

Organizational health: The ultimate competitive advantage

Scott Keller and Colin Price



The problem

Only a third of excellent companies remain excellent over the long term. An even smaller percentage of organizational-change programs succeed.

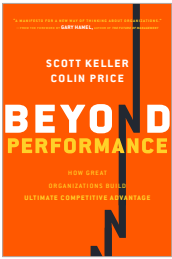
Why it matters

For-profit, nonprofit, or public-sector organizations that beat the odds not only thrive but are also the most meaningful and rewarding organizations to lead.

What to do about it

Embrace the reality that organizational health propels performance. Then transform both simultaneously, with an eye to creating a capacity for continuous improvement. Start the process by determining, given your unique circumstances, where you want to go and how ready you are to go there.

To sustain high performance, organizations must build the capacity to learn and keep changing over time.



This article is adapted from Scott Keller and Colin Price's *Beyond Performance: How Great Organizations Build Ultimate Competitive Advantage* (Wiley, June 2011).

If you're like most senior executives, you want your organization to be exemplary. But if you're honest with yourself, you also know that it's not and that, in fact, you're not even sure what exemplary means or how you'll ever get there. Most management writing won't help: despite the multitude of volumes written on organizational excellence, nothing we're aware of combines a view on the “steady state” of high, sustainable organizational performance with a dynamic perspective on how companies can transform themselves to achieve it.

We've tried to fill that gap with our forthcoming book, from which this article is adapted. Our central message is that focusing on organizational health—the ability of your organization to align, execute, and renew itself faster than your competitors can—is just as important as focusing on the traditional drivers of business performance. Organizational health is about adapting to the present and shaping the future faster and better than the competition. Healthy organizations don't merely learn to adjust themselves to their current context or to challenges that lie just ahead; they create a capacity to learn and keep changing over time. This, we believe, is where ultimate competitive advantage lies.

Getting and staying healthy involves tending to the people-oriented aspects of leading an organization, so it may sound “fluffy” to hard-nosed executives raised on managing by the numbers. But make no mistake: cultivating health is hard work. And it shouldn't be confused with other people-related management concepts, such as employee satisfaction or employee engagement.

Nor should you study what other companies do and then apply their approach. While you can always learn helpful things from others, we have found that the recipe for excellence in a particular organization is specific to its history, external environment, and aspirations, as well as the passions and capabilities of its people. Creating and sustaining your own recipe—one uniquely suited to these factors—delivers results in a way that your competitors simply can't copy.

Why health?

The case for health starts with an understanding of how it relates to performance. Performance is what an enterprise delivers to stakeholders in financial and operational terms. It is evaluated through such measures as net operating profit, return on capital employed, total



We have identified nine elements that contribute to organizational health: accountability, capabilities, coordination and control, culture and climate, direction, external orientation, innovation and learning, leadership, and motivation.

For more on health, see “The link between profits and organizational performance” and “Anatomy of a healthy corporation,” on mckinseyquarterly.com.

returns to shareholders, net operating costs, and stock turns. Health is the ability of an organization to align, execute, and renew itself faster than the competition to sustain exceptional performance over time. It comprises core organizational skills and capabilities, such as leadership, coordination, or external orientation, that traditional metrics don't capture.

More than a decade of research and even more of experience have led us to believe strongly that health propels performance—and that, in fact, at least 50 percent of any organization's long-term success is driven by its health.¹

Statistical evidence

We have developed a survey to measure organizational health and administered it to over 600,000 employees at more than 500 organizations across the globe. The survey's immediate purpose has been helping organizations to measure their health and then to improve in areas of weakness.

But the data we've collected over the years have also enabled us to study the relationship between organizational health and performance. And there's a strong positive correlation. Companies in the top quartile of organizational health are 2.2 times more likely than lower-quartile companies to have an above-median EBITDA² margin, 2.0 times more likely to have above-median growth in enterprise value to book value, and 1.5 times more likely to have above-median growth in net income to sales (Exhibit 1).

The results within individual organizations mirror the results from our large sample of companies. At a multinational oil corporation, for example, we analyzed correlations between performance and organizational health across 16 refineries. We found that health accounted for 54 percent of the variation in performance (Exhibit 2).

'Experimental' evidence

We'd be the first to admit that correlations should be treated with caution. But the case for health doesn't rely solely on them. We've also tested our hypotheses at real organizations trying to improve the way they work.

¹In addition to the evidence presented in this article, we reviewed the existing literature, including more than 900 books and articles from academic journals. We also talked to more than 30 CEOs and to a group of leading scholars.

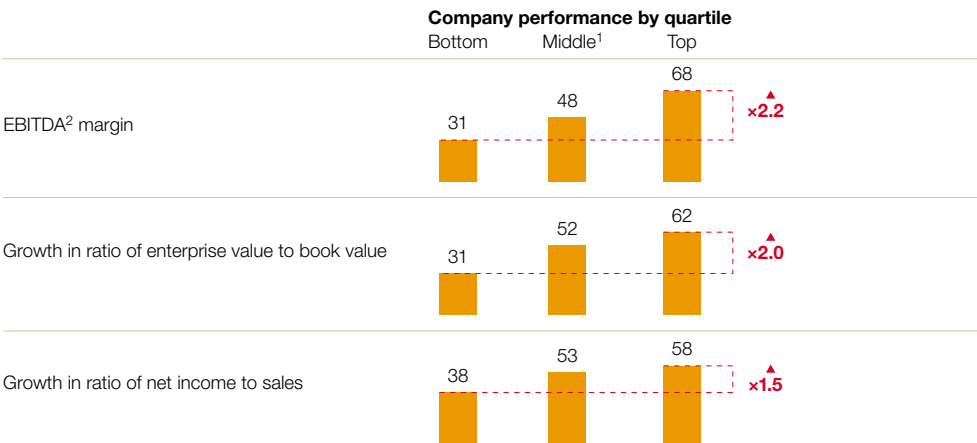
²Earnings before interest, taxes, depreciation, and amortization.

At a large financial-services institution, for example, we selected an experimental and a control group that were comparable and representative of the wider organization by criteria such as net profit before taxes, customer economics, and branch staff characteristics. The two groups then implemented a sales stimulation program over an 18-month period—one using fairly traditional performance-focused

Exhibit 1

Healthy companies perform more successfully.

Likelihood that companies with strong organizational-health profiles have above-median financial performance, %



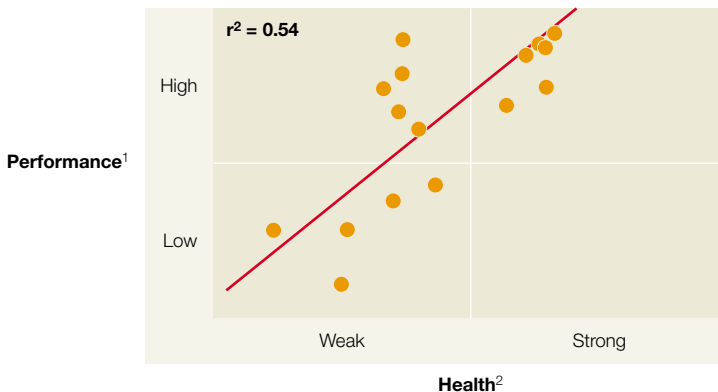
¹ Comprising 2nd and 3rd quartiles.

² Earnings before interest, taxes, depreciation, and amortization.

Exhibit 2

At one oil company, organizational health accounted for 54 percent of the variation in the performance of a group of refineries.

Correlation between organizational health and performance at business unit level; example: 16 refineries at an oil company



r^2 is the proportion of variance explained by a regression.

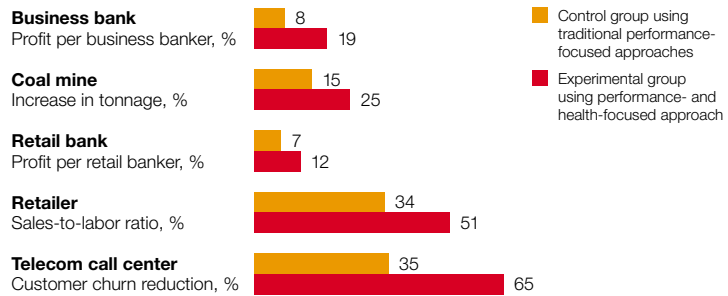
¹ Dollar cost of units produced against industry benchmark.

² Relative to the average of the organizational-health database index.

Exhibit 3

A focus on both performance and health produced higher returns for a variety of initiatives.

Comparison between traditional and experimental change efforts over an 18- to 24-month period



methods, the other following a more balanced approach emphasizing performance and health.³

The results were striking. In business banking, the traditional approach yielded improvements in value of 8 percent, the more balanced approach 19 percent. In retail banking, the traditional approach delivered a 7 percent improvement, compared with 12 percent for one emphasizing performance and health. Similar studies in other industries yielded similar results (Exhibit 3).

Evidence from transformation efforts

Finally, we've surveyed thousands of executives who have been through organizational-change programs.⁴ Data from one survey, on why change programs fail, showed that what we might see as “the usual suspects”—inadequate resources, poor planning, bad ideas, unforeseen external events—account for less than a third of the failures. More than 70 percent resulted from poor organizational health, manifested in symptoms such as negative employee attitudes and unproductive management behavior. Furthermore, our 2010 survey of executives at companies undergoing transformations revealed that organizations focusing on both performance and health rated themselves as nearly twice as successful as those focusing on health alone and nearly three times as successful as those focusing on performance alone.

³During the trial, we took care to minimize any distortions—operational restructuring, changes in leadership, significant staff turnover, or other corporate initiatives—that might have a disproportionate effect on one group.

⁴These McKinsey Global surveys, available on mckinseyquarterly.com, are “Building a nimble organization” (July 2006), “Organizing for successful change management” (July 2006), “Creating organizational transformations” (August 2008), and “What successful transformations share” (March 2010). All subsequent survey data cited in this article come from one of the four surveys.

Working toward ‘and’

The link between health and performance is good news. Unlike many of the key factors that influence performance—changes in customer behavior, competitors’ moves, government actions—your health is something you can control. It’s a bit like our personal lives. We may not be able to avoid being hit by a car speeding around a bend, but by eating properly and exercising regularly we are far more likely to live a longer, fuller life.

Of course, that doesn’t make the pursuit of performance and health any easier. Most companies know how to keep a close eye on performance, but health often suffers from neglect. We asked more than 2,000 executives to name the areas where they wished they had better information to help them design and lead transformation programs, for example. Only 16 percent chose near-term performance. More than 65 percent chose the company’s health for the longer term.

What’s more, even when companies do understand both performance and health, many pursue them separately. The result can be HR-led “people programs” that bear little relationship to a company’s strategic and operational imperatives, performance-improvement initiatives that cut more muscle than fat, or both.

In our experience, building health and achieving its accompanying performance benefits generally require transformational change. The approach we’ve found most effective for pursuing it consists of five stages, which we refer to as the five frames of performance and health. For each stage, you must answer a basic question that applies to both performance and health and then address a related performance- or health-specific imperative (Exhibit 4).

While no two change programs are alike, we believe that the five frames contain the key ingredients for an organization-wide transformation that delivers performance and health in almost all circumstances. In what follows, we offer examples from companies that have excelled in one stage or another to highlight what’s required to tackle both aspects of a transformation—with an emphasis on health, since pursuing it as an explicit goal is less familiar to most organizations. Although we firmly believe that each organization must find its own way through the five frames, these examples of companies that have made significant and lasting improvements in both performance and health offer some inspiration, as well as guidance on tactics we’ve seen work well.

Exhibit 4

Performance and health can be viewed through five frames.

	Performance imperative	Health imperative
Aspire: Where do we want to go?	Develop a change vision and targets that are deeply meaningful to employees.	Determine what “healthy” looks like for the organization in view of your change vision.
Assess: How ready are we to go there?	Identify and diagnose your organization’s ability to achieve its vision and targets.	Uncover the root causes of mind-sets that support or undermine organizational health.
Architect: What must we do to get there?	Develop a concrete, balanced set of performance-improvement initiatives.	Reshape the work environment to create healthy mind-sets.
Act: How do we manage the journey?	Determine and execute the right scaling-up approach for each initiative in the portfolio.	Ensure that energy for change is continually infused and unleashed.
Advance: How do we keep moving forward?	Put in place a continuous-improvement infrastructure to take the company forward beyond one-time change.	Equip leaders to lead from a core of self-mastery.



Aspire

The importance of setting aspirations that emphasize health as well as performance came through loud and clear in one of our surveys: change programs with well-defined aspirations for both, we found, were 4.4 times more likely to be rated extremely successful than those with clear aspirations for performance alone.

Wells Fargo offers an example of how to pursue both: setting strategic objectives and then defining related health essentials. When current CEO John Stumpf became president, in August 2005, he brought his top team together in a two-day offsite session to debate Wells Fargo’s aspirations for its next era. The performance goal that emerged was to

maintain the company's track record of double-digit compound annual growth in earnings per share and revenue. To that end, the team doubled down on the bank's long-term cross-sell aspiration of "going for gr-eight" (eight products per customer), with the medium-term goal of adding at least one product on average to its already industry-leading cross-sell rates. The bank's leaders also set performance targets related to customer loyalty and customer attrition in all key businesses.


But a broader aspiration also emerged, which the team summed up in the phrase "One Wells Fargo." This idea grew out of the realization that a huge amount of the value the team sought to create lay in what it called "mining the seams" of the organization: working together more effectively across the company's lines of business to break down "silo thinking" and give customers a better experience that fulfilled more of their financial needs.

Thinking about the bank as One Wells Fargo helped the senior team focus on changes that would be needed to make the organization healthier: management practices related to customer focus, strategic clarity, and collaborating to share ideas and information were all strong within the lines of business but had to be distinctive across them as well. If One Wells Fargo was the strategy, organizational changes would be needed to support and enable it.

Assess

Before you move from goals to actions, it pays to take a hard look in the mirror to understand your company's readiness to achieve its aspirations. What capabilities matter most to meeting your performance goals, and how strong are they in your company today? What mind-sets about "the way things get done around here" could undermine your quest for health, and what are their root causes? The value of such assessments of a company's readiness to change can't be overstated: in our 2010 survey, respondents at companies that diagnosed problematic mind-sets were four times more likely than those that didn't to rate their transformations as successful.

When Pierre Beaudoin took over the aerospace division at Bombardier, in 2001, for example, he knew that it needed a performance boost to ride out the industry's post-9/11 downturn. He also wanted the company to become a healthy, self-improving organization. The aspirations he set—Can\$500 million in bottom-line savings, along with a continuous improvement in service and products for customers—required lean capabilities that Bombardier lacked at the time, as well as a significant change in mind-sets.



Probing cultural issues wasn't something that came naturally to a company that prided itself on technical expertise. In Beaudoin's words, "It was a challenge for me and for my leadership team to explain why we were spending so much time on the 'soft stuff' when we could be fixing factories, hardware, airplanes. We had lots of conversations explaining that if we did the soft stuff right, our employees, with our help, would be more able to do what they're supposed to do, like make our factories efficient and work on engineering problems."

These conversations and a more formal organizational self-assessment yielded a shortlist of beliefs that limited the value placed on individuals, the role of teamwork, efforts for continuous improvement, and the drive for results. One area where the company urgently needed to change was attitudes toward handling problems. As Beaudoin explains, "Suppose I come to a meeting and hear about four problems, and I slam my fists on the table and say, 'I don't want to hear about problems any more; you guys are there to fix them.' Well, guess what—I'm not going to hear about problems. And that's how you get yourself in deep trouble."⁵

Architect

Once a company knows where it wants to go and how ready it is to go there, it must work out the way from here to there. Countless leaders have told us that this is the hardest part of changing their organizations. But it's also the stage in a company's journey when efforts to improve performance and health start to fuse: they interlock and reinforce one another as a focused portfolio of performance-improvement priorities becomes a vehicle for shifting mind-sets toward health.

To understand what this symbiotic relationship looks like in practice, consider the turnaround A. G. Lafley famously engineered at Procter & Gamble after taking the helm, in June 2000. Lafley established some explicit priorities for P&G: focusing on 10 out of 100 countries, for example, and on four core businesses. Emphasizing these priorities was critical to P&G's performance improvement. It also built a platform for one of Lafley's deeper goals: to make P&G a more consumer-driven and externally focused company—a healthier one, in short.

As Lafley was setting priorities, he decided to draw up a not-to-do list. One item on it was P&G's "skunk works": experimental technology projects outside the company's mainstream businesses. These

⁵For an interview with Pierre Beaudoin on Bombardier's transformation, see Bruce Simpson, "Flying people, not planes: The CEO of Bombardier on building a world-class culture," mckinseyquarterly.com, March 2011.

Lasting, healthy change also requires an organization motivated to go the extra mile over and over again as employees carry out their routine, day-to-day tasks while fundamentally rethinking many of them.

endeavors—which had an annual budget as high as \$200 million—reflected technological goals rather than customer needs and culminated in products and services that had to be “pushed” to the market in the hope they would be taken up. All this worked against Lafley’s customer-focused aspiration. And so the not-to-do list was rigorously enforced: “If we caught people doing stuff that we said we were not going to do, we would pull the budget and the people, and we’d get them refocused on what we said we were going to do.”

Often, shifting mind-sets means changing formal systems, structures, processes, and incentives. At P&G, Lafley made sure that planning processes started with an understanding of consumer trends and reframed the organizational structure to give it a stronger consumer orientation. Finally, role modeling, storytelling, and skill development can also play a vital role in shifting mind-sets. Lafley, for instance, set up an in-house college for managers and dedicated a substantial part of his own time to coaching. Although this soft stuff is often overlooked, it’s vital. Senior executives who told us, in one of our surveys, that they’d implemented initiatives to change their employees’ mind-sets and behavior during a transformation were twice as likely as others to report that it had succeeded.

Act

When it’s time to get moving, pilot programs are almost always the right way to start working on performance. If things go well, successes can be replicated elsewhere; if they go awry, you can confine mistakes to a small area. Early results also help to build your employees’ motivation and appetite for change. One key to successful pilots, we’ve found, is conducting them in two stages: first, a standard proof of concept and, second, a proof of feasibility, which will ensure that you have a replicable means of capturing the value you’ve identified

across your organization. Too many companies don't take the second step and find that they can't build on their initial success.

But even the most carefully constructed pilots aren't enough. Lasting, healthy change also requires an organization motivated to go the extra mile over and over again as employees carry out their routine, day-to-day tasks while fundamentally rethinking many of them. The whole process can feel like trying to change the wheels of a bike while you're riding it. Not surprising, most companies find this difficult: one of our surveys found that only some 30 percent of all executives who had been through a transformation thought their companies had been completely or mostly successful at mobilizing energy in it.

CEO Julio Linares took the reins of Spain's incumbent telecom operator, Telefónica de España, in January 2000, as earnings and cash flow were sliding. He used three methods to create a powerful engine for change as he transformed the company. The first was to help people "understand how the project they were working on would contribute to that year's targets and, therefore, to the overall transformation program." With that goal in mind, Linares and his team emphasized growth, competitiveness, and commitment as critical themes. Developing new distribution models and improving customer segmentation came under the heading of growth; adopting lean work processes and enabling online transactions, of competitiveness; and embedding a new set of company values and reorganizing business units, of commitment.

Second, Linares ensured that the whole company felt ownership of the changes. He and his senior team brought the telco's top 500 executives together every January, for example, to help design the program for the year to come. Beyond this core group, Linares sought to "give relevant people at different levels of the organization an opportunity to participate" in the redesign of the transformation program "and then to complement that with a strong communication program." Sometimes, companies need to reach out even further to create a shared sense of ownership. When structuring the transformation of India's Larsen & Toubro, CEO A. M. Naik explained, "We involved one in four employees, about 7,000 people. I visited 38 locations of the company." He added, "When the vision was finalized" in a document, "everyone could say, 'That word was mine,' you know? Maybe that word was in the minds of a thousand people. But the process created a shared vision everyone could believe in."⁶

⁶For an interview with A. M. Naik, see Ramesh Mangaleswaren and Adil Zainulbhai, "Reinvigorating a corporate giant: An interview with the chairman of India's largest infrastructure company," *mckinseyquarterly.com*, March 2011.



One way to support personal development of this sort is to expose managers to centered leadership—a group of five interrelated capabilities that research by our colleague Joanna Barsh, a director in McKinsey’s New York office, has shown generate higher performance and greater satisfaction at work and in life when used together.

These capabilities are finding meaning in work, converting emotions such as fear or stress into opportunities, leveraging connections and community, acting in the face of risk, and sustaining the energy that is the life force of change.

To read more, see “How centered leaders achieve extraordinary results,” on mckinseyquarterly.com.

Finally, Linares used progress evaluations, which are always important, as a third tactic for maintaining energy. Linares explained the need for them in this way: “The market is going to change constantly, and because of that you need to make a constant effort to adapt your company. Some parts of the program will end, but new ones will come up.”⁷

Advance

The final stage is to make the transition from the intensive work and constant upheaval of a transformation to a period of continuous improvement. According to one survey, companies that build a capacity for it into their organizations are 2.6 times more likely to consider their transformation programs a success over the long term.

Continuous improvement can be cultivated during a major transformation effort by building an infrastructure, as you go, that includes knowledge sharing, learning methods, and expertise to help the company continue to improve. For these to be embraced after the initial transformation effort is complete, the right leadership skills and mind-sets must be in place. After the formal end of a trans-

formation program at ANZ Bank, for example, the company trained more than 6,000 leaders in areas such as self-awareness, resilience, and the ability to energize oneself and others. The response was tremendous: participants spoke of the program’s “profound impact” and described the experience as “life changing.” ANZ also held other personal-leadership workshops to develop its employees’ ability to improve continuously, cascading the workshops right through the organization in a process that eventually touched more than 26,000 employees.

These efforts helped ANZ usher in an era of nonstop progress, which included grassroots business initiatives, organizational de-layering, bureaucracy busting, internal job markets, and greater diversity. Supporting these endeavors were some 180 “champions” who worked, on top of their regular jobs, to foster continuous improvement in the businesses.

⁷For an interview with Julio Linares, see Josep Isern and Julie Shearn, “Leading change: An interview with the executive chairman of Telefónica de España,” mckinseyquarterly.com, August 2005.

ANZ's strong financial performance, in the years after its transformation, was accompanied by striking evidence of organizational health: it had the highest level of staff engagement of all peer organizations in Australia and New Zealand, and the share of employees who agreed that "we live our values" and "are earning the trust of the community" was 85 percent and 81 percent, respectively.



If you want to change your organization for the better and to make the changes stick, you must focus on its long-term health even as you push for higher performance now. We hope our research has convinced you that this sensible-sounding but often-ignored maxim is true. And we hope you see, from the examples earlier in this article, that practical insights and tried-and-true tools will let you tackle performance and health simultaneously. We fervently believe that business, and even society as a whole, will improve when organizations begin to report—and be judged—on their health just as frequently and rigorously as they are on their performance. ○

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