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

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

The problem

Building a healthy organization is difficult. “One off” reorganization initiatives often bring only ephemeral benefits. Attempts to close every benchmark and best-practice gap also end in disappointment.

Why it matters

Sustained organizational health is among the most powerful assets a company can build. Healthy companies generate total returns to shareholders three times higher than those of unhealthy ones.

What to do about it

Companies that consistently outperform their peers typically follow one of four distinct organizational “recipes,” each characterized by a distinct set of management practices. Leaders should identify the one that most closely matches their strategic aspirations. The trick then is to be truly great in a handful of practices rather than trying to master them all, while avoiding “recipe killers.”

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

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

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

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

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

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

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

How we track health

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

When we have done this with similar units—such as factories, processing units, and regions—in a given company, we have frequently found a strong correlation between organizational health (as measured by our survey) and the unit's financial or operating performance.

For example, when we established health scores at 16 refineries in the same energy group, we noted a sharp linear relationship between those scores and each refinery's performance as defined by gross profit per unit of output. Health explained 54 percent of the variation in the units' profits.

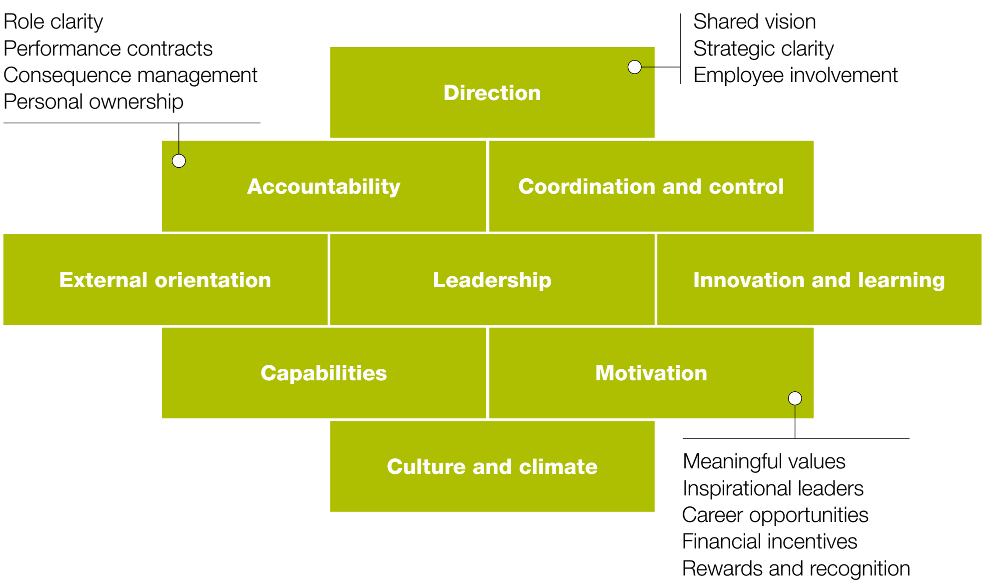
[2]These were the fortunate ones. Our global survey shows that only one-third achieve change goals.

[3]On a scale ranging from "never or almost never" to "always or almost always."

Exhibit 1

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

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



In the insurance industry, we found similar results when we compared 11 claims-processing sites. In this case, we found a strong correlation between health (as defined by the site-specific summary score) and performance (defined as a carrier's specific proprietary amalgamated metric across indemnity, expense, and customer-satisfaction metrics). Health differences explained about one-third of the variation in performance.[4] This is a significant number, since the remaining two-thirds includes known determinants of performance, such as competition, macroeconomic forces, and local-market dynamics (we did not evaluate the relative importance of these forces, which, unlike organizational health, leaders cannot control).

After replicating these findings across many clients and industries, we began to wonder about the strength of the health effect. Could health possibly explain performance variations across companies, industries, and geographies?

[4] The explanatory power rose to 56 percent when a single outlier was removed.

When we compared the health metrics of more than 270 publicly traded companies[5] with their financial-performance metrics, we found that the healthiest generated total returns to shareholders that were three times higher than those of companies in the bottom quartile and over 60 percent higher than those of companies with "middle of the road" health profiles. We have not yet isolated the specific health effect for the sample as a whole, but judged by the energy and insurance-company examples, it is likely to be substantial.

Management practices matter

The most interesting findings, though, came when we looked more closely at the healthiest organizations in our database. Obviously, all had high health scores as measured by the nine outcomes of health. But when we delved deeper and looked at the 37 practices that management teams focus on to deliver those outcomes, we discovered that four combinations of practices, or "recipes," were associated with sustained success. Indeed, further analysis showed that companies strongly aligned with any of these four organizational recipes were five times more likely to be healthy and to deliver strong, sustained performance than companies with mixed (or random) recipes.

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

The hallmark of the first, or *leader-driven*, recipe is the presence, at all of an organization's levels, of talented, high-potential leaders who are set free to figure out how to deliver results and are held accountable for doing so. This open, trusting culture is typical of highly decentralized organizations or of new businesses, where the resolve of strong leaders, effectively multiplied by their peers across the organization, is essential to create something from nothing. While most organizations use career opportunities to

[5] The full database includes many nonpublic companies and government organizations that were excluded for this analysis.

motivate employees, companies in this cluster use career opportunities as a leadership-development practice. Role modeling and real experience are more important than passing along sage lessons.

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

Exhibit 2

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

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

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

The third recipe, which we call *execution edge*, includes companies that stress continuous improvement on the front line, allowing them to raise quality and productivity constantly while eliminating waste and inefficiency. These companies place a heavy emphasis on sharing knowledge across employees and sites—not just as a way to foster innovation, but, paradoxically, also as the primary way to drive standardization. Knowledge sharing helps to manage the frequent trade-offs between the top-down need for networkwide consistency and bottom-up encouragement of employees; without it, the best ideas might not get disseminated across different units of an organization. Such companies are unlike market-focused ones, which push alignment and consistency more strongly from the top down by analyzing external trends and developing a clear strategy for where the market is going.

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

Implementing a healthy recipe

The case of a global chemical manufacturer we know highlights the power of the recipe approach. This company faced increasing energy costs, intensifying international competition, stricter environmental regulation, and the shutdown of one of its sites in an environmental-permit dispute. It had to move quickly to reduce its costs, improve its maintenance productivity, and raise production.

This company's mining operation had approximately 450 employees distributed in an area more than five times the size of Manhattan. A health-feedback session where the voice of the organization was "mirrored" back to it showed clearly that the appropriate recipe was execution edge. After an action-planning workshop, executives developed interventions to encourage the most important practices for this recipe: knowledge sharing, employee involvement, and a creative and entrepreneurial environment. Efforts were made to redefine the role of frontline supervisors (including retraining), to engage the frontline workforce, and to step up the impact of employee communication. These initiatives led to greater employee involvement in decisions and more bottom-up knowledge sharing.

For example, the company introduced regular one-on-one visits between miners and supervisors to discuss productivity strategies, to review progress meeting production targets, and to engage in "micromine planning." Supervisors became the bottom-up conduit for cross-fertilizing these ideas in daily shift-production meetings, weekly "step back" meetings, and monthly management meetings.

Other miners and supervisors, motivated no doubt by the continuing emphasis on accountability for production, voluntarily adopted the best solutions. Not unexpectedly, the miners and supervisors began to feel greater ownership of their work, and employee engagement increased by 20 percent.

As for the operational-performance goals, wrench time[6] increased to 45 percent, from a baseline of 22 percent. Productivity, in turn, rose by 50 percent over a two-year period, generating additional profits of $350 million. Costs fell sharply, with annual run-rate savings of approximately $180 million.

It is worthwhile noting that the transformation blended health objectives with performance goals. Neither was treated in isolation. One reinforced the other, making each immediately relevant and maximizing the likelihood that the organization will sustain performance and respond successfully if challenged again by severe market disruption.

[6]An indicator of maintenance performance: a measure of the amount of time that craft personnel spend actually carrying out their primary tasks (for instance, using tools to make a repair), as opposed to time spent traveling from project to project or sitting in meetings.

Building a healthier organization

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

The imperative of alignment between strategy and health

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

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

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

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

The importance of selection

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

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

The danger of recipe killers

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

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

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

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

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