The McKinsey Quarterly

Anatomy of a **healthy corporation**

How can business leaders embed "healthy" thinking in the organization?

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The challenge of sustaining corporate performance has long exercised the minds of executives and management thinkers. Pioneering leaders such as GM's Alfred Sloan and IBM's Thomas Watson, who sought to create enduring institutions, have become the stuff of business legend. And scholars have spilled oceans of ink trying to explain what makes strong performance endure.[1]

Yet many senior executives, try as they might, still find it hard to shift their attention away from today's stock price and the next set of interim results. The forbidding presence of hedge fund and private-equity investors on corporate share registers and the increasingly short tenure of CEOs have only intensified the obsession with short-term performance.

[1] For a summary of recent research on the diverse sources of long-lived performance—sources ranging from complex economic forces to luck, industry attractiveness, and corporate excellence—see Jay B. Barney, "Strategic factor markets: Expectations, luck, and business strategy," *Management Science*, 1986, Volume 32, Number 10, pp. 1231–41; Richard Schmalensee, "Inter-industry studies of structure and performance," in *Handbook of Industrial Organization*, Volume 2, eds. Richard Schmalensee and Robert. D. Willig, Amsterdam: North-Holland, 1989, pp. 951–1009; Richard P. Rummelt, "How much does industry matter?" *Strategic Management Journal*, 1991, Volume 12, Number 3, pp. 167–85; Gabriel Hawawini, Venkat Subramanian, and Paul Verdin, "Is performance driven by industry- or firm-specific factors? A new look at the evidence," *Strategic Management Journal*, 2003, Volume 24, Number 1, pp. 1–16; and Gerry McNamara, Federico Aime, and Paul M. Vaaler, "Is performance driven by firm-specific or industry-specific factors? A response to Hawawini, Subramanian, and Verdin," *Strategic Management Journal*, 2005, Volume 26, Number 11 , pp. 1075–81.

Article at a glance

Executives generally appreciate the importance of monitoring the underlying health of their companies and of taking action to improve it. Impeded by a variety of cognitive and other traps, however, they seldom practice what they preach.

The challenge is to embed healthy thinking at all levels of the organization. The first step is to understand the attributes of a healthy company—in our experience, one that shows resilience to shocks, executes well, aligns employees around a common purpose, focuses on renewal, and ensures that its practices complement one another.

Businesses can work toward this elusive goal by regularly analyzing the way they allocate resources, striking a balance among different types of initiatives, developing appropriate metrics to test their health, adapting their core processes, and reinforcing healthy attitudes through performance contracts.

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A series of articles in *The McKinsey Quarterly* has described the way companies can take steps today to ensure that they perform well not only this year but also in the years to come. Underlying these actions is a mental discipline founded on the simple metaphor of human health, which improves when cared for and deteriorates when neglected. Further research has deepened the understanding of what a healthy corporation looks like and, more important, what business leaders can do to embed healthy attitudes throughout their organizations.

Mental minefields

Given the familiarity of the concept of human health, why do business leaders find it so difficult to nurture health in a corporate context? At least three sets of impediments block the way.

The first might be called the "mindfulness" trap: the tendency to be pulled back into a short-term performance perspective by the press of daily business, much as moments of reflection at home come abruptly to a halt when the doorbell rings. Mental effort enters into the problem too: running through the remaining steps for next week's product launch is less tiring and potentially more satisfying in the short term than pondering, with all the attendant frustrations, how to build a more customer-oriented culture.

Then there are the cognitive traps: a preoccupation with the near-term outputs of performance and what is needed to produce them, the mistaken belief that organizational health is soft and intuitive and therefore lacking the hard-nosed rigor and precision needed to drive performance, and the easy but wrongheaded assumption that near-term performance and long-term health embody a set of trade-offs (and that the first to some extent precludes the second). Another cognitive trap—the long-term one, an insidious complement to its short-term counterpart—assumes that health problems arise in the unknown future rather than taking hold (as we know, for example, from our own cardiovascular systems) in the present.

Finally, there is the self-knowledge trap: our tendency to say (and believe) one thing and do another. One management scholar, Henry Mintzberg, famously demonstrated in the 1970s that managers often see themselves as strategic visionaries, though in practice they spend a remarkably small proportion of their time on anything related to strategy. Likewise, it's hard to find managers who don't acknowledge the importance of managing a company's health, and most insist that they already do so a lot even if they should be doing more. Yet when you diagnose what happens in major organizations, executives are frequently surprised by the disparity between what they think they are doing and what they actually do. The managing director of a North American chemical manufacturer we know talked a good game about regenerating and replacing assets—and then promptly promoted and lauded two site managers who had met their short-term financial targets by starving the facility of maintenance capital.

Attributes of health

What characteristics must companies have to be truly healthy? It's important for executives to develop a clear picture of what sound health really looks like before they try to embed healthy thinking in a company's processes and people. To arrive at this clear picture, we did three things. First, in an effort to mine what was already known about the question, we reviewed more than 800 empirical-research papers, journal articles, and books published from the 1950s to 2005. Second, we analyzed 60,000 responses to an organizational-health survey we have administered to employees and managers at hundreds of companies over the past five years. Last, we distilled what we learned from a series of executive forums and more than 30 in-depth interviews with functional leaders across all disciplines.

We winnowed the resulting insights to find those that had support from empirical evidence; were broadly applicable across companies, industries, and geographies; and could be acted upon in a practical way. Then we distilled the survivors into five overarching characteristics of business health: resilience, execution, alignment, renewal, and complementarity.

It's important to stress that we are not trying to claim that these five have a causal relationship with corporate health; we made no effort to isolate the five characteristics from other possible success factors, such as the macroeconomic environment, the attractiveness of different industries, or luck. We also recognize that trade-offs and tensions among the five characteristics must be managed.

Nonetheless, these characteristics represent a coherent and interrelated set of ideas. Resilience and execution can be seen as what it takes to get into a “bracing” position—the ability to withstand shocks and discontinuities. Renewal and complementarity are more associated with what sporting commentators call the “front foot”: the ability to see and act proactively rather than merely react. Alignment around a common goal is desirable whether companies are in the bracing position or on the front foot.

Resilience

We know that markets are unkind, customers fickle, and competitors relentless. Beyond these everyday problems, managers must contend with unpredictable and often threatening disruptions: financial-market meltdowns, extreme weather conditions, power failures, even terrorism. Healthy companies are practiced at spotting and managing key risks (including low-probability but high-impact catastrophes), and they build mechanisms and have the resources—cash reserves or backup IT systems—to get through difficult periods. Wal-Mart Stores’ ability to reopen most of the 125 stores in the path of Hurricane Katrina within a few days owed much to an alternative railroad supply system, which temporarily replaced paralyzed highways, that the company had set up for just such an eventuality. Land Rover wasn’t as farsighted: the British automotive company had a near brush with disaster in the 1990s, when the sole manufacturer of its chassis went bankrupt, jeopardizing more than 11,000 jobs.

Execution

Even as companies hedge against external shocks, they need to get the basics right, make good decisions, and perform essential tasks. Brilliant products, clever promotions, or surging markets can obscure sloppy execution for a while. But sooner or later, as Atari spectacularly demonstrated when it fell from grace in the mid-1980s, this kind of fragility will be exposed; the games company lost the ability to turn out high-quality products because it focused too much of its energies on marketing and cost control.

As both our experience and our reading of the academic research suggest, companies that execute well share certain attributes: distinctive capabilities, the ability to make sound and timely decisions, strong forecasting skills, and employees who understand their roles and responsibilities. Too many managers take these things for granted. A healthy company pays attention to them constantly.

Alignment

Many companies seem robust in the face of external surprises and good at conducting day-to-day business, yet their managers and employees lack cohesiveness of purpose. In our experience, healthy companies, however scattered and disaggregated physically and organizationally, generally work toward a common cause. They usually achieve this kind of alignment when they sketch a compelling vision of the future for everyone connected with them—employees in particular—by articulating a shared identity that rises above individuals, functions, and business units; by reflecting stakeholder concerns in corporate values; and by reinforcing the sense of common purpose with formal mechanisms, such as performance contracts.

Renewal

Healthy companies invest in their future by expanding into well-chosen markets where existing assets and competencies provide real leverage, usually with the help of a winning formula that has been honed from experience and facilitates smooth integration across the entire value chain and the efficient extraction of synergies. Nike's forays into golf, ice hockey, and soccer in the areas of footwear, sportswear, and equipment, for example, follow a pattern that the company first set with basketball.

Renewal also requires attention to softer issues, such as the ability to generate ideas and adapt to change, both culturally and strategically. Markets and industries move quickly; most companies do not. Smith Corona was a peerless and highly successful typewriter maker until the electronic age overtook it.

Complementarity

The concept of complementarity, explored in detail by John Roberts in his book *The Modern Firm*,[2] often figures in organizational practices, such as hiring policies, training programs, and consistent and mutually reinforcing behavioral incentives. Toyota Motor has long been singled out as a company whose aspirations for quality, management of suppliers, and capability-building and management systems all serve to reinforce the drive for steady improvement.

Effective communication and collaboration are crucial to ensuring that assets, processes, relationships, and management practices act in concert. Typically, in healthy companies information flows *across* the organization, as well as from top to bottom, tapping into social networks beyond the formal organizational structure.[3]

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[2] John Roberts, *The Modern Firm: Organizational Design for Performance and Growth*, Oxford: Oxford University Press, 2004.

[3] For more on networks and organizational performance, see Robert L. Cross, Roger D. Martin, and Leigh M. Weiss, "Mapping the value of employee collaboration," *The McKinsey Quarterly*, 2006 Number 3, pp. 28–41; and Robert L. Cross, Salvatore Parise, and Leigh M. Weiss, "The role of networks in organizational change," *The McKinsey Quarterly*, Web exclusive, April 2007.

Healthy actions

The five attributes we've outlined are emergent characteristics of a company's performance system rather than narrow outputs of performance. A manager therefore cannot expect to take an action or a set of actions that automatically "creates," say, resilience or renewal, much as the effect of medicine on a fever depends on what's going on elsewhere in the patient's body.

For this reason, executives must not think of any one of the attributes as though it operated independently. There are invariably tensions among them—moving to improve one could weaken or compromise another. To the extent that renewal involves adaptation or a radical transformation, for example, a company's usual execution skills can suddenly look obsolete and ineffective. What's more, making all the different parts of an organization complement one another generally yields value, but changing a single element, without being sensitive to its impact on the rest, could ultimately jeopardize the performance of the whole.

The discipline of managing tensions among the different characteristics of health requires a willingness to transcend daily routines and conventional mind-sets and to view the performance system in its full complexity. Vital corporate and individual processes are highlighted by our suite of recommendations: breaking down a company's resources into separate performance and health components, ensuring a balanced portfolio of strategic and other initiatives, integrating that approach into planning and budgeting, identifying metrics for assessing health, and building health into formal performance mechanisms. Individually, and even collectively, these recommendations do not create health or, still less, its attributes. They do help an organization to focus routinely and instinctively on the health imperative and to avoid falling into the traps identified earlier.

Monitor the way you allocate resources

The quickest way to get everyone in an organization thinking deeply about its health is to break down resources into two categories—those devoted to driving performance and health, respectively. One ready reckoner is labor costs: executives, for example, should routinely know how many of their employees work on delivering the current operating plan as opposed to looking after the underlying health issues described earlier. That way, they can have well-informed conversations about whether or not they are investing resources in a balanced way.

Exhibit 1 shows how one financial institution further breaks down its resources by taking all the money going out of the business during a quarter and splitting it into two piles: payments for current operations (expenses

EXHIBIT 1

A new look at resources

Disguised example of European financial institution

Traditional income statement

	€ million	%
Total income	**41,235**	**100**
Expenditures		
Personnel	18,132	44
Product advertising	932	2
Corporate advertising	376	1
General and administrative expenses	7,103	17
Management training and development	1,263	3
Depreciation of property and equipment	1,034	3
Amortization of goodwill and other intangible assets	673	2
Goods and materials	2,678	6
Total expenditures	**32,191**	**78**

Restructured expense overview

		Expenses	€ million	%
Performance	**Current account**	Personnel	15,676	38
		General and administrative expenses	7,103	17
		Depreciation of property and equipment	1,034	3
		Amortization of goodwill and other intangible assets	673	2
		Goods and materials	2,678	6
		Subtotal	**27,164**	**66**
Health	**Strategic account**	Innovation	1,124	3
		Productivity/scale	1,332	3
		Reputation/influence	1,308	3
		Institutional capability	1,263	3
		Subtotal	**5,027**	**12**
		Total	**32,191**	**78**

necessary to generate that quarter's revenue) and payments for everything else. The first stack can be defined as purely performance related; the second represents longer-term investments, excluding in-kind capital replacements. Regularly making these calculations allows executives to see how much IT expenditure, say, goes toward innovation and R&D (health) and how much toward improving labor productivity (performance). It also allows them to compare the company's investments in health-related activities (such as brand building, lobbying, and community outreach) with the cost, for instance, of outsourcing operations to boost profitability (performance).

Balance the strategic portfolio

Companies can keep an eye on their health by regularly assessing all their business ideas and new initiatives—projects or programs to change or improve something in the business. They should evaluate these projects both by mapping the point when each would be likely to create the greatest value and by looking at whether a project involves familiar, routine work that plays to their strengths and experiences or is a novel departure, which could be riskier and consume additional resources. Healthy companies seek to keep a balance between the two and know that it is not a trade-off between the short and long terms: investing for the long term means action today.

One North American chemical manufacturer we know reviews its project list quarterly, updates the expected value of initiatives once a year, and seeks to ensure that they always represent a mix of efforts to deliver immediate performance and those likely to bear fruit in subsequent years. Companies can use this approach to manage the different attributes of health: one European retail bank designed the initiatives charted on the grid in Exhibit 2 to strengthen its renewal and execution capabilities.[4]

Integrate into core processes

Extending health-oriented strategic thinking into detailed planning and budgeting processes is the next step; for instance, an analysis of the underlying health of cash flows should inform traditional budget reviews. One idea that we find works well is to initiate, as a formal part of the performance-management process, a health dialogue that might touch on the relevance of investment priorities or the product pipeline to a company's future performance. Reviews can also examine human-resource allocations and the way executives spend their time—an exercise that can yield surprising results about their practical commitment to the company's health. A Middle East oil joint venture, for example, recently identified six priority processes as the object of its new focus on health: managing the portfolio of assets so that it contains a full range of projects, at all stages of the hydrocarbon maturation life cycle; managing wells and reservoirs; capital execution; contracting and procurement; talent management; and operational excellence.

Have the metrics to match

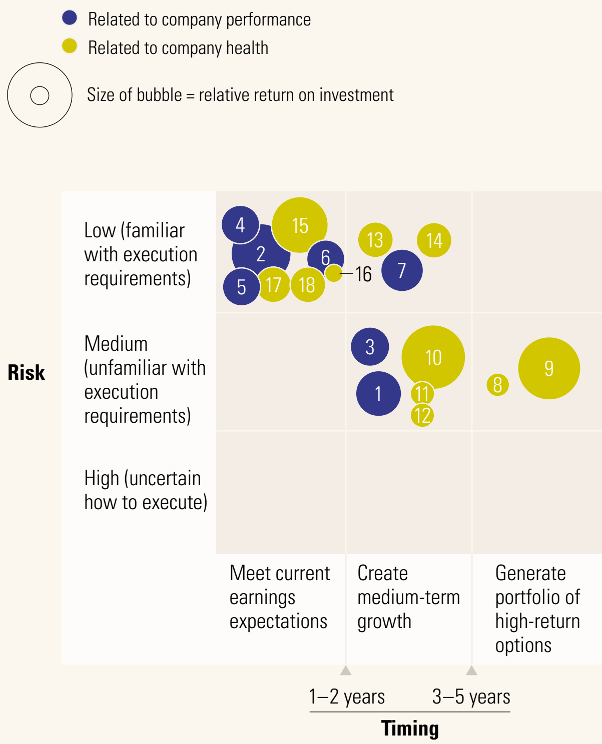
Many businesses make a religion out of counting their new customers and the growth of their revenues. Banks look at their cost–income ratio, insurers at the combined ratio. But these metrics don't necessarily measure corporate health, so executives should develop a number of health variables for each of the attributes vital to the health of the business. A retail bank, for instance, might test its resilience by tracking its credit fraud volumes and recurring revenues or its execution skills by determining the turnaround time on loan applications. A company can monitor its alignment by calculating the proportion of its senior managers who disagree about strategies and corporate priorities. To concentrate the minds

[4] For more on this portfolio-of-initiatives approach to strategy, see Lowell L. Bryan, "Just-in-time strategy for a turbulent world," *The McKinsey Quarterly*, 2002 special edition: Risk and resilience, pp. 16–27.

EXHIBIT 2

A balanced portfolio of initiatives

Disguised example of European retail bank



Initiatives

Performance

1 Turn payments services into profitable business
2 Increase low-cost deposits
3 Turn low-value deposits into fee-based transactions
4 Double volume of loan bookings
5 Standardize remittance-processing system
6 Eliminate branch back office
7 Remove redundancy of branch network

Health

Renewal

8 Offer financial consulting
9 Sell mutual funds
10 Launch bancassurance products and services
11 Launch electronic cash-payment scheme
12 Acquire consumer loan books
13 Tailor products for overseas foreign workers
14 Integrate credit cards into retail product suite

Execution

15 Employ customer relationship management (CRM) for mass-affluent customers
16 Conduct product rationalization
17 Cross-sell to credit card holders
18 Cross-sell credit cards to depositors

of its executives, it can test its capacity for renewal by tracking the share of its revenues from new markets and new products and its complementarity by calculating how much of its revenues come from products and services that span business units and from promotions.

Companies typically use key performance indicators (KPIs) to track how they are doing, but health measures are different in nature.[5] The approach we recommend can be helpful in identifying where a company most urgently needs to act.

[5] A fuller discussion of metrics can be found in Richard Dobbs, Keith Leslie, and Lenny T. Mendonca, "Building the healthy corporation," *The McKinsey Quarterly*, 2005 Number 3, pp. 62–71, in which the authors explain why companies should focus on a manageable number of health metrics covering the main areas of the business—not least important, operations, marketing, and external relations.

EXHIBIT 3

A contract for health

Disguised example of European retail bank

Eastern region branch manager
Performance and health contract

		Weighting, %
Performance	Cost-to-income ratio <75%	20
	Income per customer per year >€300	20
	Cross-selling	15
Health	Create new customer segmentation	10
	Increase customers' use of ATM and online channels	10
	Recruit 5 sales representatives in 1st quarter	5
	Train 50% of team in customer relationship management	5
	Establish team satisfaction survey	5
	Demonstrate company's key leadership skills	5
	Improve communication skills course	5

Factors in a health performance contract

- Individual incentive scheme explicitly includes company health goals
- Overall business priorities define indicators of company performance and health
- Personal- and team-development objectives support business targets
- Manager is involved early in target setting to ensure full buy-in
- Contract is agreed to up front and documented

Reinforce through performance

Once a company has redesigned its regular strategic, budgeting, and planning processes to inject a strong dose of "healthy" thinking—and appropriate metrics are in place—executives must embed health in formal people-management mechanisms, including performance contracts, incentives, career path planning, and staffing decisions. Managers at all levels should know the expectations set for them. Companies should use the metrics discussed earlier to structure evaluations ensuring that employees reap rewards as much for doing health-building work as for enhancing performance.

Exhibit 3 gives an example of what a contract might look like. The precise weighting of targets depends on the situation of the individual company and the extent to which it already has struck the right balance between performance and health. The early—and full—involvement of managers in any discussion about adopting this approach is a key prerequisite for success.

Whatever gratification executives may get from a juicy set of financial results, the shareholders will ultimately judge them on their ability to repeat these achievements year after year. Becoming well acquainted with the attributes of health—and the tensions among them—is the first step in confronting that challenge. Unless companies embed a health consciousness in their key management processes, the goal of sustained performance will likely remain elusive. Q

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