966, long-time McKinsey managing director Marvin Bower observed, "The literature on company philosophy is neither very extensive nor very satisfactory."[5] I fear that the same is true today and that many commercial organizations would


at their Commander in Chief, on whom every Effort must be made to Capture ~~Line~~. The whole impression of the British fleet must be to overpower from two or three Ships ahead of their Commander in Chief supposed to be in the Centre to the Rear of their fleet. I will suppose twenty Sail of the line to be untouched, it must be sometime before they could perform a manœuvre to bring their force compact to attack any part of the British fleet engaged or to succour their own Ships which indeed would be impossible without mixing with the Ships engaged. Something must be left to chance nothing is sure in a Sea

Memo — Victory off Cadiz 9 Octr 1805

Thinking it almost impossible to bring a fleet of forty Sail of the Line into a Line of Battle in variable winds thick weather and other circumstances which must occur, without such a loss of time that the opportunity would probably be lost of bringing the Enemy to Battle in such a manner as to make the business decisive.

I have therefore made up my mind to keep the fleet in that position of Sailing (with the exception of the first and Second in Command) that the order of Sailing is to be the order of Battle, placing the fleet in two Lines of Sixteen Ships each with an advanced Squadron

## The 'Nelson touch'

In meetings on HMS Victory with his officers in the days leading up to the decisive Battle of Trafalgar, in 1805, Vice Admiral Horatio Nelson presented his plans to defeat the allied French and Spanish fleets off the coast of Spain. On October 9, 12 days before the battle, he outlined these plans in a secret memorandum, which encapsulated the strategy discussed with his captains. To this day, at least one senior officer in the Royal Navy carries with him at all times a laminated copy of Nelson's memorandum—a document remarkable for the strategic and tactical novelty of its contents. Nelson broke with the conventional naval wisdom of his day by calling for his ships to attack the enemy fleet perpendicularly, in two discrete columns, rather than forming a single line of battle and attacking the enemy in a parallel formation to maximize fields of fire. This "Nelson touch" proved pivotal in dividing—and destroying—the larger enemy fleet.

The memorandum also outlined Nelson's principles for fighting the upcoming engagement, among them a deep appreciation of the uncertainties involved: "Something must be left to chance; nothing is sure in a Sea Fight beyond all others. Shot will carry away the masts and yards of friends as well as foes." And the memorandum communicated succinctly the idea that individual commanders are better able to master changing conditions when they are empowered with the flexibility to make strategic decisions in the heat of battle—advice as sound today as it was in 1805: "The Second in Command will in all possible things direct the movements of his Line, by keeping them as compact as the nature of the circumstances will admit. Captains are to look to their particular Line as their rallying point. But, in case Signals can neither be seen or perfectly understood, no Captain can do very wrong if he places his Ship alongside that of an Enemy."

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ing caves, and kayaking). And the long-standing messes where personnel can meet and talk to colleagues have only recently been mirrored by corporations in the setting up of attractive communal spaces, dubbed village greens in one organization I know. The value of informal dits is also supported by the Royal Navy's collective *formal* memory, or long-wave culture. At every naval establishment, two books are on display in the entrance, both open at the day's date. One is a book of remembrance for those killed in action on that day; the other details past naval activities on that date. Both draw on the Royal Navy's 400-year history.

benefit from thinking more deliberately about how to foster what in effect is their collective memory. A bust of a long-dead founder in a company's entrance hall is no substitute for the way the Royal Navy meticulously charts its informal experiences of leadership and broadcasts them throughout leadership training. The experience of a special-forces commander in tackling Somali pirates—and his emphasis on the 40 separate scenarios his team contemplated ahead of the engagement—underlined to everyone listening the Royal Navy's meticulous attention to detailed and exhaustive planning.

The Royal Navy allocates time and space for these exchanges: two examples are Stand Easy (a midmorning tea break) and ship's company Adventurous Training (an off-site expedition in which a ship's department—a group that could include anywhere from 12 to 100 people—participates in team and individual activities such as mountaineering, explor-

There's a fine line, of course, between respecting timeless values that can sustain an organization when times get tough and becoming a prisoner of the past or desensitized to changes in the forces at work on that organization. The power of the Royal Navy approach is to focus on what individuals actually *did* in situations big and small, thereby providing inspiration for new challenges while acknowledging that the nature of those challenges and leaders' responses to them are an ever-changing, never-ending story.

In my experience, many organizations that lack a strong collective memory wind up ignoring their own wisdom in uncertain times. They're also more likely to follow the latest nostrum on leadership without digging into their past, thereby deskilling themselves. One antidote is making time for storytelling: low-tech oral history or cutting-edge social-media platforms that give today's leaders new opportunities to spin dits on a regular basis. Finally, although periodic, the process of commissioning and overseeing a corporate history can be of great benefit to the ethos of an organization—an invaluable opportunity for inviting staff members to consider what it has done, what it stands for, and how it does business.

To reiterate, the key is focusing on what individuals did in response to their own unique circumstances, not fixating on a specific set of strategies or tactics. One senior Royal Navy chief carries with him a small laminated copy of Nelson's Trafalgar memorandum (see sidebar, "The 'Nelson touch,'" on page 124), which summarizes the plans discussed by the Royal Navy's Vice Admiral Nelson and his captains nearly two weeks before the battle.[6] The memorandum set out Nelson's intent, strategy, resources, contingency plans, and inspiration—the essence of mission command, a forerunner of project management and the way most military operations are still run. Much has changed in the two centuries since Nelson's historic victory. Still, in today's crowded sea lanes, as much as at Trafalgar, the commander's intent must be understood by everyone, whatever his or her role. How many organizations have that degree of clarity at an operational, tactical, and strategic level?

• • •

Navy life has created a style of leadership that fosters trust, respect, and collective effort. Softer skills such as cheerfulness, storytelling, and the creation of a collective memory—all of which make indispensable contributions to the effectiveness of ships and fleets—merit serious reflection by business leaders, too. o

[1] Andrew St. George, *Royal Navy Way of Leadership*, London, UK: Preface Publishing, 2012.

[2] Andrew Oswald, Eugenio Proto, and Daniel Sgroi, "A new happiness equation: Worker + happiness = improved productivity," *Bulletin of the Warwick Economics Research Institute*, 2009, Volume 10, Number 3.

[3] Robin Dunbar, "Neocortex size as a constraint on group size in primates," *Journal of Human Evolution*, 1992, Volume 22, Number 6, pp. 469–93.

[4] Commander-in-Chief Fleet (CINCFLEET), *Board of inquiry report into the grounding of HMS Nottingham at Wolf Rock, Lord Howe Island, Australia on 7 July 2002*, July 21, 2002.

[5] Marvin Bower, *The Will to Manage: Corporate Success Through Programmed Management*, first edition, New York, NY: McGraw-Hill, 1966.

[6] Off Cadiz, Spain, October 9, 1805; the Battle of Trafalgar itself took place on October 21, 1805.

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Illustration Darren Diss

# Battle-test your innovation strategy

**Marla M. Capozzi, John Horn, and Ari Kellen**

*Leading companies use war games to focus better on their competitors, while improving the way they identify, shape, and seize opportunities to innovate.*

You thought you did everything right—gathered market research and consumer insights; brainstormed, prototyped, and tested a promising new idea; developed detailed financial models and a solid marketing plan. Yet your company's new product or service didn't perform as expected. What did you overlook?

If you answered "the competition," you're far from alone. In our experience, companies making decisions about developing and launching new products commonly fail to anticipate their rivals' motivations and actions.[1] Moreover, the failure often contributes to innovation-related disappointments, many of which are below the radar and quite insidious: your rival, for example, discounts prices to encourage customers to stock up on its product rather than try yours, ties up distributors so you can't get shelf space, or duplicates your service to dissuade consumers from switching.

Unfortunately, in the heat of competition it's extraordinarily difficult for players to identify such threats, because the tendency to overlook rivals is deeply ingrained in human behavior. Indeed, neglecting to think about competitors is one of dozens of natural human biases—along with excessive optimism and overconfidence—that subconsciously affect strategic decision making. Addressing the challenge requires tools and processes that help companies "debias" their decisions.[2]

Recognizing this problem, some companies are tackling it head on by integrating war games into their innovation activities. By simulating the thoughts, plans, and actions of competitors, these companies are improving their products and services, while gaining a deeper understanding of how their innovation assets compare with those of rivals—insights that help them better identify, shape, and seize opportunities.

In this article, we'll look at how companies use war games to sharpen their products and services as they wrestle with three interrelated types of innovation decisions: those involving individual products, portfolios of offerings, and market-entry strategies. We'll focus on situations involving medium-term innovations—new products or services expected within one to three years. While it's obviously important to keep an eye on rivals at *all* times, competitive insights gleaned at this stage are particularly actionable, and a company's ability to adjust its approach relative to competitors, and thereby to change the outcome, is high.

## Product-level decisions

The development team of a consumer-electronics company was debating the mix of components and features to include in the next version of an important product. Advances in the underlying technology meant that the launch, planned for the following year's holiday season, could well represent a significant upgrade that would influence several generations of the product.

To see how the competitive landscape might evolve—and be shaped—the company ran an in-depth war game. Over three days, cross-functional teams of product designers, marketing and sales experts, and supply-chain managers, assuming the roles of executives in the company and a leading rival, participated in a series of games representing three consecutive holiday seasons.

The choices the opposing team made were revealing, for it identified several new components and technologies the competitor might include in its own update of this kind of product. While there were obviously no guarantees the competitor would act as predicted, the rigorous preparation the company had undertaken to ensure that players on both sides would behave realistically suggested that the competitor's rationale for making the moves would be strong.[3] Moreover, if the competitor *was* thinking along the lines the simulation predicted, the resulting changes to its product and market positioning would be significant, requiring a speedy and decisive response from the company.

Fueled by these insights, the company went on to identify a host of moves it could make to seize the initiative—including partnerships, bets on particular technologies, and an attractive, untapped consumer segment it could target to spur growth.

Ultimately, many of the game's predictions did materialize, and when the competitor moved as expected with its new product, the company was ready. Its own updated product was a hit with consumers, and it went on to sell more units than the competitor did over the following three holiday seasons.

An additional insight the war-gaming process sparked was that meeting the needs of the consumers the company was targeting wouldn't always require using the very latest technology. In some cases, an older—and cheaper—one was more than adequate. The company used this knowledge to its advantage in subsequent sourcing and pricing decisions.

To increase the likelihood of gaining such insights, the consumer-electronics company included a range of framing questions when it designed and ran the game. We include a sampling of them here as thought starters for any company looking to plan and run a product-focused war game of its own.

- How much of a lead or leap—technological or otherwise—must we make in the next generation of our product or service?
- How might our new product or service stand up to the pressures of the existing—and, potentially, the new—competitive landscape?
- What price point will our product or service support and sustain?

## Portfolio-level decisions

War gaming can also help companies develop and deploy their product portfolios more strategically across geographies and customer groups. Consider the experience of the global high-tech company whose leaders wanted to better understand how changing competitive dynamics would affect the company's B2B business.

For years the company had sold a comprehensive range of specialized TV models to hotel chains across the price spectrum. (Compared with the company's consumer models, the hotel TVs were more robust, had additional software features, and in some cases were more energy efficient.) Recently, though, new competitors had begun arriving on the scene in force, and competition had increased broadly. To learn what effect the new conditions might have on the company's portfolio of products and how they were positioned, it created four rival teams, each representing a new or established competitor, and ran a series of war games against them.

The results suggested the threat was bigger than the company had suspected. Notably, several of the games quickly degenerated into value-destroying price wars. That outcome helped company leaders understand how quickly its high-end TVs would migrate down to the buyers from lower-cost hotels as rivals discounted prices on their own higher-end units to gain market share. If the company were to maintain its pricing policy, the executives recognized, the resulting profit squeeze would be enormous.

In response, company leaders essentially decided to ignore certain market segments, where price competition would be fiercest—areas it had strongly contested before. Instead, the company would place its biggest innovation and marketing bets on serving midscale hotels. In this growing segment, it had a better chance of differentiating some of its existing products and services, and of creating more value for customers (by helping hotels capture additional revenue streams, for example). The company went on to identify several possible partnerships with players in the industry value chain. It has successfully leveraged these partnerships to begin implementing the new strategy.

Useful questions the high-tech company considered when planning and running the game included the following:

- Which product classes will face the most competition, and will supply-side dynamics or customer demand drive it?

- Can we adapt any of our existing products to differentiate them further for the geographies or segments that will face the most pressure?

- Which customer segments will our competitors focus on, and how do these segments overlap with the ones our new offering targets?

## Go-to-market decisions

Finally, war games are a useful way of testing and refining launch strategies to help ensure that new product and service offerings get the most traction in the market.

That's what happened when a financial-services firm wanted to determine which of a handful of promising new services had the greatest potential to reach global scale quickly and thus should be fast tracked. Company executives were particularly keen to test one technology-driven service that they felt had the potential to catch rivals off guard and to capture additional revenues from much-coveted business customers.

The company ran a series of simulated launches pitting itself against three rival teams whose members began the games unaware of the new service. Executives were surprised to learn how quickly and convincingly the opposing teams reacted to the offering and developed a version of their own. Worse, in some cases an opponent team's offering appeared superior to the company's, or at least close enough that company executives felt it would be tough for business consumers to differentiate between the two. "If we go to market with this offer," said one team member, "we'll get creamed."

This exercise had a sobering effect on the executives, who began to recognize that overconfidence and excessive optimism had clouded their thinking. The company has since gone back to the drawing board and is using many of the observations gathered from the war game to help improve the new service and its market positioning.

Notably, the company's team of developers has also begun identifying ways to use the service's underlying technology to create entry barriers that could help delay a competitive response by up to a year. Given the tendency of players in the industry to copy good ideas quickly, the ability to create such barriers—and to include this skill in regular development activities—should serve the company well in years to come. Questions that it considered in the design and execution of its game included the following:

- What ideas could put our product or service out of business in the next one to three years?
- Can we create value and continued appeal with our service given the possible responses of attackers and other competitors, our responses to them, and their responses to our responses, over a defined period of time?
- What next versions and extensions are required to keep our idea in play, sustainable and scalable, and how do we start building them now?

• • •

War games are a tried-and-true strategic tool, yet relatively few companies use them to innovate. Those that do so effectively can not only avoid the problem of overlooking what the competition might do but also determine how likely their new products and services are to survive in the crucible of the marketplace. o

[1] Academic research supports this view. For example, a 2005 survey of business executives found that the expected actions and reactions of potential rivals almost never play a role in decisions to introduce and price new products. For more, see David Montgomery, Marian Chapman Moore, and Joel Urbany, "Reasoning about competitive reactions: Evidence from executives," *Marketing Science*, 2005, Volume 24, Number 1, pp. 138–49.

[2] To learn more about countering the effects of cognitive biases in strategic decision making, see Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," mckinseyquarterly.com, March 2010; and John Horn, Dan Lovallo, and S. Patrick Viguerie, "Beating the odds in market entry," mckinseyquarterly.com, November 2005.

[3] A full examination of the fundamentals of war-game design is beyond the scope of this article. For ideas on that topic, see John Horn, "Playing war games to win," mckinseyquarterly.com, March 2011.

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**Extra Point**

# Four flavors of frustration

If you're a senior leader pulled in too many directions, worried there aren't enough hours in the working day, and frustrated you're just not getting the right things done, you're in excellent company. A recent McKinsey survey found that only 9 percent of global executives were fully satisfied with the way they spent their time, and roughly one-third were actively dissatisfied. A segmentation analysis of the unhappy leaders revealed four distinct groups of similar size:

### Online junkie

Online junkies stick to the office and spend less time than others managing and motivating their employees.

**Roles:** Wide ranging
**Communication channel:** E-mail, phone
**Pain points:** Personal contact

38% of time spent using **asynchronous messaging**

### Schmoozer

Schmoozers spend much of their time on the outside and can be elusive for their direct reports.

**Roles:** CEOs, sales directors
**Communication channel:** Face to face, meetings with clients
**Pain points:** Strategy, thinking time

29% of time spent on the **phone**

### Cheerleader


Cheerleaders are good with employees, but spend little time with outsiders (including customers).

**Roles:** C-suite executives
**Communication channel:** Face to face, internal meetings
**Pain points:** External orientation

55% of time spent **face to face**

### Firefighter

Firefighters are invariably dealing with emergencies, micromanaging and operationally focused.

**Roles:** General managers
**Communication channel:** E-mail
**Pain points:** Direction setting, meeting people

39% of time spent **alone**

Illustrations by Bill Butcher

For more on senior executives' time challenges and suggested remedies, see "Making time management the organization's priority," on page 26.

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