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The Next Normal

# Transformation with a capital T

Delivering sustainable change

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# Introduction

Welcome to the "next normal"—the new reality emerging from the ongoing COVID-19 pandemic. How will life, public health, and business continue to change? We've chronicled our response in a wide-ranging series of publications—more than 575 articles and counting since the outbreak began.

This volume is the second of five edited collections produced to accompany "Our New Future," a multimedia series airing on CNBC, examining the forces and themes shaping the next normal. Our first segment and its accompanying collection can be found in the article "How six companies are using technology and data to transform themselves," on McKinsey.com.

This collection focuses on transformations: intense, organization-wide programs to enhance performance and boost organizational health. Many CEOs say they have been involved in multiple transformations, yet few have delivered even a single, sustainable, at-scale effort.

In these pages, we have collected some of the best insights we have published recently on the difficult topic of transformation—on how to lead these efforts under any circumstances, on how the coronavirus has compounded the challenge, and on specific industry case studies. We have also included content that has resonated particularly powerfully on McKinsey.com, plus articles authored by Harry Robinson, global leader of McKinsey Transformation and anchor of the transformation segment of our multimedia series on CNBC. We hope you find these insights useful as you continue to navigate your way into the evolving next normal.

Over the coming weeks, we will publish three more collections to complement segments on CNBC. Topics feature organization, sustainability, and resilience. You can download this and other collections in this series as they become available at McKinsey.com/thenextnormal, where you will also find our entire collection of coronavirus-related insights.

**Raju Narisetti**
Publisher
McKinsey Global Publishing

# Contents

# Navigating coronavirus

# The CFO's role in helping companies navigate the coronavirus crisis

Strong, steady leadership from the finance organization is critical for addressing immediate concerns about safety and survival, stabilizing the business in the near term, and positioning it for recovery.

*by Ankur Agrawal, Kevin Carmody, Kevin Laczkowski, and Ishaan Seth*

**The spread of the novel coronavirus** has created a worldwide humanitarian and economic crisis. The events we are living through are in many ways unprecedented, with large-scale quarantines, border closings, school closings, and physical distancing. Governments and communities have been jolted into action to "flatten the curve."

Organizations, too, have needed to accelerate their actions to protect employees, customers, suppliers, and financial results. The challenges are many and varied: with some companies losing up to 75 percent of their revenues in a single quarter, cash isn't just king—it's now critical for survival. While always important, digital connectivity is now fundamental to the continuity of business operations, as remote work becomes the norm across much of the globe. The need for frequent, transparent communication with colleagues and investors has only ramped up in importance as business conditions, epidemiological forecasts, and rules of conduct change daily, if not hourly.

Amid all this uncertainty, the CFO can play a strong, central role, alongside executive peers, in stabilizing the business and positioning it to thrive when conditions improve. The CFO is the leader, after all, who day to day most directly contributes to a company's financial health and organizational resilience. Our experience in helping clients through both internal and external crises offers lessons about the actions that CFOs should take in the wake of the pandemic to put their companies on a sound financial footing and help reduce some of the fear and uncertainty. We share those lessons in this article, outlining the critical steps CFOs and finance organizations can take across three horizons: immediate safety and survival, near-term stabilization of the business in anticipation of "the next normal," and longer-term preparations for the company to make bold moves during recovery.[1] Our guidance is based partly on empirical research McKinsey has conducted on companies that outperformed competitors coming out of previous crisis points and recessions.[2]

## Resolve and resilience: Addressing the immediate crisis

Economically, the COVID-19 crisis is most immediately one of liquidity and resulting financial stress. As the coronavirus has spread, thousands of companies have had to close their doors temporarily. Their supply chains have been disrupted. Consumers can no longer make many discretionary purchases. The finance leader's top priority, then, has to be optimizing cash reserves, as the magnitude and duration of the crisis remain unclear. Specifically, the CFO should focus on assessing the company's liquidity, launching a centralized cash war room, developing different scenarios based on potential paths of the virus's spread, and rolling out an internal and external communications plan.

### Launch a cash war room

Most CFOs are already moving quickly to quantify their companies' cash on hand as well as any incremental capital they can access. Finance leaders will need to forecast cash collections associated with the latest sales projections. With many customers delaying payments, however, some companies may need to double down on collections to remain solvent. When working capital is no longer sufficient, CFOs should consider tapping lines of credit and other options while reviewing opportunities to raise capital, such as through divestitures or joint ventures. If necessary, they should also seek relief on debt covenants as early as possible to strengthen the balance sheet before doing so becomes a matter of survival. In such times of crisis, when a cash shortage is a distinct possibility and conditions are changing constantly, setting up a cash war room can help CFOs implement aggressive curbs on spending throughout the organization. Additionally, CFOs can use various tools or mechanisms—what some would call a "spend control tower"—to prioritize payments and impose clear reporting metrics that track liquidity in real time.

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[1] For regularly updated articles on the business implications of the coronavirus pandemic and how organizations can respond, see McKinsey's collection, "Coronavirus: Leading through the crisis," on McKinsey.com.
[2] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com.

### Develop scenarios

Amid this period of heightened uncertainty, finance and strategy teams will need to rely on a range of scenarios rather than on individual time-horizon–based frameworks.[3] The finance leader should develop a point of view about two or three integrated scenarios that encompass multiple eventualities—for instance, which paths might the pandemic take, and which geographies or industries are poised for faster recovery than others? The CFO should also articulate clear thresholds or trigger points that suggest what financial actions the company will take and when. The financial planning and analysis (FP&A) group is uniquely positioned to help in this regard, as it works closely with the business units and can help project the effects of the pandemic on various aspects of demand and supply. Rolling forecasts should incorporate both macroeconomic and company-specific data to identify major areas of EBITDA risk. The forecasts should also identify second-order impacts, such as geographical supply-chain disruption and employee dislocation, as well as likely sources of cash leakage and customer-liquidity projections.

Once all this is in place, the CFO should guide the creation of a framework that a small executive team can use to make business decisions (to rationalize projects, for example) and monitor conditions (for triggers that might cause various scenarios to unfold, for instance). The CFO will need to track in real time the effect that cash decisions are having on the company's ability to ride out the downturn and resume business operations once demand begins to bounce back.

### Institute a communications plan

The CFO must take a lead role in the financial and strategic aspects of crisis management. As mentioned previously, the company's primary finance focus during this period will be on implementing a "cash culture"—that is, preserving cash and deploying it dynamically. The CFO must communicate this priority throughout the organization and help establish incentives to reinforce it so that all departments and business units understand "why this matters now" and what their specific role is in helping optimize cash.

It is equally critical to communicate proactively with boards of directors and investors. The message to both should focus on the crisis's actual and projected effects on the company, the actions being taken to protect the business, the liquidity situation, and any changes to earlier earnings commitments. In addition, the CFO would be wise to increase the frequency of investor communications after the first few months of upheaval, particularly when new information is available. Such connections are essential for demonstrating that executives are taking fast and resolute action based on their best understanding of the situation.[4]

# The CFO should guide the creation of a framework that a small executive team can use to make business decisions and monitor conditions.

[3] "Economic Conditions Snapshot, March 2020: McKinsey Global Survey results," May 2020, McKinsey.com.
[4] For more on communicating with investors during this crisis, see Tom Kolaja and Tim Koller, "When investors call: How your business should talk about coronavirus," March 2020, McKinsey.com.

## Return: Stabilizing the business

Once concerns about cash preservation have been addressed, the CFO needs to ensure that the company is positioned to operate effectively in this next normal. The finance leader's critical tasks here will include making operational improvements to bolster productivity, reevaluating the investment portfolio, and investing in the finance function's capabilities.

### Bolster productivity

Our research shows that, during the last economic crisis, a small subset of leading companies (we call them "resilients") pursued productivity improvements more often and more frequently than others, creating the capacity for growth during recovery.[5] As a result, they outperformed competitors, doubling their generation of TRS over the subsequent decade. What's more, when compared with peers, the resilient companies reduced their operating costs by three times as much—and they made the moves to do so 12 to 24 months earlier than peers did.

The CFO and the finance organization can make several operational moves to support near-term performance improvements. For instance, to shore up revenues, the CFO can promote the development of new products and services that will assist customers who are experiencing financial difficulties, thereby promoting loyalty from valuable customer cohorts. The CFO can actively reallocate resources to businesses with strong existing revenue streams and optimize the company's use of alternative sales and delivery channels, such as e-commerce.

With much of the world in lockdown and demand falling, it will be necessary for finance leaders to take decisive actions for reducing operating costs, but it will also be critical for CFOs to maintain some flexibility and to balance those reductions against the eventual need to scale operations back up as the economy recovers. In the meantime, the CFO and finance team can also bring some rigor to

spending management by implementing rapid zero-based budgeting for all discretionary expenditures, such as indirect procurement.

### Reevaluate investments and strengthen the balance sheet

CFOs should use this period of crisis as an opportunity to perform a deep diagnostic on the balance sheet—for instance, reviewing goodwill impairments; refinancing debt; reducing inventory, accounts-payable, and accounts-receivable terms; and so on. This sort of balance-sheet cleanup can extend the company's financial flexibility while keeping everyone focused on key metrics at a chaotic time. Additionally, CFOs should guide peer executives in a review of major R&D, IT, and capital allocations and use the opportunity to optimize the company's investment portfolio. It is very likely that business units' initial projected returns on investments will have changed significantly as a result of the pandemic. Finance leaders will need to quickly shift human and financial resources to higher-yielding projects and the initiatives most valuable to the company's future.

### Turbocharge the role of financial planning and analysis

Under crisis conditions, the FP&A team must accelerate its budgeting and forecasting work, providing continually updated business information that the CFO and the finance organization can then incorporate into an integrated forecast. The FP&A team should use collaborative tools to monitor and manage key performance indicators; in a crisis period, issues with data latency will not be acceptable. And the team's updates need to become a true rolling forecast, supported by a "decision cockpit"—a real-time dashboard business leaders can use to focus on the seven to ten key metrics that will guide the organization's operations through the coming months.

Some finance organizations may lack executives with the skills necessary to elevate the FP&A team into such a role—those with analytics and business

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[5] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com.

backgrounds may be in particularly short supply. To build up the finance bench, the CFO will need to scout for dynamic, proactive individuals; explicitly recognize their performance; and support their experiments with new tasks and new roles on the fly. Additionally, with the likely sudden and dramatic rates of unemployment in many sectors (such as hospitality and travel), finance organizations may be able to recruit top talent with some combination of the digital, finance, and business expertise required but that had previously been harder to find.

## Reimagine and reform: Thriving in the next normal

Once the crisis abates, senior management will want to move forward. To enable the company's pursuit of bold strategic moves, the CFO and peer executives should convene a small group of talented executives whose mandate is to focus on strategic planning, with oversight and support from senior management and the board. The team will set the game plan for investments, portfolio shifts, and major productivity initiatives that will position the company to win after the pandemic.

There are five big moves that our research shows have the greatest impact on a company's ability to significantly outperform the market: dynamic resource reallocation, programmatic M&A, strong capital expenditure, productivity breakthroughs, and differentiation improvement.[6] All are important, but in the current crisis, reallocating resources for future growth, realigning the portfolio through acquisitions and divestitures, and boosting productivity are the most critical.

### Adopt a transformation mindset when reallocating resources

Crises are often opportune times to restructure parts of the business that require transformation (and to take the related charges). This one is no different. The CFO and finance organization would be well served to adopt a transformation mindset when they are setting targets, managing performance, constructing budgets, or challenging

their business on growth or expense actions. The finance team should launch a review of the portfolio, with a focus on achieving the full potential of each business unit. This is a time to shelve incremental thinking and seek out transformational plans that could boost revenues or reduce costs—not by 5 to 10 percent but by 30 to 40 percent.

### Consider how M&A and divestitures could improve the portfolio

Roiled markets and plummeting valuations can create a ripe environment for M&A. CFOs should be a leading voice in determining how to use M&A as a tool to manage the crisis (through divestitures, for instance) and to reallocate capital toward high-priority needs (through product, geography, or supply-chain acquisitions, for instance). A programmatic approach to M&A—where companies pursue frequent small and medium-size acquisitions—may hold some promise during this disruptive period.[7] Consider that during the last financial crisis, companies that maintained a programmatic approach to M&A outperformed through the downturn and maintained excess TRS through the recovery. In fact, the top-performing companies through the downturn (those with top-quartile TRS) had the highest average volume of annual transactions during that time period and returned roughly six times that of the bottom-quartile performers. Similarly, resilient companies divested assets 1.5 times more than their nonresilient peers.

### Boost productivity through digitization

This is the first economic disruption that requires a large part of the global workforce to perform their duties remotely, making digital-collaboration tools necessary to keep the business functioning. But the finance team's use of digitization to help the company manage the crisis should not be considered a onetime event. Digital initiatives that once seemed out of reach—from automated closings to real-time forecasts—are now business critical. The CFO and finance team should take a leadership position in advocating for the use of digitization across the organization, long after the

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[6] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[7] Jeff Rudnicki, Kate Siegel, and Andy West, "How lots of small M&A deals add up to big value," *McKinsey Quarterly*, July 2019, McKinsey.com.

crisis has passed. The CFO and finance team can codify the solutions they have developed—the cash war room, rolling forecasts, and collaborative dashboards, for instance—and help scale them throughout the organization. This active, informed embrace of digitization will be invaluable for ensuring accurate reporting, informed decision making, and business continuity in any future crises.

Meanwhile, much attention has been paid to the massive disruptions to global supply chains. These disruptions have changed business leaders' ROI calculus overnight—from being solely focused on efficiency to now accounting for resilience and stability. Consider how business-process-outsourcing centers worldwide are reeling from lockdowns and limited bandwidth in their own countries (India and the Philippines, for instance), and think about the degree to which many of the critical processes they support have been disrupted. CFOs will need to do the hard of work of digitizing and automating core business processes to reduce their exposure to exogenous shocks and to create resilience.

In the coming days, weeks, and months, as employees are struggling with anxiety about their health, their future, and their loved ones, finance leaders must demonstrate empathy—but also bounded optimism that the organization and its people will find a way through the crisis.

The CFO can back up this view with clear actions and decisions. Regular communication is critical: the CFO must be forthcoming about the "knowns" and the "unknowns." This will help ease misgivings, decrease distraction, and keep people motivated. Also critical is empowering others in the finance organization to direct aspects of the crisis response while establishing a financial decision-making framework that will help executive peers make necessary trade-offs.

No one knows how long the pandemic will last, but in time, business and daily life will find a new equilibrium. CFOs are key to ensuring that their organizations not only survive the current crisis but thrive in the next normal.

# A transformative moment for philanthropy

Here's how the positive changes in individual and institutional philanthropy sparked by the COVID-19 pandemic can take root and grow.

*by Tracy Nowski, Maisie O'Flanagan, and Lynn Taliento*

The philanthropic response to the COVID-19 pandemic has shown the sector at its best. From the launch of community-based rapid-response funds to the development of diagnostics and vaccines, philanthropy is showing up both to help flatten the curve in the short term and to address the inequities the crisis will exacerbate over the long term.

What's striking is not only the scale of capital being committed by major philanthropists (at least $10.3 billion globally in May 2020, according to Candid, which is tracking major grants) but also how it is being given: at record speed, with fewer conditions, and in greater collaboration with others. According to the Council on Foundations, almost 750 foundations have signed a public pledge to streamline grant-making processes, and individual donors are partnering with their peers to make sizable grants with less paperwork.

Confronted with the global pandemic, individual and institutional philanthropy has been responsive, engaged, and nimble. The challenge—and

opportunity—for the sector will be to make those features stick. The gravitational pull toward old ways of working will be strong, especially as philanthropies grapple with the impact of an economic downturn on their own endowments. But many of the practices that have emerged during this pandemic, including the five that we highlight in this article, should be expanded and formalized as the world heads into the long process of recovery (exhibit).

## Reduce the burden for grantees

Over the past 20 years, the philanthropic sector has adopted a more data-driven and rigorous approach. While those developments have strengthened the field in many ways, they have made the process of seeking and managing grants more cumbersome, especially for small, community-based organizations. The COVID-19 pandemic has accelerated moves to reduce those hurdles, prompting many foundations to relax grant requirements, speed up decision making, and give recipients additional flexibility in how they use funds.

Exhibit

**Philanthropies have made positive changes in response to the COVID-19 pandemic.**

**5 practices to build on during the recovery**

| Reduce the burden on grantees | Accelerate pace and volume of giving | Partner with other donors to go further faster | Invest more in local communities | Support the public sector |
|---|---|---|---|---|
| • Continue granting practices that worked well during the pandemic<br><br>• Join discussion on creating a common grant application in philanthropy | • Free up more capital and consider increasing payout rate beyond 5%<br><br>• Consider if the rate of spend down on endowments matches mission | • Resist temptation to start from scratch<br><br>• Team up with partners to combine expertise and drive efficiency | • Evaluate amount of local giving<br><br>• Support partners that understand and have roots in the community<br><br>• Help organizations that support and/or are led by people of color | • Provide risk capital to support new government initiatives<br><br>• Support cross-agency work to solve underlying problems<br><br>• Help government organizations train leaders and attract top talent |

# If ever there was a time for foundations to consider permanently accelerating the pace and volume of giving, it's now.

What would it take to simplify further the processes for grant approval and reporting? Looking to college admissions for inspiration, imagine a common application for grant seekers, similar to the Common App platform that enables students to apply to many colleges using a single application. There could be a central clearinghouse with data-collection tools that nonprofits could use to share information with any donor, thus eliminating the burden of bespoke application forms and different data-reporting requirements. The platform could also store each organizations' grant-approval history, as well the reviews of those grants. It could even spur donors to adopt a shared calendar of application and decision deadlines, allowing nonprofits to plan their annual budgets. If such a platform could trim just 15 percent off the cost of raising money from foundations, US nonprofits could save at least $4 billion a year.[1]

The barrier to such innovation is not cost but collective will. Some efforts are already underway—for instance, the JustFund web platform allows grassroots organizations to connect with small foundations and giving circles through a common proposal. But the real transformation can occur only if leading foundations collectively adopt a single platform. The pandemic offers proof that philanthropies are willing to bypass their unique vetting processes in the interest of speed and impact. As the crisis abates, donors should question whether their processes produce enough impact

to justify their costs—and whether it might be time for a sector-wide effort to ease nonprofits' administrative burdens.

## Accelerate the pace and volume of giving

The COVID-19 pandemic has prompted a number of donors to dig deeper into their endowments and change their grant-making approaches to deploy more capital than they had planned. Some have doubled or quadrupled their payout rates, others will distribute 20 percent of their total assets this year, and others have committed as much as $1 billion to COVID-19 relief.[2] All are recognizing that this historic pandemic demands an extraordinary response.

If ever there was a time for foundations to consider permanently accelerating the pace and volume of giving, it's now. At present, US foundation assets total almost $1.1 trillion, according to Candid, while another more than $120 billion sits in donor-advised funds (DAFs). Foundations typically pay out around 5 percent of those assets each year to meet the federally mandated minimum, and DAFs have no such payout requirement, prompting many to demand faster distribution of dollars that have already produced tax benefits for their donors.

In 2002, our colleagues Paul Jansen and David Katz argued in *McKinsey Quarterly* that donors should assess the time value of philanthropy in the same

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[1] Figure is a rough estimate, using data on fundraising-related expenses of US nonprofit organizations from Internal Revenue Service filings, Urban Institute's National Center for Charitable Statistics, Giving USA Foundation, National Council of Nonprofits, and Charity Navigator, among others.
[2] Among those doubling grants are the Mary Reynolds Babcock Foundation and Libra Foundation. Philanthropist Jeff Skoll announced a $100 million grant that will quadruple the Skoll Foundation's payout.

way an investor does: putting more value on a dollar deployed today than one spent in the future. The conclusion was that delaying grant making in favor of capital accumulation often exacts a significant cost. While an increasing number of philanthropists have since committed to giving away the majority of their wealth in their lifetimes instead of conserving their assets to exist in perpetuity, the average annual spend down of foundation endowments has barely budged.

As we enter the long recovery effort, boards and leadership teams, as well as individual philanthropists, should have explicit discussions about the rationales for their giving horizons. Does perpetuity help achieve your social-impact objectives, or is it serving another objective, such as family unity or founder legacy? If family connection is the primary goal, is setting up a permanent foundation the best way to achieve it? What do you believe your giving will be able to do better 50 or 100 years from now? If you have already received the tax benefit for your giving, why not disburse more of the funds sooner?

With approximately 112,000 foundations in the United States alone, a one-size-fits-all answer to these questions is neither appropriate nor desirable. But for philanthropists tackling issues that are compounding and getting harder to solve with every passing day—among them, racial inequity, weak public health and education systems, and the climate crisis—accelerating spending may make sense.

### Partner with other donors to go further faster

Private investors typically look to investment managers who have specific expertise and a successful track record; private-equity investors frequently deploy their capital alongside others they trust, following others' due-diligence efforts rather than conducting their own. Yet when it comes to philanthropic giving, many individual donors—and

institutional foundations—often go it alone. They build sizable teams that develop expertise, create new initiatives, and deploy grants largely in isolation from other donors.

The pandemic response has demanded a different approach, bringing donors together at the local, state, national, and global levels to pool resources, align on priorities, and deploy funds rapidly through collaborative funding platforms. For instance, seven foundations partnered to create the Families and Workers Fund, providing flexible funding to organizations working to prevent people from falling deeper into poverty because of the effects of COVID-19. Similarly, the COVID-19 Therapeutics Accelerator was formed to develop treatment options, anchored by $125 million in funding from the Bill & Melinda Gates Foundation, Wellcome Trust, and Mastercard. It was quickly supported with follow-on funding from others.

While donor collaboratives existed well before the COVID-19 pandemic, they were more the exception than the rule. Going forward, what if each foundation and donor aimed to allocate at least 25 percent of their funding to support initiatives led by other donors? Building nimble, impact-oriented governance models is no small feat when there are multiple donors with their own strategies involved. Yet such partnerships are highly effective when they rally donors around concrete and measurable goals—and when they collaborate to scale, share expertise, and combine diverse networks.

### Invest more in local communities

Philanthropists are often drawn to global problems, leading them to invest in the well-being and empowerment of people living thousands of miles away. While these contributions are critical to address global inequities and injustices, the pandemic has rightly turned many philanthropists' attention to the severe inequities in their own backyards, producing a swell of local giving. According to Candid, almost 600 state and

local community-focused COVID-19 funds have cropped up around the United States, attracting contributions from private foundations, corporations, and individual donors alike.

While such local giving has often been deprioritized by philanthropists focused on national or global issues, the current crisis is a reminder that we each depend on—and have an obligation to support—the strength and resilience of our local community. All philanthropists should consider increasing the percentage of their giving that is truly local, looking beyond organizations that primarily serve elite interests. Donors should look to local organizations that support communities of color and those that are led by people of color, particularly women. Structural racism has left these organizations chronically underfunded, yet they are often doing the most vital work to strengthen local communities and reduce inequality.

Upending power dynamics and empowering grassroots leaders will require many foundations and donors to shift their mindsets and build new capabilities. Local giving is an opportunity for philanthropists to test and learn from a range of community-led and participatory grant-making models, which they can then apply in their work across their countries or around the world.

## Support the public sector

While philanthropists have responded to the COVID-19 pandemic with record levels of support, the massive responsibility for leading the response and recovery falls primarily on the shoulders of the public sector. Philanthropists have rightly coordinated with city and state governments during this crisis—for example, in the Chicago Community COVID-19 Response Fund launched by the Chicago Community Trust, the United Way of Metro Chicago, and the City of Chicago.

While a handful of foundations collaborate with government at the state and local levels and an increasing number seek to influence government policies by supporting advocacy, the vast majority of foundations have steered clear of investing in public-sector capacity building. This is a significant missed opportunity. Given the vast scale of government (which dwarfs the nonprofit and philanthropic sectors), the use of philanthropic dollars to improve the efficacy of government is a potential high-return investment.

There are several ways that private philanthropy can help make government more effective. First is to double down on its role of providing risk capital to support innovative programs. Now is the time to collaborate with public-sector partners to plan, test, and validate new approaches, which agencies can then adopt if proven effective.

# The vast majority of foundations have steered clear of investing in public-sector capacity building.

Second is to support cross-agency efforts that address underlying problems. Government agencies tend to focus on delivering against their particular mandates (for instance, financing affordable housing and policing). They find it challenging to address root causes across departments (for instance, getting the homeless into permanent supportive housing instead of police placing them in temporary shelters).

Third is to address talent and personnel constraints. That can take a few forms: training government employees and leaders who are in critical positions, helping governments identify and attract top talent, and supporting the creation or expansion of positions that fill specific skill gaps (for instance, data analytics and supply-chain management).

In addition to supporting government agencies' effectiveness, perhaps philanthropy's most crucial role is to support the public-policy ideation that is necessary for the recovery stage of the COVID-19 pandemic. This is a historic moment to make major changes to our economic and social orders; private philanthropy can help drive the reimagination by funding the analysis, debate, and advocacy of new ideas, with a particular focus on ensuring that vulnerable communities are not left behind. To help safeguard public-sector accountability and community involvement, donors can strengthen the ecosystem of the think tanks, advocacy organizations, movements, and media needed to ensure that the public policies that drive social and economic recovery are responsive to community needs.

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Since the COVID-19 pandemic took hold in March 2020, donors and foundation teams have been working around the clock, drawing upon their missions and values to guide them through uncertainty. With this renewed sense of purpose comes an opportunity to reshape priorities and practices for the next era of giving. The pandemic has demonstrated that the sector can and will pivot quickly in a crisis. The challenge for leaders working in philanthropy is to expand and institutionalize the practices that emerged during the crisis for the work that lies ahead.

**Tracy Nowski** is a partner in McKinsey's Washington, DC, office, where **Lynn Taliento** is a senior adviser; **Maisie O'Flanagan** is a senior adviser in the Silicon Valley office.

# The state transformation mandate during COVID-19

A bold transformation approach can help US states close their impending fiscal gaps and improve both performance and efficiency.

*by Trey Childress, Ian Jefferson, Aly Spencer, and Todd Wintner*

**COVID-19 is primarily a humanitarian crisis,** affecting lives and livelihoods across the world. Its knock-on effect for state governments is a fiscal crisis that dwarfs the Great Recession of 2008. In addition to the budget challenges, the demands on state services have spiked and the means by which those services are delivered (in person or by digital means) are of greater importance as public-health protocols endure.

Many state governments have already acted and are making tough decisions to meet these needs. US state governments are almost all bound by constitutional amendments to balance their budgets annually or biannually—a constraint not found in many other governments around the world. Within these constraints, states may consider options such as raising revenues, monetizing assets, and creative public financing, as well as traditional cost-reduction efforts. But states have the opportunity to consider a tried-and-tested, though rarely used, recipe to transform government at scale—improving performance and efficiency. Transforming in the face of crisis is not a radical idea, whether in the private or public sector. However, transformation is challenging for large and complex organizations. Indeed, McKinsey research has found that 80 percent of public-sector transformation efforts fail to meet their objectives.[1]

Experience shows there is a proven recipe for beating these odds. The recipe involves three necessary elements: setting a bold aspiration, ensuring execution at pace, and sustaining the transformational change. A successful approach involves the following:

— starting with a comprehensive diagnostic across all areas and functions to identify the full potential for improvement

— setting clear and quantified targets

— accelerating priority initiatives

— moving initiatives through a well-defined stage-gate process

— standing up a rigorous "execution engine" to drive implementation, support widespread capability building, and overcome barriers

This article introduces the initial phases of that journey (Exhibit 1). First, we review how states responded to the global financial crisis of 2008 and the steps they have taken since the COVID-19 pandemic began. We then outline three tactical actions that states could take immediately in the "do now" phase to respond to the fiscal crisis as it unfolds. In the "discover" phase, we examine how governments might rapidly identify cost-efficiency and effectiveness opportunities across their organization, launch early initiatives to build momentum, and stand up the execution engine to drive implementation.

The transformation approach is a powerful mechanism for progress, but it is not for the faint of heart. These extraordinary circumstances demand extraordinary actions. This approach hinges on mobilizing the broader organization while demanding flexibility, open-mindedness, creativity, and stamina from both leaders and frontline employees throughout the effort.

## Great Recession impacts hinder COVID-19 budget options

On September 29, 2008, the Dow Jones Industrial Average dropped an unprecedented 778 points in a matter of hours. After watching financial titans declare bankruptcy one by one for months, the market had finally lost faith. For most Americans, this was the largest financial shock they had ever experienced.

The Great Recession tested the resilience of US financial systems and the capacity of government. The economic shock was felt acutely by states,

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[1] Martin Checinski, Roland Dillon, Solveigh Hieronimus, and Julia Klier, "Putting people at the heart of public-sector transformations," March 5, 2019, McKinsey.com.

Exhibit 1

## States can consider phasing their response to the COVID-19 fiscal crisis.

| Immediate actions | Phase 1 | Phase 2 | Phase 3 |
|---|---|---|---|
| **Do now** | **Discover** | **Design and decide** | **Deliver** |
| Execute early interventions to make immediate impact (eg, cash control tower)<br><br>Set new standards to be used through full transformation effort | Conduct top-down assessment to identify full potential of performance improvements and cost efficiencies<br><br>Launch immediate initiatives in parallel<br><br>Establish transformation office to drive progress | Mobilize broader set of government leaders<br><br>Refine financial cases for priority initiatives<br><br>Assess additional opportunities<br><br>Develop implementation plan for full transformation | Drive execution through empowered transformation office, talented initiative teams, and rigorous performance transparency and management |

**Enablers throughout transformation**

*Integrate change management* to shift the mindsets and behaviors necessary to sustain the transformation—especially in a COVID-19 working environment

*Build capabilities* to match future needs, including the promotion of robust data infrastructure and analytics skills

which experienced a collective $690 billion budget shortfall over the subsequent five-year period.[2] All but Vermont had a balanced-budget requirement, meaning funding shortages had to be resolved in-year. To close this gap, states turned to their well-worn playbook of austerity measures, including borrowing from rainy-day funds, implementing top-down expenditure reductions, using pension-plan adjustments and reserves, raising fees in certain areas, and appealing for federal funding.

Despite enlisting their full arsenal of austerity measures, states were pushed to a breaking point by the cumulative burden. Twenty-eight states drained their rainy-day funds to a point where they had less than a week's worth of operating costs; 17 used them entirely. Others cut elementary- and secondary-education funding by as much as 40 percent,[3] leading many districts to reduce the number of school days and furlough employees.

Between 2008 and 2013, state-government workforces were reduced by about 6 percent,[4] and the average state-pension funding ratio fell to 75 percent. And, even though the federal government injected about $1.3 trillion into the economy as part of the largest fiscal recovery plan in US history (at the time),[5] states were still left with challenging decisions.

More than a decade later, a quarter of states have not restored their rainy-day funds to pre-recession levels, and all but five states remain below the recommended threshold of two months' operating expenses.[6] Per-student funding for higher education is down 13 percent.[7] State government workforces are still almost 5 percent smaller than they were in 2008. Pension-plan funding levels are down to 66 percent on average across states,[8] and the federal deficit has more than doubled.

[2] Cumulative, adjusted to 2020 dollars; for more, see Elizabeth McNichol, Michael Leachman, and Joshuah Marshall, "States need significantly more fiscal relief to slow the emerging deep recession," Center on Budget and Policy Priorities, April 14, 2020, cbpp.org.
[3] *2009 State Expenditures Report,* National Association of State Budget Officers, Fall 2010.
[4] "'Lost Decade' casts a post-recession shadow on state finances," PEW, June 4, 2019, pewtrusts.org; this calculation does not include employees of the K–12 or higher education systems.
[5] Kimberly Amadeo, "ARRA, its details, with pros and cons," *The Balance,* April 11, 2020, thebalance.com.
[6] *The Fiscal Survey of States,* National Association of State Budget Officers, Fall 2019; comparison to Great Recession is based on FY 2007 inflation-adjusted amount.
[7] Inflation adjusted for 2008 versus 2018; for more, see Elaine S. Povich, "Coronavirus and the states: Governors coalesce to reopen on their terms; budgets look increasingly bleak," Pew Charitable Trusts, April 14, 2018, pewtrusts.org.
[8] "The state pension funding gap: 2016," Pew Charitable Trusts, April 12, 2018, pewtrusts.org.

Today's fiscal crisis dwarfs the Great Recession, and GDP forecasts suggest the worst drop since World War II (Exhibit 2). Twenty-five percent of small businesses closed temporarily, and 43 percent fear permanent shutdowns in the next six months.[9] The price of oil has plummeted, even falling below zero per barrel at one point. Finally, retail sales tax fell 8.7 percent in March 2020,[10] the largest decline on record.

Meanwhile, demand for social programs and state expenditures has surged. In the span of a few weeks, 36 million Americans have filed for unemployment insurance. Spending on the federal Supplemental Nutrition Assistance Program (SNAP) is up 40 percent nationwide.[11] Extensive shortages of personal protective equipment have required states to step in as wholesale buyers, inflating unit prices more than tenfold.

Traditional austerity measures simply cannot be scaled to close the impending fiscal gap, especially after being blunted in the aftermath of the previous crisis.

## Do now: Manage near-term response

Operational transformation presents another set of options in addition to raising revenue, increasing debt, leveraging assets, and reducing austerity across the board. For states that must balance their budgets annually, instead of chipping away at a budget tailored to a current operating model, state governments can modify service delivery. Launching targeted interventions that redefine government operations can stabilize budgets faster, cultivate long-term resilience, and help states adapt to new ways of doing business. Many of these

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[9] *Special report on coronavirus and small business,* a joint report from MetLife and US Chamber of Commerce, April 3, 2020, uschamber.com.
[10] *Advance monthly sales for retail and food, April 2020,* US Census Bureau, May 15, 2020, census.gov.
[11] "USDA Increases Monthly SNAP Benefits by 40%," US Department of Agriculture Press Release, April 22, 2020, usda.gov.

Exhibit 2

## US GDP is expected to experience the steepest decline since World War II, regardless of whether the virus is effectively contained.

**United States real GDP,** %, total draw-down from previous peak

**Scenario 1**
Assumes virus is contained and growth returns

**Scenario 2**
Assumes virus recurrence; slow long-term growth with muted world recovery



Pre–World War II era          Post–World War II era
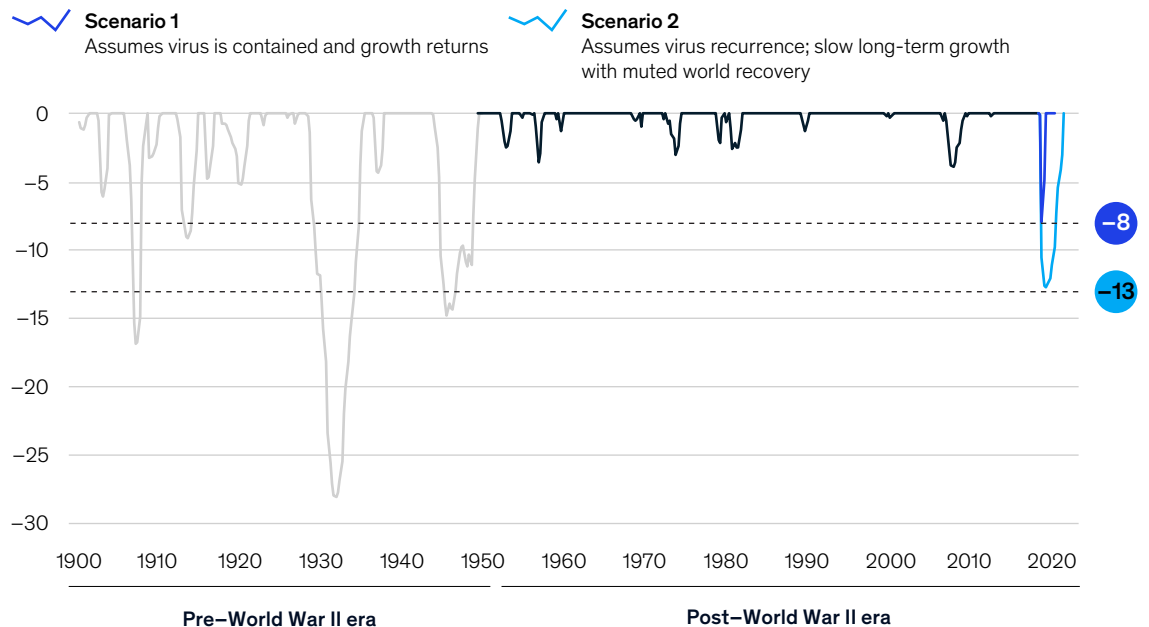
Source: Oxford Economics; US Bureau of Economic Analysis; McKinsey analysis

changes will require years of development and execution, but a few could be launched immediately and in parallel with emergency-response initiatives.

### Adopting vigilant cash-flow management

Unlike the private sector, most state governments are not equipped to manage real-time liquidity. In good times, comparatively predictable government cash flows render the need to actively monitor cash unnecessary. Fragmented and antiquated accounting systems further complicate taking nimble cash actions. But in times of great volatility— and certainly in times of crisis—expected sources of inflows can quickly become sources of outflows; for example, expected personal income taxes become unemployment insurance payments.

The fallout caused by COVID-19 will require an extensive, sophisticated, and protracted disaster response. For the next several years, all states are at risk of facing liquidity crises as revenues plummet and expenditures soar. Even states with robust rainy-day funds, largely built on the backs of natural-resource endowments, face a bleak outlook as oil prices fall.

In these uncertain times, states can evolve to meet the demands of the challenge at hand. Introducing vigilant cash management is the first step to a successful emergency response. Creating a "cash control tower" can accelerate capability building and enable state governments to do the following (Exhibit 3):

— *Monitor cash sources and uses to ensure* the proper allocation of resources.

— *Create and maintain a near-term forecast* that shows discrete sources and uses of cash to make decisions on near-term actions.

— *Identify cash-generation initiatives,* including those with operational trade-offs, if necessary.

— *Shift mindsets and behaviors to improve cash management* by developing the tools and capabilities necessary to ensure the organization treats liquidity as a core objective.

In our experience, a cash control tower can improve cash balance by 6 to 12 percent within weeks. For

Exhibit 3

## Various roles within a cash control tower can help achieve vigilant cash management.

**Roles and responsibilities**

| | | |
|---|---|---|
| 🔍 | **Dedicated cash control tower analyst** | Tracks estimated and actual emergency spending and forecasts cash flows |
| | **Procurement and spend control lead** | Reviews spending categories and reduces budgets in certain areas (immediately, when necessary)<br><br>Considers cash-generating levers available to the procurement team |
| | **Financial services lead** | Focuses on aggressive working-capital management |
| | **Treasury lead** | Provides expert knowledge on debt-service obligations, public-servant retirement plans, and retiree healthcare |
| | **Real-estate and facilities lead** | Provides expert knowledge on property and assets |

many organizations, this cash-balance improvement alone is the difference between solid ground and the brink of a liquidity crisis.

### Addressing the surge in critical government services

On May 8, the US Department of Labor reported that 14.7 percent of the American workforce was unemployed in April. Unemployment insurance claims have increased 2,000 percent in the past few weeks.[12]

With each passing day, state residents become more dependent on government for basic services. This economic vulnerability will likely result in greater housing and food insecurity, susceptibility to health risks, and other acute needs down the line. As requests for unemployment insurance, housing assistance, SNAP, Medicaid, and Temporary Assistance for Needy Families swell, states could consider preparing operations for exceptional levels of demand. Planning for this involves both anticipating spikes and identifying short-term solutions to tide over existing systems.

Anticipating service demand is critical for maintaining operations while intake systems experience surges. Services that have not yet been bombarded by an influx of claims could stress-test their capacity immediately. Additionally, identifying and monitoring leading indicators can serve as a warning for the magnitude of spikes down the road.

However, when service-delivery processes do begin to buckle under pressure, states could consider the following short-term solutions for supporting systems:

— *suspending nonessential services*—for example, by granting automatic extensions to certain licenses

— *redeploying staff* to areas of higher demand

— *auto-approving claims* that meet predefined criteria

— *front-loading mitigation criteria* to screen for eligibility, thereby shielding less-adept back-end systems from processing unqualified claims

### Implementing controls to maximize available federal funds

In times of crisis, organizational decision making can shift from a coordinated top-down approach to a decentralized frontline response. Diligent tracking processes may also break down when conditions call for more agility. In these situations, governments become vulnerable to unbounded emergency-spending commitments or responsible for many initiatives launched with minimal planning and unclear accountability. To ensure federal funds are not left on the table and to use those funds responsibly, states should consider coordinating with federal agencies in these five steps:

— *Closely track agency-level rulemaking and appropriations* to maximize fiscal and operational impact.

— *Contact federal counterparts* through their regional offices and establish a protocol to ensure steady lines of communication as resources go online.

— *Centrally track applications and deadlines* required by federal agencies to recover qualified expenditures or receive up-front payments.

— *Maximize the use of federal relief funds to meet budget gaps* by fully accounting for eligible expenses and avoiding potential clawbacks from ineligible uses.

— *Maximize the benefit of CARES Act funds for economic relief and stimulus* by assessing the potential for impact and ensuring effective and quick deployment of the money.

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[12] "COVID-19 impact," US Department of Labor, May 21, 2020, dol.gov.

## Discover: Embark on long-term transformation

While immediate actions strengthen emergency-response capabilities, addressing the looming budget shortfalls will require sweeping changes across a much longer time horizon. The "discover" phase of the transformation journey involves quickly laying the groundwork for the coming years. Tactically, this means setting up a central transformation office to compel progress, launching priority initiatives to achieve early financial impact and demonstrate momentum to state workers and citizens, and conducting a rapid diagnostic across all areas and functions of the organization to assess the size of the opportunity for operational innovations.

### Improving procurement

States can improve procurement by managing demand for vendors, refining pricing through analytical category management, and modernizing procurement capabilities.

One US state recently worked to optimize its contractual services across multiple agencies. By transforming approval and ownership processes and improving personnel capabilities, the state saved more than $100 million in the first year of its integrated program.

Similarly, a major US city pursued procurement reform as a high-value intervention. Reviewing vendor cycle times and quality assurance, clean-sheeting its largest contracts, and better managing category spending using advanced analytics allowed the city to identify 10 to 20 percent in savings for centrally procured items.

### Automating services

States could systematically identify areas of citizen service that can be automated or moved online to reduce cost to serve.

For example, one state's economic- and social-support agency digitized its entirely paper-based enrollment process in three weeks.

The process—application filing, processing, screening, and approval—was shortened from an average of 38 days to eight days, thereby dramatically improving citizen satisfaction and reducing associated costs.

### Carrying out Medicaid controls

States can implement Medicaid controls such as third-party liability, utilization management, and program integrity measures to accrue savings of 1 to 3 percent while improving healthcare services.

In the past decade, the Medicaid program more than doubled in terms of percent of state budget without notable changes in the number of quality outcomes. In 2019, one state embarked on a journey to transform its Medicaid program. By engaging the collective wisdom of agency staff, the state identified more than $1 billion in savings across 70 initiatives while sustaining desired quality outcomes.

### Addressing tax delinquency

States can review delinquent tax revenues and cash compliance, along with other tax-gap elements due to under- or unreported income. This revenue leakage is typically estimated at 10 to 20 percent of potential annual collections.

One state confronted an unexpected budget gap by using advanced analytics to increase tax revenues. The state detected and treated 10,000 underreporting businesses and captured $60 million to $100 million in revenues while simultaneously reducing the undue burden of mistargeted investigation.

Beyond this short list are hundreds of additional context-specific opportunities. In the earliest phases of transformation, states could consider launching a comprehensive analysis across their governments to take stock of potential efficiency and effectiveness improvements. This exercise involves evaluating both government departments and relevant cross-cutting enablers (Exhibit 4).

Exhibit 4

## States could complete a comprehensive analysis of opportunities to increase efficiency and effectiveness across departments and cross-cutting enablers.

**Opportunity to achieve cost savings for agencies,** an illustrative example

Low (~1%) ▢▢ ▨▧ High (~10%)
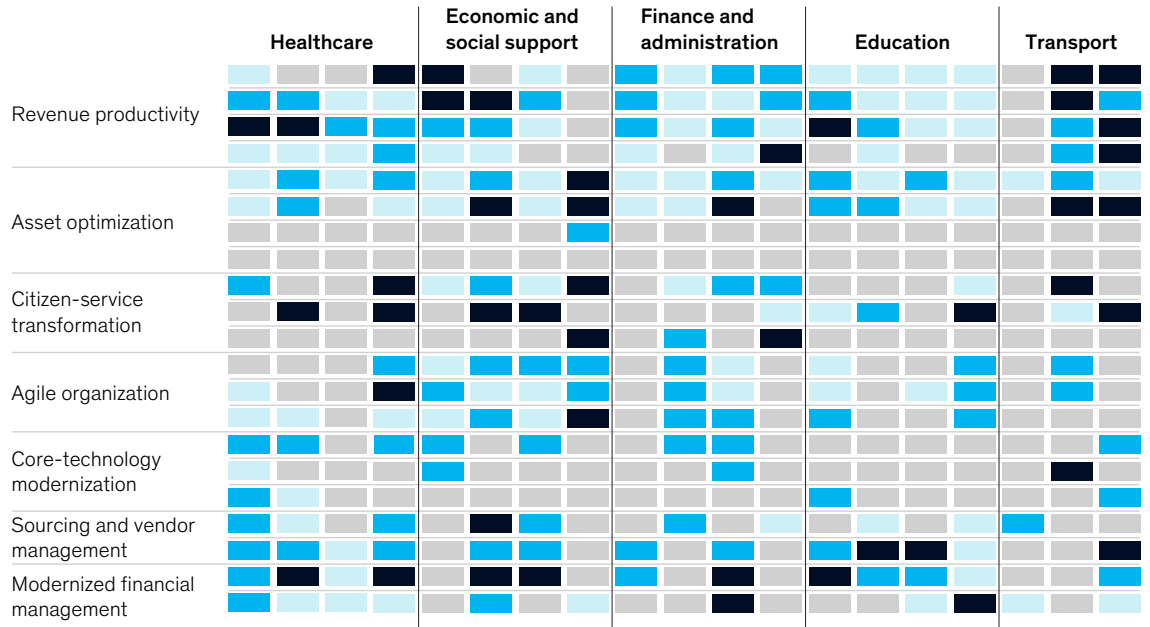


Depending on the scope of analysis, states could reach savings of 3 to 10 percent in operating expenses, as well as improved service quality.

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Committing now to sweeping operational transformations could help states mitigate cuts in government services and economically

devastating hits to their public-sector workforce, while improving their ability to address long-term liabilities such as debt and pensions. At times, states will have to accept doing less, with less—but there is real opportunity to spur positive, lasting change through large-scale transformation.

# Leading
# the charge

# The wisdom of transformations: How successful CEOs think about change

What works and what doesn't, from those who know.

*by Oliver Bladek, James Deighton, Alison Dunn, Tip Huizenga, and Wesley Walden*

**Embarking on a transformation** is one of the most critical decisions a CEO will ever make. It requires big commitments both internally and externally, and puts the spotlight on her or his ability to lead and deliver. The context and need for transformation are always different, but the level of commitment and focus from the CEO is invariably the same. A successful transformation puts her or his career on a new pathway—as does an unsuccessful effort.

Transformation is one of those words that gets routinely misused. Many CEOs will say they have been involved in multiple transformations. But by our definition— an intense, organization-wide program to enhance performance and to boost organizational health[1]—very few have delivered one sustainable, at-scale business transformation, let alone several.

Those who have managed this kind of metamorphosis offer a rare perspective. We interviewed 12 CEOs from around the world about their transformations and what made them successful. Their companies are active in a broad range of industries (from public sector to banking, resources, telco, and healthcare) and an even more diverse range of contexts (from severe financial distress to modernizing the business through agile ways of working).

In this article, we'll discuss the common themes that emerged from the interviews that were also supported by our data. These insights can be grouped in three areas: committing to transform, leading the transformation from the front, and sustaining a new way of working.

## Committing to transform
We heard three recommendations from CEOs for others who are thinking about taking the plunge:

— **Affirm your conviction that the business needs to change.** All the CEOs had a clear picture of the threat or opportunity facing their business. Some were obvious to management

(higher costs versus peers, high debt levels at a time when growth was slowing, declines in price for their products), while some were perhaps a little less visible but still keenly felt (capital tied up in popular, unproductive assets; the threat of automation; a government policy change; an aspiration to grow into a regional or national champion). In a couple of cases, an adversarial culture prevented issues from even arising, yet the CEO knew something was wrong. In every case, the CEO could clearly articulate the one or two reasons why a transformation was required.

— **Frame transformation as a higher level of performance—not a project.** Before starting a transformation, CEOs we spoke with recognized that the current mode of working would not lead to achieving the intended transformation outcomes. In other words, the methods used to achieve historical success were insufficient to reach a higher level of performance. One CEO framed it as "this is not business as usual—if you think you can go through and be consistent with how you managed in the past, then you shouldn't go into it." Minor change programs are often thought of as projects that have an obvious start and end when the mission is accomplished. But that won't work in a true transformation. Instead, CEOs see transformations as the way to, yes, deliver value, but also to accelerate the metabolic rate of decision making and execution within the company, as the start of a never-ending journey to continued excellence.

— **Set an uncomfortable but inspirational ambition for your leadership team.** Another theme was the need to aim extremely (even painfully) high. One CEO felt that the company's management team was initially cynical about the scale of the ambition. Another said, "we were really concerned if this was even deliverable." These limiting beliefs could have come from the existing culture; as one said, "our internal incentives didn't encourage us to be as bold as we could be … you can't just keep slicing but need to make fundamental change." The

[1] Michael Bucy, Stephen Hall, and Doug Yakola, "Transformation with a capital T," *McKinsey Quarterly*, November 2016, McKinsey.com.

CEOs we interviewed believe it is critical to set an extremely high aspiration—not only to show that this transformation is different from previous efforts but also to orient the company toward a new full potential. This ambition should also incorporate all levers of value creation: margin expansion through revenue, working capital, capital expenditure, and operating cost reduction. The first of these may be the least expected source of transformation value: our research indicates that about 40 percent of the average program's value delivered comes from growth and top-line topics.

## Leading the transformation from the front

What do successful leaders do in a transformation? We heard four suggestions:

— **Show true ownership by mandating involvement and getting into the detail.** The CEOs we spoke with spent real time within their transformations. "If the senior leader isn't managing, it's being done to the business rather than by the business." Simply put, CEOs did not delegate transformation accountability, but spent "real time on it every week," or "mandated involvement [in the transformation] when required." They stressed the need to personally role model the future they aspired to see. One CEO wanted to role model so well that "the detractors have no place to hide." Another suggested that "you have to be serious and go in with the mindset that we're going to do this no matter what." The role modeling requires executives to go deep into the minutiae of the business. Our research shows that transformations are five times more likely to succeed if leaders model the change, and two-and-a-half times more likely if leaders spend more than half their time on it.

— **Involve everyone in the transformation, not just senior leaders.** Ambitious targets and timelines in CEO-led transformations require a large team to execute. One CEO was impressed when her "staff came back with a thousand ideas on how to improve the organization … we were amazed at how much intellectual value there was in the organization that we had left untapped." Another delivered on the company's initial aspiration with "25 percent of employees directly involved. Imagine what we would get with 100 percent of the workforce."

— **Build execution discipline from the start by focusing on the immediate activity.** Unsuccessful transformations often struggle because of a perception that "it can't be done," "we can't afford it," or other limiting mindsets. Successful launches happen when teams avoid dissonance coming from long-term challenges and focus on the immediate next step—creating a catalog of ideas for initiatives. Across the next nine weeks, these initiatives can be shaped into a realistic plan with defined financial outcomes and an executable set of milestones. While understanding the risks and challenges that may arise is important, they do not all have to be solved in the initial planning phase. Some CEOs spoke of a two-speed transformation, in which they implemented some immediate interventions (first speed) to "create the oxygen" needed for the full transformation (second speed). Not only does this make the program self-funding, they said, it also quickly demonstrates the organization's bias to action and momentum for change.

— **Develop one voice as a leadership team on the transformation.** It is essential that top leaders commit to the transformation. Their resolution encourages the incremental effort that thousands of others must make for the transformation to succeed. "If you show any sign of weakness or that you're not committed, your people will pick it up straight away. They will not go the extra mile because they're not sure about whether you're committed as the CEO." Leaders say that they had to work individually with each of their team members to bring them along the journey. They acknowledged the prejudices that

[2] See "How to Beat the Transformation Odds," *McKinsey Quarterly*, April 2015, mckinsey.com, based on a survey of about 2,000 global executives.

each team member had and spelled out the need to "reset our expectations to ensure we lead by example." To create this environment, one CEO had to "acknowledge my own weaknesses and build strong relationships individually." Many acknowledged that not every member of their teams would make the journey.

## Sustaining a new way of working

What can leaders do to build momentum for the long term? CEOs offered a few suggestions:

— **Invest in people and culture from the start.** A common CEO regret is not addressing the needed shifts in behavior and culture early in the transformation. One CEO reflected "I didn't realize how deep a change we had to make in culture before we can deliver the quality of change we were looking for." Another identified the point when individuals' ownership of their role in the transformation really cemented: "You see this wave start to crest where people are saying, 'I have the right to change my part of the business.'" While a transformation's performance infrastructure may drive results, CEOs were uniform in their view that cultural change underpinned the sustainability of the impact.

— **Make engagement personal, so people in the company know why it is transforming.** CEOs recognized that transformations build momentum and ultimately sustain their impact when lower-level employees feel empowered. One CEO accomplished this by ensuring everyone understood the commercial outcomes of the decisions they were making. Another focused on the personal impact: "We celebrated the little things and reminded people of the potential importance of the transformation to each of them personally … I would go to meetings and say, 'in my 30 years

in this business this is the most significant change I have seen, and each of you have built a new capability through this that you can take throughout the rest of your career.'" CEOs identified a number of prerequisites to making it personal. One mentioned how "the story needs to be relevant on how it's important to them." Another said that "people need to see it is congruent, and explain the 'why,' especially if there is a lot of pain."

— **Flex your new execution discipline to help weather future challenges.** While better business outcomes are the overt goals of a transformation, execution discipline is an invaluable by-product—especially because as the transformation progresses, the remaining value gets smaller and more difficult to extract. One CEO reflected that "market challenges usually get harder and harder"; another found that "initiatives changed to become longer and more strategic." This continuous-improvement engine changes the game for companies. One CEO felt that "there is no aspirational state, as you always reset to a new aspiration." Our data suggest that three of four companies embrace the transformation methodology, continuing to use it years later to improve the business.

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The most common suggestion from our CEO panel was to go "all-in": not only in setting the scope of a transformation but also in the time and willingness to be at the center of the effort. A close second was the idea that time is of the essence. One CEO reflected that "most people are not like wine; they do not necessarily get better with age." The same goes for a company's problems. There will never be a better day than today to start a company on its new path to a more successful future. We hope that these CEO insights may improve the vintage of the fruits of your transformation.

**Oliver Bladek** is an associate partner in McKinsey's Sydney office, where **Tip Huizenga** is a senior partner. **James Deighton** is a partner in the Melbourne office, where **Alison Dunn** is a vice president and **Wesley Walden** is a senior partner.

# The secret to unlocking hidden value in the balance sheet

For many companies, managing financial resources is a challenge. But combining analytics with a holistic approach to balance sheet management can help capture the opportunity and improve performance.

*by Michael Birshan, Arno Gerken, Stefan Kemmer, Aleksander Petrov, and Yuri Polyakov*

Many large companies are supreme revenue generators, reflecting their ability to create excitement around their offerings and consistently meet their customers' needs. When it comes to managing their financial resources, however, they are often less successful. Many struggle to maintain a strong, real-time grip on their finances and, as a result, leave significant value on the table.

Suboptimal financial resource management is rarely the result of a single policy or decision. Rather it is the by-product of entrenched ways of working that, over time, undermine a company's financial regime. Such suboptimal management usually manifests in one, or several, of five areas of activity: funding and capital structure, liquidity (cash) management, capital productivity, risk management and contingency planning, and, where relevant, commodity-related strategy. Inefficiencies in these areas directly undermine financial performance. In an age of shareholder activism, they also leave executives exposed. Shareholders expect companies to be demonstrably at the cutting edge of financial engineering. When they see a deficit, they are increasingly likely to make their voices heard.

Underperformance in the management of a company's financial resources is a common challenge. However, it is addressable, if leaders prioritize the tools and processes necessary to make a difference. Chief among these are the latest analytical resources, which can enable more consistent modeling, better responsiveness to economic and geopolitical events, closer adherence to key performance indicators, and a sharper view of capital expenditures. Cutting-edge analytics, combined with a holistic approach across the five areas of activity, compose powerful levers to transform financial resource management into a significant source of opportunity.

## CFOs face multiple challenges

Financial resource management sits alongside a range of responsibilities that fall under CFO remit, including value steering and control, portfolio management, risk management across products and business lines, value communication, activist-threat management, and operational excellence in the finance function. Within financial resource management, a CFO's charges are balancing priorities and resources across the balance sheet and capital structure, managing liquidity and cash, and optimizing the company's risk position. None of this is easy. A common CFO refrain is that they "always could get something wrong" whether that be insufficient or excessive hedging, matching funding to capital-expenditure priorities, or holding too much cash at a negative carry. There is also a very consistent sense of struggling to meet the demands of competing interests, both internal and external.

In funding and capital structure management, a CFO has the constant challenge of achieving a funding mix that reflects the company's strategy at a particular moment in time while maintaining financial flexibility and keeping the weighted average cost of capital at a reasonable level.[1] There are plenty of theories as to optimal levels, and CFOs often face a challenge in justifying their positions.

With respect to managing liquidity, CFOs must weigh a precautionary attitude based on current resources against the instinct to pursue value creation. Right now, for example, many companies are sitting on cash accumulated through years of profitability and postcrisis caution. Despite rising investment and stock buybacks, the average cash holdings of the world's top 25 nonfinancial companies remained a near-record high of $43.6 billion in 2018, according to Moody's Investors Service. However, it's tough to find the right balance. Activist investors often challenge companies which accumulate excessive case balances without an apparently good reason. On the other hand, there are countless examples of "buccaneering" ventures that end up on the rocks.

Capital allocation that does not take into account the impact of an investment on a company's risk profile and risk management is a significant source of jeopardy.[2] The fact that companies lack

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[1] Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, first edition, Hoboken, NJ: John Wiley & Sons, 1990.

comprehensive project maps and criteria to evaluate opportunities consistently, leading to a sense of randomness in decision making, often exacerbate exposures.[3] A rush to "get the deal done" can lead to ignoring changes in a company's risk profile over time. This stems from the lack of an integrated view of exposures across business units and inconsistent measurement and reporting of financial risks.

When it comes to foreign exchange (FX) and interest rate risk management, hedging programs are often too generic, while alternative approaches, such as natural hedges, are missed. Very few companies effectively align their hedging strategies with definitive levels of risk tolerance. It is common to see rules of thumb applied—for example, hedge a certain percentage of cash flows. These kinds of assumptions can lead to low hedge effectiveness, margin compression or over-hedging, and a loss of competitiveness as a result of favorable interest rates, exchange rates, or commodity prices.

Finally, commodity price and risk management often occur outside the ambit of an end-to-end risk management approach, particularly among large commodity companies, making commodity hedging less effective.[4] To add to the challenges, the financial aspects of managing companies' carbon footprint are often ignored when funding and risk management decisions are made.

## Companies should optimize across five elements

CFOs can create value by optimizing their financial resource management approaches to the five key areas of activity, represented by the segments of the pentagon in Exhibit 1. However, they can achieve more substantial, or even game-changing, impact by taking a holistic approach. That means leveraging advanced analytics to unlock insights across the segments, or at least the majority of them, and using that information to make cross-cutting decisions.

Companies must make qualitative and quantitative assessments of the state of the play. However, a historic-, interview-, or dialogue-based assessment is insufficient. Rather, they must embrace compre-hensive modeling that focuses on forward-looking simulations. The simulations should model each relevant element of the pentagon along a large number of scenarios, including stress cases, bearing in mind that changes in one element will invariably affect another—additional leverage, for example, is likely to modify risk management policy.[5]

Sophisticated multifactor modeling, applied holistically, can unlock insights that embrace all of a company's financial positions. It can also help improve forecasts and risk communication protocols, helping CFOs explain and justify financial management strategies. In areas such as FX,

# CFOs can become game changers by taking a holistic approach, leveraging advanced analytics to unlock insights.

[2] Martin Pergler and Anders Rasmussen, "Making better decisions about the risks of capital projects," May 2014, McKinsey.com.
[3] Marc Goedhart and Tim Koller, "The value premium of organic growth," January 2017, McKinsey.com.
[4] Arno Gerken, Olivier Plantefève, and Xavier Veillard, "Managing industrials' commodity-price risk," October 2019, McKinsey.com.
[5] Abhishek Anand, Cindy Levy, Ernestos Panayiotou, and Aleksander Petrov, "Navigating stormy waters: A stress-testing framework for non-financial corporates," McKinsey, November 2016.

Exhibit 1

## CFOs can create value by holistically optimizing their financial resource management approaches across five key areas of activity.

**5 key areas of activity**
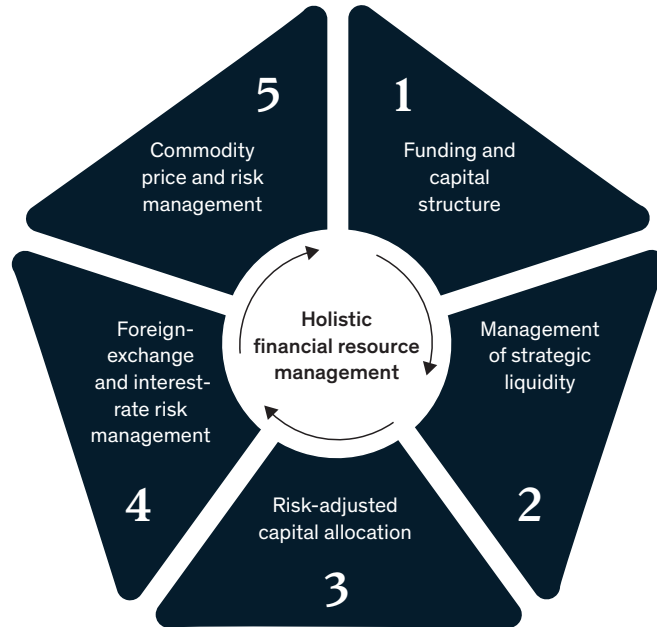


1 Identify best capital structure to minimize weighted average cost of capital while maintaining financial flexibility

2 Quantify cash required to boost resilience and capture opportunity; increase return on invested capital through investment, deleveraging, dividends, and fewer banking charges

3 Increase long-term return on investment by consistently evaluating organic investment opportunities and M&A targets, taking into account impact on overall risk profile

4 Optimize hedging by redefining risk appetite and increasing hedge effectiveness

5 For companies with commodities as primary income-generating assets, improve performance by designing, implementing, and managing risk for profit-generating strategies

interest rate, and commodity risk management, this can lead to a more realistic view of underlying exposures. CFOs can then act to take out inefficiencies. In capital management, companies can test their assumptions with respect to target leverage and consider how alternative balance-sheet structures may affect borrowing costs.

Company and industry circumstances, which change over time, uniquely drive each element in the financial resource management pentagon. Therefore, incremental adaptions and improvements are likely to be insufficient. A holistic approach, on the other hand, can create a multiplier effect that feeds directly to value creation. Very much as seen in investment, in which diversification is a standard theoretical paradigm, optimizing across multiple

elements can allow companies to lift returns without increasing risk exposures. This means being able, and willing, to make changes across funding, risk management, and capital allocation. More granular analyses of capital allocation, for example, can precipitate balance sheet restructuring that frees up strategic liquidity for investment.

Still, one size does not always fit all, and companies can also make significant gains by focusing on specific areas of activity. One top-tier automaker unlocked annual savings of $15 million by reducing balance sheet hedging by 50 percent (without a shift in risk appetite) and converting part of its FX forward-based hedging program to out-of-the-money options.

Exhibit 2

## A leading infrastructure company deployed a holistic approach to create probability models for a range of factors, taking into account uncertainties.

**Uncertainty regarding future sources of liquidity,**
sources of cash (stressed/simulated)

Committed bank facilities +
liquid short-term investments +
free cash flow stressed by
- Lower demand
- Supply-chain disruptions
- Geopolitical issues
- Adverse markets
- Reputational-risk events
- Higher taxes
- Special charges

Likelihood

0.03
percentile

1.5    2.0    2.5    3.0    3.5

Available
liquidity, € billion

**Advanced modeling techniques**
- Create joint uncertainty distribu-
tions for macro factors (eg, GDP,
government-debt levels, inflation)
consistent with commodity prices,
foreign exchange, and interest rates

- Incorporate potential impact of
geopolitical crises, economic
shocks, and new economic
paradigms (eg, persistently
negative interest rates)

**Uses of liquidity,[1]**
uses of cash (stressed)

Resilience
1. Fixed costs
2. Critical capital expenditures
3. Debt repayments
4. Dividends
5. Disaster liabilities

Strategic opportunities
6. Price of potential targets
7. Safety cushion

Total liquidity
requirement,
€ million

120    30    300    125    200    300    250    1,325

1    2    3    4    5    6    7

- Introduce impact of cyber-
related risks (eg, cloud outage,
contagion malware, large
data exfiltration)

[1] Stressed by foreign exchange, interest rate, commodities, and inflation.

A leading infrastructure company, meanwhile, deployed a holistic approach to address a surfeit of cash on its balance sheet and significant exposure to foreign exchange markets (Exhibit 2). This involved using advanced techniques to create probability models for a range of factors and taking into account uncertainties, such as cyberrisks and data risks. The company's analysis showed that its liquidity buffer of $2.2 billion was excessive and that, in fact, it required just $1.3 billion of liquidity to maintain resilience

and strategic flexibility. It used the outstanding $900 million to repay a maturing bond, reduce hedging costs, and boost its dividend. It generated additional savings by swapping $500 million of fixed-rate debt to a floating rate. The combination of these actions contributed to a 15 percent increase in the company's valuation over a year.

The arguments for holistic financial resource management are compelling. However, there are

also sound performance metrics behind the theory. Companies that reallocate resources (including financial resources) most aggressively (41.0 to 100.0 percent) achieve 10.2 percent growth in total returns to shareholders, compared with 7.8 percent for companies that reallocate 20.0 percent or less.[6] Over 15 years, this implies a 40 percent relative valuation uplift.

———————

Holistic transformation, assisted by advanced analytics and modeling, can be a game changer in corporate financial resource management. Effectively implemented, it can generate a seamless view of a company's key future financial position. Rarely will all five elements identified in this article be equally relevant; leaders must pick and choose (perhaps two or three), according to their own strategic agenda. In most cases, a holistic approach will require trade-offs between the various risks and commitments in focus. However, successful transformations are likely to boost financial transparency, support a nimble approach to management, and create a significant boost to the bottom line.

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[6]Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds*, Hoboken, NJ: John Wiley & Sons, 2018.

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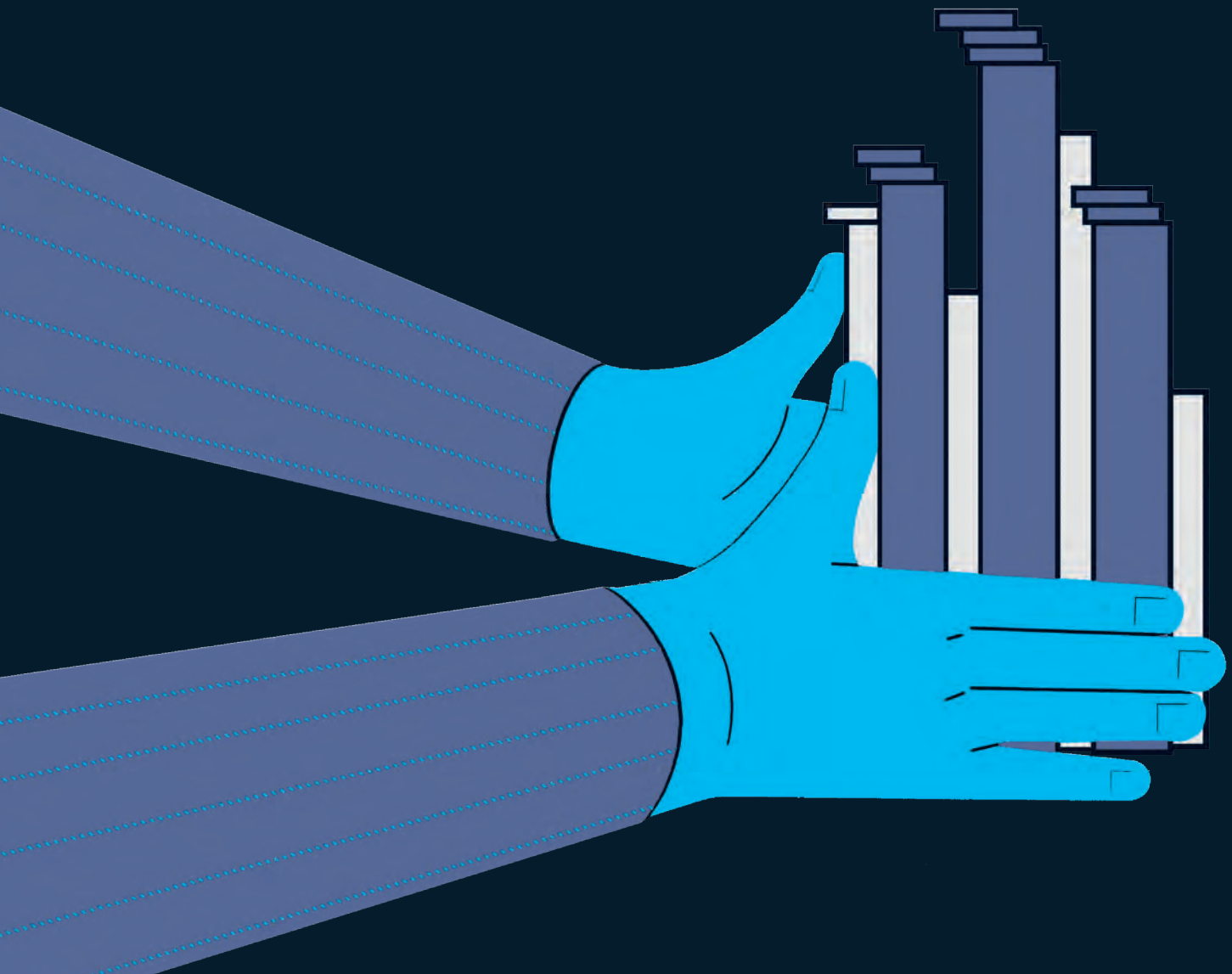
# Why your next transformation should be 'all in'

Improve the odds of a successful business transformation by going "all in" to kick-start performance and remake your portfolio.

*by Chris Bradley, Marc de Jong, and Wesley Walden*

Business transformation programs have long focused on productivity improvement—taking a "better, faster, cheaper" approach to how the company works. And for good reason: disciplined efforts can boost productivity as well as accountability, transparency, execution, and the pace of decision making. When it comes to delivering fast results to the bottom line, it's a proven recipe that works.

The problem is, it's no longer enough. Digitization, advanced technologies, and other forms of tech-enabled disruption are upending industry after industry, pressuring incumbent companies not only to scratch out stronger financial returns but also to remake who and what they are as organizations.

Doing the first is hard enough. Tackling the second—changing what your company is and does—requires understanding where the value is shifting in your industry (and in others), spotting opportunities in the inflection points, and taking purposeful actions to seize them. The prospect of doing both jobs at once is sobering.

How realistic is it to think your company can pull it off? The good news is that our research demonstrates it's entirely possible for organizations to ramp up their bottom-line performance even as they secure game-changing portfolio wins that redefine what a company is and does. The more challenging news? Our research suggests that to achieve truly transformational results, it is actually *necessary* to do both. What's more, "all-in" transformations that focus on the organization's performance *and* portfolio appear to load the dice in favor of transformational results. By developing these two complementary sets of muscles, companies can aspire to flex them in a coordinated way, using performance improvements to carry them to the next set of portfolio moves, which in turn creates momentum propelling the company to the next level.

## Life on the power curve

If you want to see where you're going, it's best to start with a point of reference. Our choice, the power curve of economic profit, came out of a multiyear research effort that sought to establish empirical benchmarks for what really makes for success

Exhibit 1

## The power curve: The global distribution of economic profit is radically uneven.

Average annual economic profit (EP) generated per company, 2010–14, $ million, n = 2,393[1]
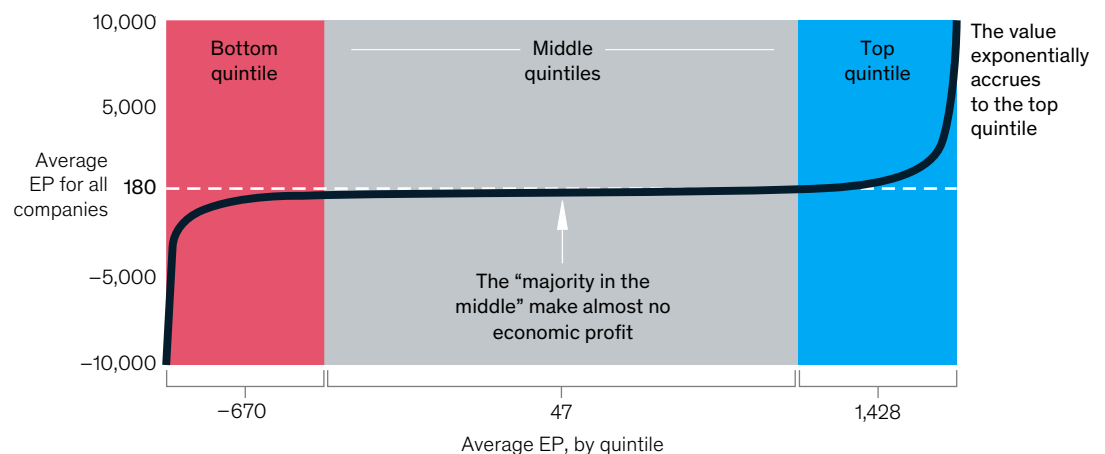


[1]Excluding 7 outliers (companies with economic profit above $10 billion or below −$10 billion).
Source: Corporate Performance Analytics by McKinsey

# Although there is an enormous gulf between the middle firms and the top-quintile firms, companies can and do move up.

in strategy. To create Exhibit 1, we plotted the economic profit (the total profit after subtracting the cost of capital) earned by the world's 2,393 largest nonfinancial companies from 2010 to 2014. The result shows a power curve that is extremely steep at both ends and flat in the middle. The average company in the middle three quintiles earned less than $50 million in economic profit. Meanwhile, those in the top quintile earned 30 times more than the average firm in our sample, capturing nearly 90 percent of all the economic profit created, or an average of $1.4 billion annually.

Although there is an enormous gulf between the middle firms and the top-quintile firms, companies can and do move up. Eight percent, or one in 12 companies, managed this feat across the decade we examined (from a starting position in 2000–04, to an ending position of 2010–14). As described in *Strategy Beyond the Hockey Stick* (Wiley, 2018), the specific odds of a company succeeding are largely explained by its endowment (for example, its size and debt capacity), its trends (a declining or improving industry), and the application of five big moves.[1]

While all of these factors matter, the five moves play the biggest role in determining whether or not a company successfully climbed the power curve. They are also the ingredients of a truly *transformational* transformation program, so let's look at them next.

## Big moves in the transformation tool kit

To place the five big moves in the context of transformation, we divided them into two categories. The first covers "performance-related" moves. These include substantial changes that lead to better margins and potential new fit-for-purpose business models.

Productivity improvements are a management favorite in the performance genre, but to qualify as a big move, the relative improvement versus your sector must outpace 70 percent of firms over a decade.

Differentiation improvement is the other performance-related move, covering innovation in products, services, and business models. Similarly, for this move to really transform the business, we said that your company's gross margin improvement must put it in the top 30 percent of its industry's improvement—or, to put another way, you must deliver 25 percent more improvement than your industry median.

The second category covers three "portfolio-related" moves. The first is active resource reallocation, which we define as the company shifting more than 60 percent of its capital spending across its businesses or markets over ten years. Such firms create 50 percent more value than counterparts that shift resources at a slower clip.[2]

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[1] Chris Bradley, Martin Hirt, and Sven Smit, "Strategy to beat the odds," *McKinsey Quarterly*, February 2018, McKinsey.com.
[2] See Chris Bradley, Martin Hirt, and Sven Smit, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds*, New York, NY: Wiley, 2018.

Meanwhile, a big move in programmatic M&A—the type of deal making that produces more reliable performance boosts than any other—requires the company to execute at least one deal per year, cumulatively amounting to more than 30 percent of a company's market capitalization over ten years, and with no single deal being more than 30 percent of its market capitalization. Finally, for capital programs to qualify as a big move, the ratio of capital expenditure (capex) to sales must exceed 1.7 times the industry median for at least a decade.

While the five moves are by definition big relative to competitors, this does not mean they are brash or reckless. In fact, making big moves tends to reduce the risk profile and adds more upside than downside (although how much of each depends in part on your industry's trends, as we will see). The way we explain this to senior executives is that when you're parked on the side of a volcano, staying put is your riskiest move. Moreover, the five moves are cumulatively big

and are most effective when combined in carefully considered ways. The successful big movers rarely lurch; they are far more likely to move consistently and steadily, with a constancy of purpose, over a long period of time.

## Combining moves to transform

As shown in *Strategy Beyond the Hockey Stick*, for companies in the middle ranks of the power curve, making one or two of the five big moves increases a company's odds of rising into the top quintile from 8 percent to 17 percent; making three big moves boosts these odds to nearly 50 percent. In our latest research, we sought to become more granular about the relationship between different categories of moves, by segmenting 1,435 companies that started in the middle three quintiles of the power curve into four transformation "stories" (Exhibit 2). Those relationships are interesting in their own right, and we also hope they will help leaders raise their sights in a nuanced

Exhibit 2

**Addressing both a company's performance and its portfolio offers the highest odds of lasting improvement.**

**Probability of moving up** to the top quintile of the power curve from the middle 3 quintiles over a decade (n = 1,435), %

Overall probability of moving up = **8%**
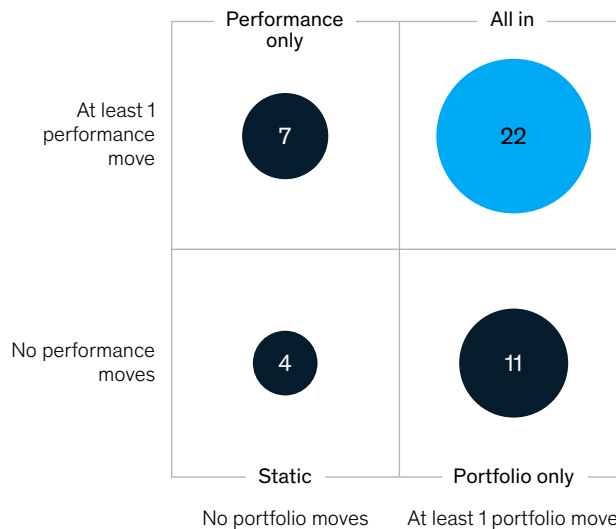
| | Performance only | All in |
|---|---|---|
| At least 1 performance move | 7 | 22 |
| No performance moves | 4 | 11 |
| | Static | Portfolio only |
| | No portfolio moves | At least 1 portfolio move |

# Approaches that go all in by addressing both a company's performance and its portfolio yield the highest odds of lasting improvement.

way. Resetting aspirations often represents a critical need. It's quite rare for companies to make more than a single big move; about 80 percent of our sample made exactly one move, or none at all.

### Static

The largest group, representing 47 percent of the companies we studied, didn't make any of the five big moves. This doesn't mean they didn't make plans or moves—only that their moves weren't big enough to reach our bar for transformational results. The members of this "static" group had the lowest odds of reaching the top quintile of the power curve, at 4 percent.

### Performance only

Twenty-six percent of the companies made at least one big, performance-oriented move, but no portfolio moves. As a result, they nearly doubled their odds of rising to the top quintile of the power curve.

### Portfolio only

Meanwhile, 15 percent of the companies we studied made a major move that reshaped their portfolio, but they didn't make big moves in productivity or differentiation. At 11 percent, they had an even better chance than the performance-only group of vaulting to the top quintile. For example, Tele2, a Sweden-based telecom, used a strong programmatic-M&A strategy, featuring 16 acquisitions during the period we studied (2000 to 2012), to gradually expand to

new markets while using the infrastructure from its acquisitions to strengthen its product offering.

### All in

The 12 percent of companies in our sample that made at least one big move in both categories were rewarded with the highest odds of climbing the power curve, at 22 percent. Consider the case of Sun Pharmaceutical, an India-based manufacturer of generic drugs, which made clear differentiation improvements and executed a strong capital program over the period we studied. This allowed the company to seize upon the industry trend of increased local and global demand for generic medicines. In 2007, the company divested its research arm to focus fully on generics. This resulted in an aggressive expansion of the company's production capacity (with a capital-expenditure ratio twice as high as the industry median at that time) and a strong focus on higher-margin generics (its gross margin doubled between 2000 and 2014).

The implication of these transformation stories is clear: approaches that go all in by addressing both a company's performance and its portfolio yield the highest odds of lasting improvement. Over the course of a decade, companies that followed this path nearly tripled their likelihood of reaching the top quintile of the power curve relative to the average company in the middle three tiers.[3]

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[3]Our analysis thus far has assumed that companies started in one of the three middle quintiles of the power curve—a good company earning close to its cost of capital. Keen readers may therefore ask, "What about companies starting in the bottom quintile?" We checked the numbers: in this case, performance-only, portfolio-only, and all-in programs offer similar, much higher odds than static programs (where the moves taken were small relative to competitors). Still, given more big moves, the all-in programs had the edge.

## Play to your industry context

Life would be simpler if our story ended here. However, you're not operating in a competitive vacuum. As we described earlier, other forces influence your odds of success in significant ways—in particular, how your industry is performing. To map this effect, we divided our sample of companies according to whether or not their industry improved its average economic profit over the decade we studied. We knew from our previous research that companies facing competitive headwinds would face longer odds of success than those with tailwinds, but what we now saw was the extent to which the impact of different combinations of moves affected the odds for each group.

### Running against the wind

Among the companies in the power curve's middle three quintiles, fully 60 percent compete in industries where the average economic profit is declining. Life is tough with a headwind, and these companies must run hard just to stand still. Just how hard becomes clear when we look at their net odds of success. We calculated this by netting their chances of moving to the top quintile against their chances of falling to the bottom quintile.

The net odds say it all: companies in declining industries have a 4 percent chance of moving up the power curve, but an 18 percent chance of moving down (meaning their net odds are negative 14 percent). If you're in this group, how you employ the five big moves says a lot about how you're likely to fare (Exhibit 3). Among our findings:

— *Standing still is a terrible idea.* The odds associated with a static approach are grim, equating to a 2 percent chance of reaching the top of the power curve and a 16 percent chance of slipping to the bottom. Nonetheless, just over half the companies in declining industries followed this path.

— *Good performance alone won't cut it.* Surprisingly, perhaps, we found that performance-only moves also equate to negative net odds. True, the downside risk is lower with this approach than

if you make no big moves at all—but not by much. This finding flies against the conventional wisdom that the best response in a declining industry is corporate belt tightening.

— *You can't spend your way out of trouble.* Companies taking a capex-only approach added far more downside than upside. Why? Big capital expenditures are an amplifier, pushing you faster in a good direction if the underlying investment is smart, and faster in a bad direction if it's not. Given the added drag of an industry headwind, a capex-only approach to transformation is like stepping on the accelerator in heavy traffic: you won't get far and may well crash.[4]

— *All in is your best chance.* Companies that combined big performance moves with big portfolio moves (including capital expenditures, when not the only portfolio move employed) saw a big lift in their odds. Life is still challenging for these companies—their net odds are dead even—yet this is superior to the negative odds of the other situations. Ultimately, a bit more than one in five companies in this category were able to move to the top quintile.

### Riding on the wind

The other 40 percent of the companies in the middle three quintiles have it much better, having been gifted a positive economic trend. For these organizations, the chances of success are enhanced: 15 percent, on average, rise to the top of the power curve, and just 8 percent fall to the bottom. For this group, too, the application of the big moves affected the outcome (Exhibit 4). Among the implications:

— *Don't waste your gifts.* A static approach is still a bad idea. While the odds of moving up the power curve were 9 percent for companies in this situation, the odds of moving down were 7 percent. You can do better.

— *Press your performance advantage.* In an improving industry, the returns to performance improvement are amplified massively. This runs contrary to the very human tendency of

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[4] Warren Buffett's famous (and colorful) warning to Berkshire Hathaway shareholders also comes to mind: "The projections will be dazzling and the advocates sincere, but, in the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand."

Exhibit 3

# Declining industries face tougher odds for a successful transformation.

**Declining industries:** probability of moving up to the top quintile or down to the bottom quintile of the economic-profit power curve from the middle 3 quintiles over a decade (n = 1,435), %

● Odds of moving down    ● Odds of moving up

**Overall probability**

↓ **18%** for moving down    ↑ **4%** for moving up

|                                    | No portfolio moves | Capital-expenditure (capex) moves only | Any portfolio move or combination[1] of portfolio moves except a capex-only move |
|------------------------------------|---|---|---|
| At least 1 performance move        | 11 · 2 | 25 · 7 | 21 · 21 |
| No performance moves               | 16 · 2 | 41 · 9 | 23 · 11 |
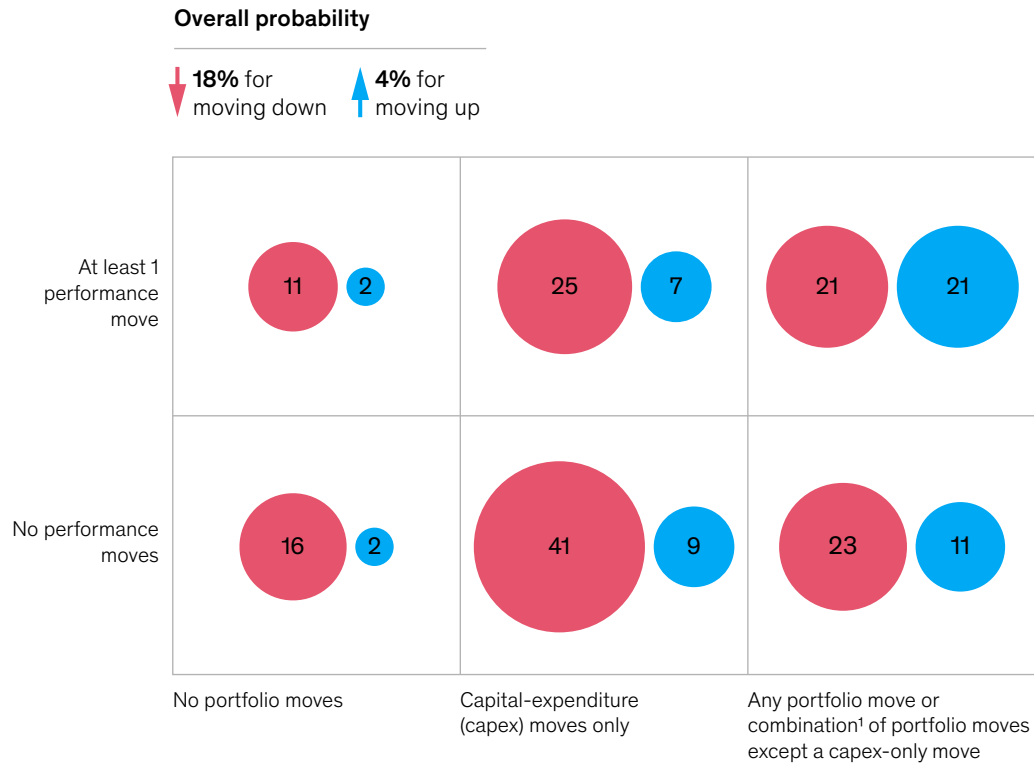
[1]For example, combining M&A and reallocation, reallocation and capital expenditure, or M&A, reallocation, and capital expenditure.

equating performance transformations with turnaround cases. If you are lucky enough to enjoy an industry tailwind, a performance-only transformation raises your upside odds to 15 percent and lowers your downside chances to just 2 percent. When in the fast lane, step on the gas.

— *Don't spend big without better performance.* Far from being oil and water, growth and productivity improvement are well paired. Nonetheless, be wary of big capital-expenditure programs that don't improve the overall cost and gross-margin economics of the business. Your net odds of success are much worse in this scenario than if you made no big moves at all. Combining a big capital-expenditure move with a big performance move, however, gives you net odds that are more than seven times better than standing pat.

— *All in wins again.* Indeed, the all-in approach to transformation wins out. Depending on their particular combination of portfolio and performance moves, organizations in this category saw their chances of entering the top quintile reach a whopping 39 percent, versus a 6 percent chance of slipping down.

The takeaway from all this is that two big rules stand out as commonly and powerfully true whatever your context: first, get moving, don't be static; second, go all in if you can—it's always the best outcome (and also the rarest).

## Getting to all in

In our experience, the companies that are most successful at transforming themselves sequence their moves so that the rapid lift of performance improvement provides oxygen and confidence for big moves in M&A, capital investment, and resource reallocation. And when the right portfolio moves aren't immediately available or aren't clear, the improved performance helps buy a company time until the strategy can catch up.

To illustrate this point, consider the anecdote about Apple that UCLA business professor Richard Rumelt describes in his book, Good Strategy/Bad Strategy (Crown Publishing, 2011). It was the late 1990s; Steve Jobs had returned to Apple and cleaned house through productivity-improving cutbacks and a radically simplified product line. Apple was much stronger, yet it remained a niche player in its

Exhibit 4

## Improving industries enjoy better odds of a successful transformation.

**Improving industries:** probability of moving up to the top quintile or down to the bottom quintile of the economic-profit power curve from the middle 3 quintiles over a decade (n = 1,435), %

● Odds of moving down   ● Odds of moving up

**Overall probability**

↓ **8%** for moving down   ↑ **15%** for moving up

| | No portfolio moves | Capital-expenditure (capex) moves only | Any portfolio move or combination[1] of portfolio moves except a capex-only move |
|---|---|---|---|
| At least 1 performance move | 2 / 15 | 17 / 32 | 6 / 39 |
| No performance moves | 7 / 9 | 15 / 8 | 12 / 20 |
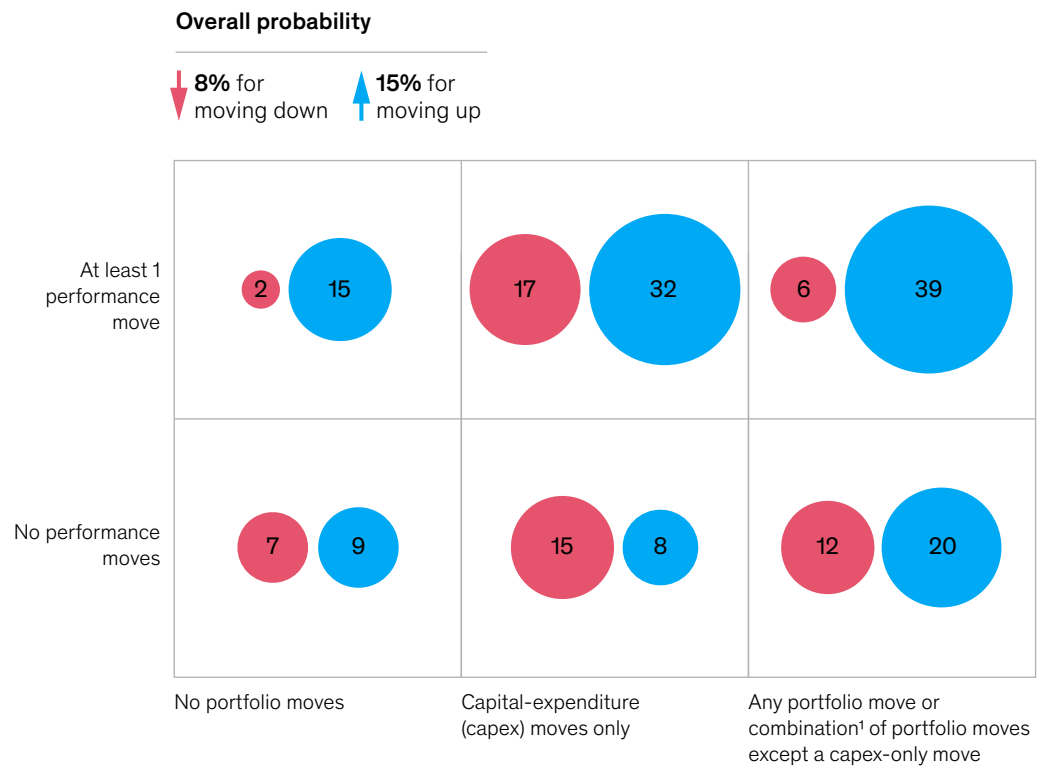
[1]For example, combining M&A and reallocation, reallocation and capital expenditure, or M&A, reallocation, and capital expenditure.

# Are you all in?
**Gauge your level of preparedness by asking six questions.**

## Where is the value flowing, and what can we do about it?

Achieving success with big, portfolio-related moves requires understanding where the value flows in your business and why. The structural attractiveness of markets, and your position in them, can and does change over time. Ignore this and you might be shifting deck chairs on the *Titanic*. Meanwhile, to put this thinking into action, you must also view the company as an ever-changing portfolio. This represents a sea change for managers who are used to plodding, once-a-year strategy sessions that are more focused on "getting to yes" and on protecting turf than on debating real alternatives.

*For more about how to transform the dynamics in your strategy room, see "Eight shifts that will take your strategy into high gear," on McKinsey.com.*

## Do we put our money where our strategy is?

About one-third of US companies reallocate no more than 1 percent of their resources from year to year. Whether through bias, office politics, or plain old inertia, they simply roll this year's plan into next year. It should, by now, go without saying that this is a terrible starting position from which to expect transformative change. Companies can escape the cycle by creating target portfolios, adopting decision rules, and creating simple processes to break free of inertia.

*For more, see "How to put your money where your strategy is," on McKinsey.com.*

## Are we ready for cannibalism?

Increasingly, incumbent organizations are getting to the pointy end of disruption, where they must accelerate the transition from legacy business models to new ones and even allow potentially cannibalizing businesses to flourish. Sometimes this requires a very deliberate two-speed approach where legacy assets are managed for cash while new businesses are nurtured for growth.

*For more on embracing such a mindset, see the* Harvard Business Review *article "The best companies aren't afraid to replace their most profitable products," on hbr.org.*

## Are we aiming high enough?

Bold aspirations matter hugely in business transformation, but people tend to be far more comfortable when they "underpromise and overdeliver." The upshot, in our experience, can be setting initial targets (for example, in securing performance-related improvements) that are two or even three times lower than they could be over time.

*For more on how to set strong aspirations and, more importantly, how to evolve them, see "The numbers behind successful transformations," forthcoming on McKinsey.com, and "Transformation with a capital T," on McKinsey.com.*

## Will our company take this seriously?

Embracing transformative change requires commitment, and gaining commitment requires a compelling change story that everyone in the company can embrace. Philips recognized this in 2011 when it launched its "Accelerate!" program. Along with productivity improvements and portfolio changes (including a big pivot from electronics to health tech), the company shaped its change story around improving three billion lives annually by 2030, as part of a broader goal of "mak[ing] the world healthier and more sustainable through innovation."

*For more about what works—and what doesn't—in creating a change story, see "The irrational side of change management," on McKinsey.com.*

## Are you up to the leadership challenge?

Leading a successful transformation requires a lot more than just picking the right moves and seeing them through. Among your other priorities: build momentum, engage your workforce, and make the change personal for yourself and your company. All of this means developing new leadership skills and ways of working, while embracing a level of commitment as a leader that may be unprecedented for you.

*For more on addressing these challenges, see "The wisdom of transformations: How successful CEOs think about change," on McKinsey.com.*

# Achieving success with big, portfolio-related moves requires understanding where the value flows in your business and why.

industry. When Rumelt asked Jobs how he planned to address this fact, "[Jobs] just smiled and said, 'I am going to wait for the next big thing.'" [5]

While no one can guarantee that your "next big thing" will be an iPod-size breakthrough, there's nothing stopping you from laying the groundwork

for a successful all-in transformation. To see how prepared you are for such an undertaking, see the reference guide that follows, "Are you all in?" We hope these questions and related readings provoke productive and, dare we suggest, transformative discussion among your team.

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[5] "Strategy's strategist: An interview with Richard Rumelt," *McKinsey Quarterly*, November 2007, McKinsey.com.

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# Why isn't your transformation showing up in the bottom line?

The success rates of large change programs vary widely. Finance teams can make a big difference in the outcome of these initiatives by articulating and validating the link between transformation efforts and long-term value.

*by Ryan Davies, Douglas Huey, and David Kennedy*

"Transformation" is the buzzword of the day for companies in most industries, but for many it carries an asterisk: studies show wide variation in companies' rates of success with organizational transformations—whether they are changing how they go to market, updating back-office pro-cesses, automating production systems, or otherwise making significant changes in how their businesses are structured and run.

In some cases, this variation exists because executives propose fundamental changes in how the business operates but don't go through the hard process of setting commensurate performance targets. They often set targets too low, aiming for incremental change. When they do set their sights appropriately high, they often fail to adequately make clear to key stakeholders who owns the goals and responsibilities associated with various elements of the transformation. As a result, value can end up "leaking" even from good initiatives, which can sap companies' efforts to meet bottom-line targets, drain momentum from good investments, and impede buy-in for change efforts generally.

CFOs and finance teams have a critical role to play in not only setting ambitious targets but also providing the discipline to mitigate value leakage and fully deliver transformational benefits to the bottom line.

Given the steep learning curve involved with transformational change, it is typical for companies to realize some leakage in value early on. Transformation initiatives may underdeliver because of inaccurate assumptions going into the project or suboptimal execution of the project. In other instances, initiatives may deliver benefits as intended, but managerial actions in other parts of the company create leaks—for instance, when cost savings are passed on to customers through higher discounting than necessary. Sometimes macroeconomic effects outside of management's control—currency fluctuation, for instance, or a change in the cost of production inputs—end up offsetting genuine benefits from transformation. Separately, savings realized through transformation may be deliberately reinvested in growth—which, in itself, can be a wise decision—but a lack of transparency about this process can create confusion about bottom-line impact, as well as misperceptions about the success or failure of the transformation (exhibit).

To keep large transformations on track toward finance goals, CFOs and finance teams must help business-unit leaders and the CEO articulate and validate the value to be gained from the initiative,

Exhibit

## There are four reasons why the full benefits of transformation may not show up in the bottom line.

| | | Challenge | Example |
|---|---|---|---|
| **Sources of leakage** | Initiative underdelivery | Change initiatives deliver fewer benefits than forecasted | A new product takes longer to launch than planned |
| | Underperformance elsewhere in the company | Management's actions erode value, independent from or despite outcome of change initiatives | Savings from a change initiative are passed on to customers through greater discounts |
| | Exogenous headwinds | Factors outside the company's control affect performance | There are currency fluctuations, or market-wide inflation of the cost of raw materials or labor |
| | Reinvestment | Lack of transparency about reinvestments creates confusion about bottom-line impact | There is increased spending on R&D, sales, or marketing |

as well as the scope of change required. Once initiatives are under way, the finance team should provide "single stream" forecasts, business reports, and budgets—combining data about transformation activities with those for daily operations. In this way, the CEO and business-unit leaders can more easily identify which aspects of the transformation are working in which areas of the business, which initiatives might be introduced in other parts of the organization, and which should be revamped or abandoned entirely.

Over time, the CFO and finance team can also help companies sustain their transformation efforts by continually monitoring and identifying the root causes of value leakage and performance issues so teams can better address them. Business leaders will likely be better prepared to address the most common earnings-call question when it comes to change initiatives: "Are they showing up in the bottom line?"

## Big goals, detailed plans

Time and time again, we've seen that the companies that have found success with their transformations relative to peers have established the overarching purpose of change initiatives at the outset, often relying on one of three major objectives: pursuing growth, pursuing operational improvements, or reallocating portfolios. They jettison status quo approaches to planning, in which budget conversations and other discussions are grounded primarily in "what we did last year."[1] Instead they set internal and external commitments that are aspirational.

The CFO and finance team are well positioned to put teeth into the CEO's big, hairy, audacious transformation goals. They have the data and cross-functional perspective to coach teams on how to assess the value of proposed transformation initiatives and what the financial and operational milestones should be. They can also ensure that

business-unit leaders and frontline managers have detailed plans for hitting all those targets.

Indeed, the finance team must set the ground rules: in too many companies, executives—in their haste to launch a new idea—often forgo a formal evaluation of the business case by the finance group, relying instead on their own back-of-the-envelope calculations and risk assessments, turning to finance leaders only when issues crop up. But, with support from senior management, the CFO can mandate the finance team's review and approval of a detailed business plan before any transformation initiative launches.

That business plan should, of course, include key performance indicators (KPIs) that show a clear connection between operational changes and financial outcomes. A large retail company, for instance, wanted to reduce levels of inventory without negatively affecting customers' purchasing experiences. The finance team and supply-chain leaders jointly conducted a review of inventory to identify fast- and slow-moving SKUs, as well as the balance of inventory being held at distribution centers and stores at any given time. With this information in hand, they updated the operational targets—the amount of inventory on hand, stock-out rates, and so on—needed to create the financial outcomes desired. Business leaders then instituted new rules that empowered supply-chain leaders to reposition inventory as needed to ensure that customers could still find the items they wanted, when they wanted. The systematic review of KPIs made financial and operational objectives clear to all, and it encouraged supply-chain and frontline managers alike to commit to the transformation approach.

## Integrated forecasts, reporting, and budgeting

Business leaders often separate transformation efforts from day-to-day operations—giving

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[1] Tim Koller, Dan Lovallo, Olivier Sibony, "Bias Busters: Being objective about budgets," September 2018, McKinsey.com.

# A regular review of transformation-related data alongside run-the-business numbers can give stakeholders the insights they need to actively engage in and commit to a change program.

project managers and teams the time and space to pursue pilot initiatives and insulating them from the rest of the business. In doing so, they are missing a huge opportunity: by involving more employees earlier, the company can create buy-in for transformation across the organization.

The same holds true for integrated business forecasting, reporting, and budgeting: a regular review of transformation-related data alongside run-the-business numbers can give business-unit leaders, employees, and other key stakeholders the insights they need to actively engage in and commit to a change program. A big-picture, single-stream view can reveal the scope of investments the company is making, the impact of those investments for the overall organization, and how the company is meeting or exceeding budget numbers.

**Forecasting.** Once they've reviewed and approved transformation initiatives and business plans, CFOs and their forecasting, planning, and analysis (FP&A) teams will need to reconcile business plans with existing forecasts and clarify the potential value from transformation. The CFO will likely assign members of the FP&A team to clarify underlying assumptions and then revise forecasts and communicate them to senior management as well as the business-unit leaders. In this way, everyone will understand the degree to which the bar for

performance has changed. For instance, if a business unit with $1 billion in revenue expects $50 million in top-line losses because of pricing pressures but has committed to create $100 million in transformation benefits, everyone should expect the business unit to deliver $1.05 billion in revenue (accounting for the erosion).

**Business reporting.** Integrated business reporting can help the CEO and business-unit leaders clearly track the relationship between financial and operational activities and outcomes—which is critical, because the success of transformation activities can't always be judged solely through financial metrics. Consider a company that has decided to simplify its product design to reduce manufacturing costs. In the midst of this transformation, teams report that cost per unit is down and throughput rates are up, but quality has dipped slightly. A purely financial view would focus only on the direct cost per unit—a misleading figure, in this case. An integrated report, comparing current KPIs against baselines established during initial planning, as well as the targets established initially for throughput and quality, would provide a more comprehensive perspective on the net benefit of this initiative.

**Budgeting.** The budget process is where CFOs and their teams can lean in and ensure that the value being captured from transformations is retained

# Using prior-period actuals can help teams correct for the clutter sometimes associated with companies' budgeting exercises and get a clearer sense of performance against targets.

and that previous financial and operational commitments are preserved. A key challenge for them is getting the first year of the transformation in sync with the overall budget cycle. It is rare for executives to restate a budget to account for the new commitments associated with transformation; instead they tend to rely on updated forecasting. But in the second year, CFOs will have more data in hand, and therefore more opportunity to lock in transformation benefits—clearly stating the costs of transformation (one-time and recurring), the recurring benefits, the incremental benefits from partially realized initiatives, and the outstanding commitments to the transformation. The owners of the transformation project should be able to help the finance team to streamline aspects of the budget cycle, as they can supply much of the required data.

No question, enhancing existing forecasting, reporting, and budgeting processes and establishing an integrated view will require an extra measure of time and resources from the finance team, but it is critical for improving the outcomes of transformation initiatives as well as the overall health of the organization. In all three phases, it is important that finance and business leaders use prior-period

actuals when comparing performance figures and assessing the impact of the transformation. Using prior-period actuals can help teams correct for the clutter sometimes associated with companies' budgeting exercises and get a clearer sense of performance against targets.

## Translating insights into action

Establishing ambitious goals, detailed plans, and comprehensive reporting is important. But just completing those tasks won't automatically change everything; the company's leaders must then be able to turn insights into action. To do so, they need strong, ongoing support from the finance team to systematically identify sources of value leakage, make course corrections, monitor progress, and inform subsequent discussions about the company's transformation initiatives. With this level of collaboration, transformation becomes part of regular management discussions—and CFOs and finance professionals remain central participants in the dialogue.

Specifically, finance teams need to help guide their business partners' focus and decision making. Rather than overload business leaders with as much

data as possible, finance teams should seek to simplify—for instance, presenting conclusions from their analyses, using the data only to support any insights, options, and recommendations, and making sure to tie their findings to specific performance issues or emerging opportunities associated with the transformation. The finance team at one retail company has established a standard one-page template for summarizing proposed options relating to transformation initiatives, as well as decision logs, so that transformation decisions are framed and discussed in a consistent manner, at all levels of the organization.

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The most effective change programs allow companies to perform much better than peers and create outsize value for their shareholders, doing both over an extended period of time. But long-term success with transformations is hard to achieve unless executives set ambitious goals and then work with the business and the finance function to ensure that those intentions show up directly in the company's net financial performance.

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# Transforming industries

# Completing a transformation in the consumer-goods industry

In a dynamic environment, every organization must realign its operating model. Consumer-packaged-goods players are no exception. But what's the secret to a successful transformation? Here are six ideas.

*by Onno Boer, Raphael Buck, Patrick Guggenberger, and Patrick Simon*

Strong brands and product innovations for the mass market—that is the formula that has guaranteed consumer-goods companies economic success for decades. Most recently, it was the emerging markets, especially in Asia, that accounted for three-quarters of revenue growth. There, too, most companies rely on their tried-and-true operating models to manage their business. But a new era has since dawned that requires new strategies.

Indeed, consumers are changing rapidly, as are their preferences. Millennials are entering the phase of their lives in which their spend is peaking. Yet, only 7 percent of them would consider themselves loyal to brands. Many of the 1.8 billion millennials worldwide today associate consumption with higher motives: they are more keenly aware of their health, value the local origin of products, and support the sharing economy.

Moreover, digitization is not only speeding up the market, it's shifting it too. While the large online providers recorded growth of 34 percent in the past six years, conventional companies barely grew 0.4 percent. It is the industry's small outfits that benefit most from the digital marketing and distribution channels, accounting for over half of growth (exhibit). At the same time, customer communication is increasingly shifting to the internet; meanwhile, 63 percent of millennials follow brands on social-media channels. These and other market trends bring fundamental changes that the internal structures of many companies fail to adequately reflect.

## Digital opportunities, agile methods

Future-oriented, consumer-centric manufacturers or retailers run digital and agile operations at all levels: they focus on customer data, use advanced analytics to make faster and better decisions, and win and retain digital talent. In their internal organization, they use agile methods to react quickly to changing requirements and to pick up on trends early on.

Many consumer-goods companies are well aware that they are still nowhere near realizing this vision. What they need is a new operating model that meets today's and tomorrow's needs. In fact, 60 percent of the CEOs McKinsey surveyed plan to transform their organization within the next few years—knowing full well that it will not be an easy undertaking. On the often stony path from a transformation's initial idea to its implementation, a three-step approach is generally recommended.

*Diagnostic and design.* The first step is to get an accurate snapshot of the status quo: What are the organization's strengths and weaknesses? What needs to change? How do structures, processes, technologies, and capabilities have to be designed in order to optimally support a growth strategy, for example? This groundwork forms the foundation for the new operating model. It is essential here to involve experts from different functions and regions from the outset. At the end of the diagnostic and design phase, companies have a clear picture of the future organizational structure, the processes, as well as the required employee skills and work cultures for the new operating model.

*Basic check and fine-tuning.* In order to ensure that the vision designed "top down" by headquarters also meets the practical requirements at the grassroots level, it is put to the test in all business functions, regions, and markets and, if necessary, adapted to the specific requirements prevailing there. Also established in this phase are the systems needed to monitor the change process.

*Implementation and control.* At this point, the organization should be ready to implement the changes at all levels. To ensure that the transformation is both effective and sustainable, it should be accompanied by professional change management that controls the process, builds up the capabilities needed, regularly monitors progress, and closely involves senior management.
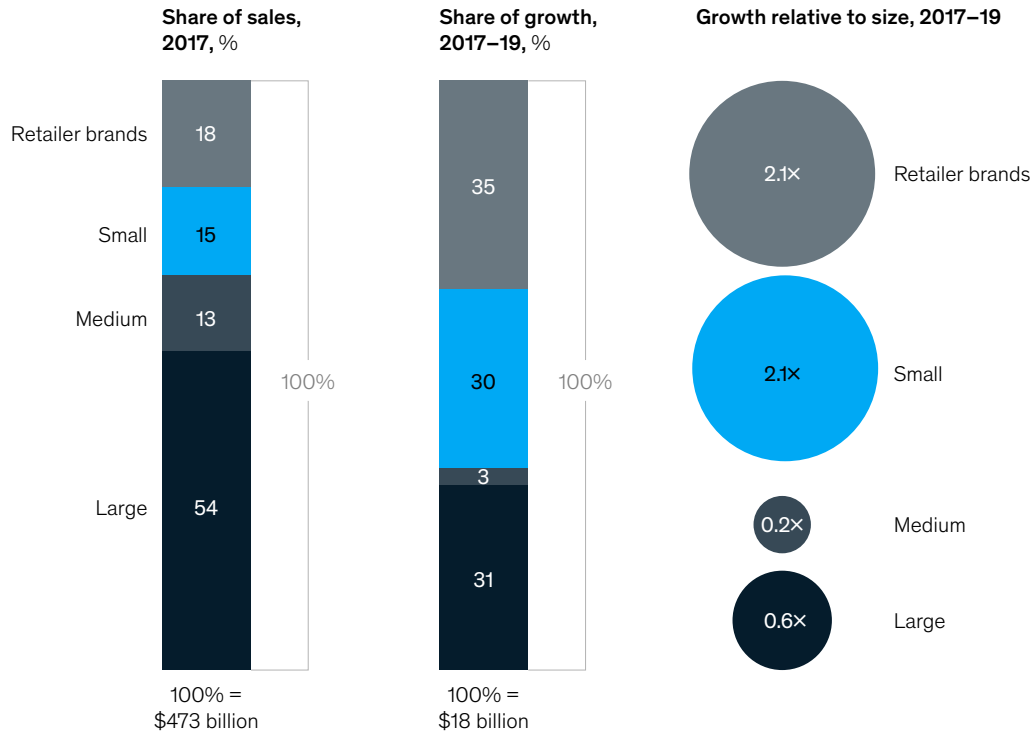
## Getting the transformation right—six determinants of success

Depending on the nature and scale of the organization in question, the amount of time and effort needed to realign the operating model

## Empowered by digitization, small brands make up almost one-third in the consumer-goods market.

**Fast-moving consumer-goods industry share of sales and of growth, United States**

| Share of sales, 2017, % | Share of growth, 2017–19, % | Growth relative to size, 2017–19 |
|---|---|---|

Retailer brands — 18

Small — 15

Medium — 13

Large — 54

100% = $473 billion

Retailer brands — 35

Small — 30

Medium — 3

Large — 31

100% = $18 billion

Retailer brands — 2.1×

Small — 2.1×

Medium — 0.2×

Large — 0.6×

Note: Large = top 25 companies; medium = next 400; small = the rest. Figures may not sum to 100%, because of rounding.

Source: Nielsen Retail Measurement

can vary. In practice, however, all successful transformations have six factors in common.

*Optimally staff roles.* An organization's prosperity or undoing can hinge on large-scale realignments. So, the smartest minds should be involved. In what is known as the "talent to value" approach, each employee role undergoes a quantitative assessment of the value it creates for the company. This is used as a basis for staffing roles with the most suitable people. The approach can also be applied to the allocation of new roles and responsibilities as the transformation progresses.

Example: A consumer-goods manufacturer that had not yet defined clear career paths in its organization and was not using top performers effectively decided to implement a radically new talent-management system. Taking the "talent to value" approach, key roles were clearly delineated for the first time and succession appointments systematically formalized. From then on, the most efficient employees were no longer deployed to the traditionally high-revenue core business, but rather to the market segments with the greatest growth and earnings opportunities. The company was thus able to harness its workforce potential in a way that created far greater value.

*Establish robust project management.* Larger transformation programs require not only a powerful team, but also clear leadership structures. The central project team should be the driving force on the ground, while a steering committee consisting of project-management and senior-management representatives calls the shots. In addition, project management should permit agile work methods and modify them as needed.

Example: A large company in the luxury-food industry commissioned the central project team to orchestrate the transformation process across all functions, regions, and markets. The team was given free rein to independently challenge and evaluate the plans drawn up by the individual business units. As a result, it was possible to process all change concepts efficiently and to quickly remove obstacles.

*Keep change simple.* The concepts underlying future operating models are often excessively complex and obsessed with detail. On the drawing board, such constructs might at first glance appear superior to simpler models. In practice, however, they usually prove to be a dangerous stumbling block in that they create countless distractions that heighten the risk of overlooking critical changes. Simpler approaches with a solid baseline plan and continuous adjustments are often more successful.

Example: A German fashion label initially designed for its organization a minimum viable product (MVP) intended as a simplified concept that it gradually developed further and refined. Advantages of the keep-it-simple principle: thanks to the rapid implementation, the positive effects soon became apparent, and early experience on the ground made it possible to better integrate suggestions for adjustments made by various departments and thus more systematically optimize the operating model as a whole.

*Think of consumers first.* Traditional market research is a thing of the past. Today, companies have huge volumes of data at their disposal that allow them to better tailor their operating model to their customers' needs. This also explains the range of different models used by leading market players today.

Example: A global apparel manufacturer no longer wanted to rely solely on the gut feeling of its designers when developing its fashion lines, so it created its own analytics department and tasked it with determining its customers' preferences. At the same time, customer-centric fashion production required a new operating model. So product development was adapted and the calendar shortened, analytical skills developed, and a new, data-based decision-making culture instilled. The

# Today, companies have huge volumes of data at their disposal that allow them to better tailor their operating model to their customers' needs.

company is now able to accurately design up to 80 percent of its product range driven by data analytics, while designers can focus their creativity on genuine new developments. The significantly improved sales figures confirmed that it was a good idea to change course toward primarily customer-data-driven fashion production.

*Go for agile sprints.* Analysis and planning phases have traditionally taken many months and have been followed by a rude awakening in the implementation phase as theoretical models collided with real-world conditions. Agile work methods can cushion the reality shock. Ideas are developed, reviewed, and continually improved. As a consequence, the goal remains the same, but the pathway there can change.

Example: A fashion brand showing signs of weakness decided to restructure its marketing organization. Its redesign took place in agile sprints in which employees from marketing, IT, product management, and creative departments iteratively exchanged ideas and developed and modified concepts. As a result, it was possible to efficiently rework the new operating model and ensure its tight fit with the marketing strategy.

*Think holistically.* Companies have to make up their minds: Do they want to eliminate isolated weaknesses or benefit from a transformation that will get their organization as a whole in shape for the future? To avoid piecemeal solutions,

management should develop a fundamentally new, all-encompassing vision. That also prevents wasting excessive resources on temporary problems that sort themselves out in due course anyway. An integrated transformation also requires farsighted personnel management that asks: What employees do we need in the long term, and how do we get them? In addition to attractive remuneration, digital talents in particular value a dynamic environment, flexible working time models, cross-functional teams, and flat hierarchies. Agile operating models feature many of these attributes.

Example: A leading online provider not only adjusted its organization's structure and processes, but also brought about cultural change. Accordingly, hierarchies were dismantled and employees were given greater responsibility. In the three years that followed, three times as many specialists applied for tech positions.

## The people factor

The six determinants of success described above can be found at the core of every successful transformation. Many companies undergoing transformations are already applying them, at least in part. However, factors that are less obvious at an operational level are often underestimated or even completely overlooked. That is especially true of what one might refer to as the "human factor": according to McKinsey studies, 33 percent of all transformations fail for lack of support by

# To avoid piecemeal solutions, management should develop a fundamentally new, all-encompassing vision.

management. Consequently, change has to be on senior management's agenda; leaders have to actively drive the change.

More than that, a transformation is an emotional challenge for everybody involved. In 39 percent of cases, it is employee resistance that causes transformations to fail. Companies seeking to motivate change need to know and understand their people and tailor their approach to individual employees. Compelling change stories that resonate with all employees, combined with intelligently planned communication, help to overcome barriers.

Consumer-goods manufacturers can learn from the most successful organizations: leveraging operating models that meet today's market requirements can get them in shape for the future by increasing their flexibility and reducing their distance to customers. In turn, they can not only react more quickly to changes and generate new growth, but they can also take the opportunity to realign their strategic focus and successfully transition their business into the next decade.

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# All in: From recovery to agility at Spark New Zealand

Three members of the telco's top team describe the challenges and rewards of going agile rapidly—and the power of a "no plan B" approach to change.

**Big organizational changes** are tough to pull off for any company, and arguably harder still for one with roots as a state-owned monopoly in a relatively small market. Yet for Spark New Zealand, the country's incumbent telecom operator, embracing change has been a way of life since late 2011, following the demerger of its fixed-access network.

Coming out of the split, Telecom New Zealand (as Spark was then known) faced significant challenges. Technology was changing quickly, historically important revenue lines were declining at speed, and the company was increasingly competing for customer attention with digital natives such as Netflix and Spotify.

In response, Telecom New Zealand embarked in 2013 on a turnaround program to lower its costs, rebalance its portfolio, and build the "performance muscle" the company would need to thrive. Telecom's longer-term goal was ambitious: turn away from its legacy infrastructure–oriented focus and aspire to become a true digital-services provider—effectively embracing the disruption sweeping the sector. Along with this move came a new name: Spark New Zealand, in 2014.

Making the shift, however, required a faster operational cadence. This led company leaders in 2017 to make the bold decision to implement agile work practices company-wide and, effectively, to take an agile approach to go agile. The resulting launch moved some 40 percent of Spark's employees into cross-functional teams (or tribes), comprising people from IT, networks, products, marketing, and digital. The agile transformation of the rest of the business began immediately after and has since reached all parts of the organization.

In this commentary, three of Spark's top leaders— outgoing managing director Simon Moutter, customer director Jolie Hodson (slated to succeed Moutter as CEO in July 2019), and HR director Joe McCollum—describe the arc of change at the company, as well as how they are confronting the challenges together as a "leadership squad." Taken together, their observations underscore the

importance of a joined-up top team in securing change—even when the changes require significant mindset shifts for themselves personally.

*This commentary is adapted from interviews with McKinsey's David Pralong, Jason Inacio, and Tom Fleming.*

## Time for a reset

**Jolie Hodson:** I joined Telecom New Zealand—as it was then known—as CFO in 2013, coming from a different industry. It was interesting to watch the behaviors and see how siloed an organization we were at that point. I recall some of the early conversations. Invariably, the sentiment would be, "We're largely all good here; you should go have a look at that part of the company over there, because there's something going on there you should be across." The other thing I noticed was a lot of statements started with "Simon says," like the children's game. And I thought: hmm, this is curious, because I didn't get the sense that Simon was that kind of leader. I think it was revealing about accountability and people's mindsets and people feeling they needed to use someone else's power to have certain kinds of conversations. At this point in time, the company's level of organizational health was low, and we knew we had a massive job to do.

**Joe McCollum:** Back then, the analysts regarded us as one of the poorest-performing telcos in the sector. If you're an organization in a fast-changing industry, and the rate of change externally is greater than the rate of change internally, then pretty soon you're going to be out of step. It showed up as a lot of senior people playing out of position, in duplication of responsibilities. People honestly believed that the "good old days" would one day return and everything would be fine, which lulled us into believing we had all the time in the world to bring a new product to market. Whereas, in reality, you've got two, three months.

The result was missed targets. Drawn on a chart, it looked like a hairy spider leg—the result of all the business plans saying that performance would

go one way when the actual performance of the company is going the other way. Yet here we were, happily writing business plans that purportedly solved the problem [see exhibit].

**Simon Moutter:** When I returned to Telecom as CEO in 2012, what I found was a company that was still in decline; we had a group of very capable people, but we were way too comfortable with losing. There was too much of everyone trying to do each other's jobs, thinking they all had a veto right. It's hard to get anything to happen when you need 30 people to say yes but only one person to say no [to stall a decision]. We had a lot of work to do giving teams clear roles to play and the accountability to deliver—this was critical in getting the organization reset. We also needed big investments in leadership and management capability, because those skills go soft when you're in a losing company for a long time.

**Jolie Hodson:** We needed a mindset of accountability, and the daily rhythm it takes to be a retailer. We also needed to be much sharper about how we spent our money—getting everyone to value a dollar like it was their own. If I think of Everest as an analogy, then getting to base camp was all about business turnaround—buying into businesses that provided growth, exiting ones we didn't need to be in, slimming down the organization where we needed to—and getting the mindsets right. And by the end of 2015, we had achieved a dramatic shift in mindsets and put the company back on a growth trajectory.

The other thing that happened was that Simon made a courageous call about our brand. We didn't believe the Telecom brand could evolve in the way we needed to support the journey we were on. So Simon made the call to shift to Spark. And we've not looked back since then [see sidebar, "'Is this a scam?': Taking a rebrand from skepticism to support"].

## Go agile to be agile

**Jolie Hodson:** As we looked around [after the turnaround phase], we thought: Do we have the "oxygen" to get to that next level? How do we make the choices? And what's really going to get us there? We didn't think it was so much about the what—we

Exhibit

**Hitting reset: In 2013, Telecom New Zealand looked back on a trail of missed targets.**

Telecom EBITDA[1]                     ▬ Actual    ▬ Projected
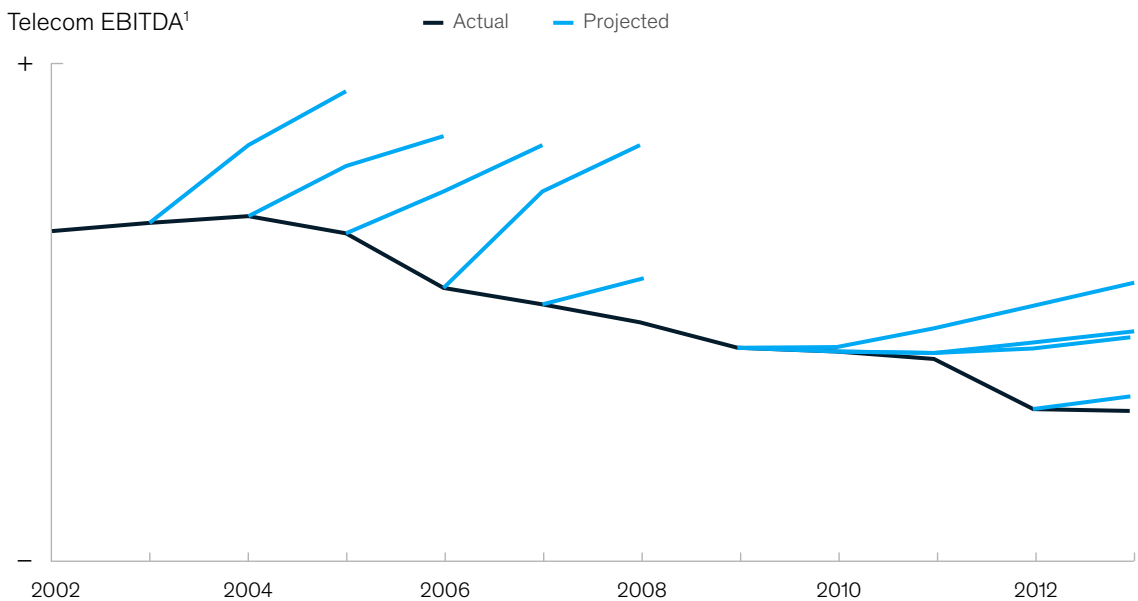


[1]EBITDA = earnings before interest, taxes, depreciation, and amortization.

Source: Spark New Zealand Telecom

## "Is this a scam?": Taking a rebrand from skepticism to support

*by Simon Moutter*

**The old brand,** Telecom New Zealand, was seen as meaning "landlines." It was valued by business customers, as well as the older, richer, whiter consumer demographic—but it wasn't working for younger New Zealanders or a more diverse New Zealand. It didn't sit well with a digital-services vision for the future. Taking the decision to change our name was probably the biggest decision I'll ever make in my corporate career, because the brand was known to every New Zealander and draws on a history that is more than 100 years old.

To make the rebrand work, it had to become the centerpiece of the transformation story. We thought of it as a symbolic act, and a symbolic act in leadership terms allows you to motivate your people in a way that says: "We're making it real; we're not just turning up with lipstick on a pig." It also said to New Zealanders, "Give us another chance. We understand we got offside, and we're trying to tell you we're different."

Initially, the announcement was received with surprise. In fact, the immediate reaction was, "Is this a scam?" The first calls we got from the media were, "Did you guys know someone's out there making a release that says you're changing your name?" The skepticism externally was also quite high—it was 80 to 85 percent opposed. But we brought it to life very quickly, and within a few months it was 80 to 85 percent supported by customers.

Over the course of the six months between announcing our intent and doing the rebrand, the people inside the organization also shifted strongly from surprise and skepticism to support. They could see how it was showing up and how it was driving real commitment in the leadership groups to deliver a new, outstanding customer experience. But it was earned. It wasn't just "Simon says we're changing the name." Our people waited to be convinced, which is a good thing, actually.

**Simon Moutter** is the outgoing managing director of Spark New Zealand.

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knew the goals we should be focused on and what we needed to do. Agile was much more about how we would get there.

**Simon Moutter:** The decision that we made in late 2017 to go "all in" with agile was not without experience of agile. What we felt wasn't so much doubt about whether agile was a good thing or not, it was deciding: Can it be a powerful thing if we apply it to the whole business, rather than to areas that we would know it to be suited? I admit that at first I wasn't really willing to engage strongly in considering it—until I saw a groundswell from our people and from the leaders who reported to me that they were convinced. They believed in it and were also up for what it implied and what we would have to do to make it real.

Our leadership team visited a range of agile companies, some born agile, others that had built agile units, and one or two that had tried large-scale transformations. What I was looking for was a model that would work for a highly performance-driven business that has a lot on the go at any one time, by necessity, and was very focused on delivery.

I was impressed when we visited ING; I thought ING's model was structured, performance driven, and very applicable in our context—"agile for grown-ups," if you like. It was less about beanbags and foosball tables and more about real delivery action, and that gave me confidence that there was an outcome that—if we could deliver it—would make a big and enduring difference.

**Joe McCollum:** With all the bells and whistles, you can have a lot of fun with agile if you're a start-up looking down the barrel at an unbelievable level of growth. But if you're a big company in a low-growth industry, then it's very different. We're in a very constraint-driven world and knew that in our industry, "agile for kids" wouldn't work. Having regained the performance ethic, we needed to use agile to hold onto it—and to strengthen the

performance muscle that we had put into this company. For us, it was about "How do we get better at what we're doing?" We saw agile as the next logical progression.

**Jolie Hodson:** We came back to New Zealand and went away for a couple of days as a leadership squad. Simon was pretty clear that as a business this wasn't a decision that only some of us could make. We were either all in and hugely committed or we weren't going to make it. There isn't a halfway ground with agile, certainly not going agile at this scale—because the old way of working would absolutely rub up against the new way of working. To be clear, we were doing this for improved customer experience, speed to market, and to empower our people. If we had two models clashing, it would be like being in molasses.

**Joe McCollum:** We sat around the table and said, look, we can move the company into agile; we've got two ways of doing it. We can either sit back and task ourselves with getting everything right, maybe dabble about with customizing the model, the language, and then we'll move to agile in two years' time. Or, why don't we give it a big run now instead? We'll try and get as much stuff right as we can manage; we'll have a bit of faith in the agile model in terms of design and effort. We'll put it all into agile, and we will openly tell our world: "We're going agile to be agile." Which means that we're not arrogant enough to think that we've got it right from the outset. We're totally open to learn and change.

**Simon Moutter:** You've got to do a lot of personal counseling of yourself, and the team needs to stay tight. It's not a situation where you can have the leadership team start to show any cracks in their intent. It's about belief, about being super committed, turning up multiple times a week as a team and working for hours if necessary to clear roadblocks, to solve a communication gap, to make a decision, to apply resourcing—whatever it takes to get to the outcome.

We thought the risks were higher going slow than going fast. When you're in a business like ours, you have to execute across a couple hundred initiatives in parallel, into multiple markets, across multiple infrastructures, with all sorts of different people. And we make our overall numbers as the sum of a thousand small numbers. It's not a straightforward path. The risk of getting caught in no-man's-land— with one foot in the old world and one foot in the new—felt much higher to us than the risk of jumping across the line with both feet and using the agile ways of working to get better at agile itself.

We weren't prepared to spend more than eight months to get from the start of the program to what we called "flip day," the day we moved the engine room of the company into an agile model. And we took a "no plan B" approach. We simply never entertained the idea of failing, and I think that mentality is critical. If you have a get-out-of-jail card, you almost inevitably roll back to it.

## New ways of working

**Simon Moutter:** We've been able to build excitement and a sense of pride around becoming the first telco in the world to go "all in" agile. We were able to engage our staff in the excitement of that possibility—that it wasn't like any old restructure that we've had in the past; it wasn't like shuffling deck chairs on the Titanic. It was genuinely an inspirational new possibility, pivotal to delivering on our ambition to become a digital-services company.

Our people bought into that vision quite quickly, and we backed it up with the most massive internal-communications program I've ever been associated with. It was extraordinarily well handled by the team, but it was a heavy load on leaders. A lot of face-to-face fronting up, lots of work to keep everyone excited about the potential.

Of course, we had people who were concerned, who were doubtful, who wondered if it might not be for them or if they were too old to get it or whatever. We had all of those emotions, but, actually, 98 percent of our people made the leap to say, "Well, I'm going to try it, this sounds like it could be a good thing." They recognized that it creates a lot of opportunities for people.

**Jolie Hodson:** When you're thinking about your organization in a completely new way, you can start with a clean piece of paper. What do we want it to look like? What is the mix of experiences? What are the capabilities we need? We took risks on people—people leading tribes and chapters—much bigger risks than we probably would have in the past. We've changed the leadership profile, which is a good thing. It's meant some people have been able to accelerate very quickly by having courage, taking risks, demonstrating new mindsets.

**Joe McCollum:** In our pre-agile world, we would have had seven or eight layers between the top and bottom of the company. Now, across much of the company, we have three. The result is that things are massively faster. When you talk to people, you hear things like, "We're getting stuff done now in two weeks that used to take us three months." Emails have dropped off significantly, because back when the developers lived in one part of the building, and the marketing people lived over there, and the product people were in another part of the building, just to organize a meeting was 27 emails. All of that has gone. Now, there's ten of us sitting around a table. In fact—and not surprisingly—there's been a big drop-off in the use of our designated meeting rooms because of this. When you have a multidisciplinary team already working together around a table, why bother getting up and de-camping to a meeting room in another part of the building when they could simply stay where they are and solve the problem in real time?

The decision making is also a lot richer now, and transparency improved immeasurably. I can't stress this enough. Otherwise, you're in a world where people come in to work, they do their little bit, they go home, but they may have no idea where that fits into the big scheme of things. Agile puts direct ownership and real-time accountability with the squad so that they have absolute clarity about where it all fits now. That's where the engagement comes from—employee engagement goes off the chart because people have richer jobs, they've got a broader perspective, and they're focused on solving problems. They don't feel like hamsters—they feel like they're part of a squad that's on a mission.

**Jolie Hodson:** If you think about getting a product to market the old way, it could be quite slow, involving an idea working its way through multiple groups. In an agile setting, you're starting with having all the people in the squad who can largely give you an end-to-end capability. We even have customers work with us on some of these squads, too, which exponentially speeds up the time from idea to design to commercialization.

For example, we've partnered with Network for Learning to provide the fiber broadband and security layers to 2,500 New Zealand schools. In

"Agile puts direct ownership and real-time accountability with the squad so that they have absolute clarity about where it all fits now."

—Joe McCollum, HR director at Spark New Zealand

the past, the design process alone would take many months, with lots of documents flowing back and forth before testing or any migration of schools even started. Whereas in an agile model, we've already designed the new solution, rolled out the proofs of concept for different-sized schools, and migrated half of the schools in eight months. This would never have happened at that pace in the past. And it's changed the way we work with the customer. They didn't come to the squads to observe—they were coming to be part of the change, to have tasks and responsibilities like any other squad member. It helps them refine their own thinking and helps us build a much stronger working relationship.

**Simon Moutter:** I'm a crusty old guy from a long way back. [Laughs.] And having become a believer in agile rather than being born that way, I boil down the advantage to the fact that a squad can make a single choice off its backlog, and the minute they do, all ten people are very focused on outcomes delivered in short cycles. And they hold each other to account; it's the peer-to-peer accountability that delivers it. They're empowered by their ability to make choices and get on with it, with a high degree of confidence that they're doing the right thing.

## Leadership challenges

**Jolie Hodson:** In a more command-and-control environment, the mindset is about working in your narrow center of functional expertise, getting your stuff done, and moving it to the next area of the business. Agile, by contrast, is very much focused on: "How do I work across this group to deliver the outcome?"

There's a fluidity that's new; you've got a 90-day set of priorities, and at the end of those 90 days if we haven't achieved the outcomes then we may not progress the initiative further. That's quite different for a leader who is used to having their own sandbox, where they know the resources they have at the start of the year, and—so long as they're doing what they said they'd do—they might otherwise take the attitude of "speak to the hand."

Behaviors like listening and collaboration become more important. Curiosity and openness to other

perspectives are critical too. You're creating a little silo of a tribe, but it's vital that these tribes work well across the company to get things done for customers.

**Simon Moutter:** By and large, decision making in a hierarchy occurs inside business units. A well-organized business unit will have most of the degrees of freedom it needs to solve problems, reallocate resources. It doesn't often have to branch across to other units to make trade-offs. That's not the case in our model. Decision making requires more clarity around priorities, and mechanisms for collaboration.

**Joe McCollum:** It puts pressure on leaders to be doers. There's a risk in traditional organizations that leaders get a lot of status, a lot of control, and they lose sight of what's really going on. But if you're leading a squad, 70 to 80 percent of your time is working with the people in the squad—it's not a "stand back," supervisory role. This may sound a bit unfair, but the shiny, presentation-orientated leadership skills where somebody gets up and looks good in a presentation—it doesn't mean anything here. It's the squad—the team—that looks at it and says, "Well, Bob's a good presenter, but Bob doesn't do very much in terms of delivery. Whereas Mary, who's very quiet, gets a lot of stuff done. If we have a choice, we'd rather put Mary on the team than Bob."

## Becoming an agile top team

**Simon Moutter:** Most leadership teams in large, complex corporate environments function more like a working group than a team, because individual accountabilities tend to prevail over the team dialogue. They each have a business unit, and they're consumed mostly by the issues and decisions of that particular business unit. The overall coordination is a smaller part of the conversation.

Agile is very different. Now, you're the CEO, but you're also part of the leadership squad. It's an extremely tight team mission; it's hard work, but fun. But it's not simple to reset your leadership model. In our town-hall meetings, I used to say that I've been a hierarchical manager all my life and I'm pretty damned good at it. [Laughs.] And so this was a big

change for me, too, to think about leading in an agile context. It's going to be challenging to anyone used to calling all the shots.

We work on a 90-day cycle—what we call the quarterly business review, or QBR—and what this means for leaders is we must be alert and ahead of the game. We need to pick up problems early so we're not turning up halfway through to do a "rug pull" on a tribe or squad. I think there's a lot of sanctity in that "90 days of certainty" method—that every tribe and squad has the right to 90 days of certainty with the QBR. And I'll admit we've still got a lot of improving to do.

But as we have improved, as squads get results in a self-determining way, it's very empowering. When I think of the old adage that true empowerment requires forceful leadership, the forceful leadership in this model comes from coaching, from helping provide extreme clarity around what the vision is, what the main strategic platforms are, and therefore what each tribe's mission is.

**Jolie Hodson:** I think for us as leaders, it was quite a vulnerable time, because most of your career you've worked a certain way. Agile is a great opportunity to learn something new and develop, but it takes vulnerability to stand up there and say, "I know I'm here to lead you through this, but I'm learning too." To use the analogy of baking a cake, in the past you'd bake the cake, you'd ice it, and just when you're about to put the candles on you'd go and share it for feedback. Now, you're still beating the eggs and you're out there sharing it at this early stage to see what works and what doesn't.

## Diversity—an unexpected benefit

**Simon Moutter:** I think the single biggest "aha" moment for me was about three weeks after we had set up our first front-runner tribes, which were the ones getting the internal learnings to help us on the journey to "flip day" as a company. When we walked on the floor, I could see the dramatic change that was occurring.

We've always had a diverse organization when you count up the numbers, but like many organizations

it shows up in career groupings. For example, our IT team had an Indian influence, our marketing and HR teams had more younger women, and our network engineers were more likely to be older, Caucasian men. And like any traditional organization, the teams tended to work as compartments. When we saw them all together, sitting at multidiscipline squads around tables, we realized what a dramatic change this would be. That moment actually started us down a path we hadn't anticipated, to launch a major program around diversity and inclusion. It caused us to change the way we thought about employment, contracts, pay equity—because you could see that any unfairness would be exposed instantly in our new model.

It's been powerful for the organization to really see why inclusivity matters. We had a diverse organization, but we didn't have inclusivity right. Focusing on both is just the right thing to do, and we've all been struck by how much better it is when a diverse squad becomes truly inclusive. They know how to work together as a group, every voice comes to the table, and it's extraordinary how much better the outcomes are and how much better the workplace feels.

**Jolie Hodson:** Agile by its nature starts to break down barriers between groups, between cultures. "Where have I come from? What have I done before? Oh, you're marketing, you must be in the 'coloring in' department. You're tech, so you won't know anything about what customers want." Squads break all that down very quickly because they are your team, your buddies, the ones that you work with every day to deliver to your customers. And because squads are limited to no more than ten people and have a clear mission and purpose, everyone has to have a voice. There isn't a place for anyone to just cruise along.

You can see the change in people as you go through this. For example, at the start, if I visited a squad with a customer, you'd have some very extroverted people who'd be happy to jump up and speak to what the squad's doing. As time went by, the whole squad could do that really easily. It's great to see that growth in people; it's not an unintended consequence, it's one of the benefits of the

# "'We're going agile to be agile.' Which means that we're not arrogant enough to think that we've got it right from the outset. We're totally open to learn and change."

—Joe McCollum, HR director at Spark New Zealand

approach, but to see it in real life after around six, seven months of working this way is pretty amazing.

## Spark's next phase

**Simon Moutter:** It never sat well with me when I left old Telecom in 2008, because I didn't feel like I'd left the company in the right shape. That was a significant driver for me in coming back as CEO in 2012. By contrast, today it makes me proud that we are genuinely seen by the vast majority of New Zealanders to be part of the solution, not part of the problem. Spark is seen as a positive company, an innovative company, and our brand and reputation would be the strongest proof point of that position being recovered. Over the past two years or so, we've been winning a range of business awards, a number of which we weren't even getting nominated for before. We also have a degree of execution excellence now that has been noticed by investors. We say it, we do it.

The success is showing up in the "hard" numbers; our mobile market share is up eight percentage points, to 40 percent, since 2013—a huge turnaround. And it shows up in "barbecue conversations." When you are introduced to someone you've never met before at a barbecue or social event, and they ask, "What do you do for a living?" there's no need to mumble under your breath anymore and get ready for an onslaught of criticism. Back then, it was uncomfortable and inevitable that you would suddenly become the center of attention for all the wrong reasons. Today, people are

proud to say they work at Spark, and the conversation immediately moves to all the new technology, or even: "Well, can you help me get a job there?"

**Joe McCollum:** Remember, we moved to agile to improve customer experience, improve speed to market, and, finally, to empower our people, and the hard numbers are beginning to stack up. From the "soft number" side of things, it's also been pretty good. We've improved our customer NPS [net promoter score] results—across all customer journeys and interactions—and we've seen almost a doubling of our employee NPS scores. In some key areas of the company, our eNPS results are +80— which is extraordinary.

And we're just getting started. On the agile maturity scale of 1 to 5, in most parts of the company we're really only at a 2 or 3. We're less than halfway through the journey, and we're already seeing significant benefits. Once we're further along, there are doors that will open for us that we simply can't envisage at the moment—a bit like a computer game where the next level reveals hidden doors in hidden walls. When we think of the new business opportunities—whether it's 5G, streaming, adjacent businesses—and the world-class customer-service backbone we're building, all combined with a super-engaged workforce, it's just such a winning combination. We're miles ahead of where we were six to nine months ago, and I think we will be miles ahead again in another six to nine months. I'm very excited about the next chapter of our story.

**Simon Moutter:** The next phase for Spark is to move beyond just being about connectivity. We can't achieve our purpose unless we support customers with all the things connectivity is used for—for example, the digital services that help people run a better business or live a more efficient or amazing life. I think we've set up a foundation to do exactly that. And we've got an outstanding leader in Jolie Hodson to take hold of the helm. She has been a key part of our journey to date and knows what it takes, and I think she'll add great value as CEO from here. It's Jolie's turn; she's earned it, and I'm absolutely thrilled that the board has chosen to run with her. It's fantastic for the company and fantastic for her.

**Jolie Hodson:** If I think about where we were even three or four years ago, and the ways we've evolved from both a customer and business perspective, it's clear we've taken a real step forward. We've been creating a foundation in terms of the infrastructure and the IT, and especially in terms of our people. And if I stand back, it was our ability to shift from

a company that was largely declining to one that's growing that I would be most proud to stand behind.

And not only are we growing into our positive financial results, but the perception around us has changed. We're seen as innovative, ready to try new things. When we do something, we do it with vigor. People want to be with us, work with us, and that's a fundamental change.

We're clear on the strategy we've developed and what we want to continue to do: focus on the future of wireless, engage our customers in ways that matter to them—including support and services. We started the journey with Spark Sport, and we see opportunities in cloud security, data, and other areas as well. And now, when we face any of these new areas, we have an organization that has the confidence, courage, and muscle memory to change—and understands that although there's ambiguity, change can lead to great new places. I'm excited about the opportunity in front of us—for our people and our customers, and for New Zealand as a whole.

This commentary is adapted from interviews with **David Pralong,** a senior partner in McKinsey's Auckland office, **Jason Inacio,** a partner in the Sydney office, and **Tom Fleming,** a member of McKinsey Global Publishing based in the Chicago office.

**Simon Moutter** is the former outgoing managing director of Spark New Zealand. From 2003 to 2008, he was chief operating officer of Telecom New Zealand; he rejoined the company in 2012 as managing director after having spent the intervening years as CEO of Auckland International Airport.

**Jolie Hodson** is the CEO of Spark New Zealand, succeeding Simon Moutter in July 2019. She joined the company in 2013 as CFO and was appointed CEO of Spark Digital in 2016 and customer director in 2018.

**Joe McCollum** is the HR director at Spark New Zealand. Prior to joining the company, in 2012, he served as HR director at a number of companies, including most recently DMGT, EMI (now UMG), and Misys (now Finastra).

# Transformation 101: How universities can overcome financial headwinds to focus on their mission

Troubled universities can reset their financial trajectory.

*by Li-Kai Chen, Claudio Brasca, Mark Hojnacki, and Charag Krishnan*

Higher education institutions in the United States face starkly different prospects. Top-ranked schools turn away throngs of top applicants, while cushioned by staggering endowments. Others, including many small liberal arts colleges, are facing declining enrollment, nervously watching expenses outpace revenue, and tapping their endowments to cover shortfalls. These pressures have forced many schools to make painful choices, including cutting programs, laying off faculty, merging with other schools, and reducing student admissions. In the worst cases, some schools have lost accreditation or have shut down. There will likely be more: our review of public data suggests that at least 90 medium-size not-for-profit institutions across the country show some signs of financial pressure.

This snapshot may even understate the problem. Moody's recently predicted that growth in operating expenses will outpace revenues at most institutions of higher education. To be financially stable, most colleges need revenue growth of at least 3 percent, Moody's advised. Just 44 percent of chief financial officers of higher education institutions say they are confident their college will be financially stable over the next 10 years, down from 54 percent in 2016, according to a survey last year by Inside Higher Ed. Among the many reasons: more than two-thirds believe that their tuition discount rate is unsustainable.

At the same time, many students feel burdened by their educational debt, which suggests that schools can't continue to rely so heavily on conventional tuition as a sustainable revenue source. Americans collectively owe nearly $1.57 trillion in student debt, according to the Federal Reserve, which is a 27 percent jump since 2014. Nearly 70 percent of the class of 2018 took out student loans, graduating with an average debt of $29,800. This doesn't include the money that their parents borrowed for their education: 14 percent of parents of the 2018 class borrowed on average $35,600 in federal loans.

Despite these bleak facts, higher education still offers enormous potential for students: the average college graduate earned $1 million more than the average high-school graduate over the course of a working life, according to a 2015 study by economists at Georgetown University. Just as important, these institutions serve as one of society's pillars of progress. Enabling them to fulfill their mission to serve students through education and expanded life experiences is critical to our future. The healthier the state of our colleges and universities, the stronger the foundation for our economy and society.

So how can struggling institutions best position themselves to pursue this mission? In this article, we'll start by reviewing the unique challenges these institutions face. We'll then outline the transformational approaches that some schools are taking to improve their student outcomes by boosting enrollment, retention, and student satisfaction, and in the process resetting their financial trajectories. These efforts—which require an extraordinary commitment and a highly focused execution—have allowed them to look past their financial challenges and toward a future centered on serving students and the community.
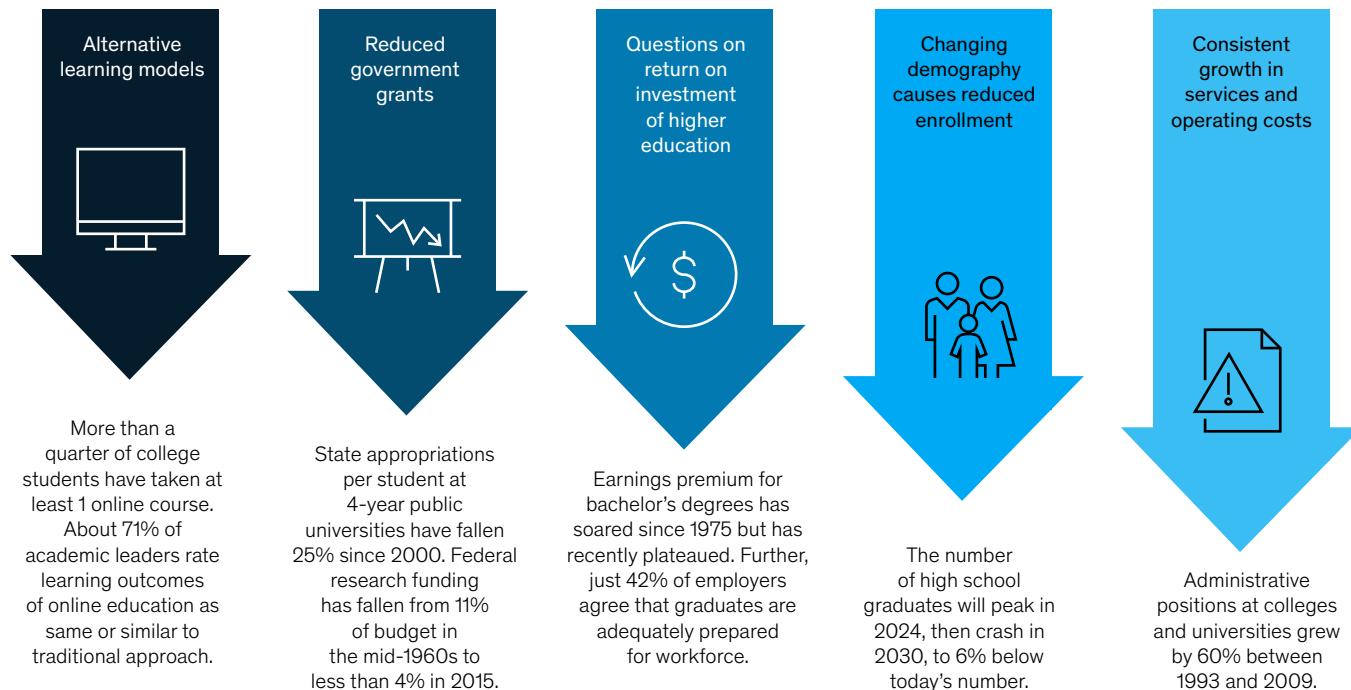
## A special set of challenges

Financially troubled academic institutions have often found it difficult to right the ship. Examples of successful transformations are rare. Even when there's a success story, issues often persist, and improvements in one area, such as career services or student success and retention, do not translate into schoolwide success.

Many universities have attempted to address a wide array of challenges (Exhibit 1) through cost reductions and austerity. But it's brutally hard to attract widespread support for a plan that offers little more than budget cuts and painful choices.

A true transformation—which often raises net surplus by 20 percent or more—is challenging. It requires an intense, operations-wide program focused on improving student outcomes and

Exhibit 1

## Higher education is confronting several challenges.

**5 biggest challenges**

| Alternative learning models | Reduced government grants | Questions on return on investment of higher education | Changing demography causes reduced enrollment | Consistent growth in services and operating costs |
|---|---|---|---|---|
| More than a quarter of college students have taken at least 1 online course. About 71% of academic leaders rate learning outcomes of online education as same or similar to traditional approach. | State appropriations per student at 4-year public universities have fallen 25% since 2000. Federal research funding has fallen from 11% of budget in the mid-1960s to less than 4% in 2015. | Earnings premium for bachelor's degrees has soared since 1975 but has recently plateaued. Further, just 42% of employers agree that graduates are adequately prepared for workforce. | The number of high school graduates will peak in 2024, then crash in 2030, to 6% below today's number. | Administrative positions at colleges and universities grew by 60% between 1993 and 2009. |

boosting organizational health and performance. It also demands an internal alignment around a common vision and strategy to deliver the full potential of what's already there.

The reported failure rate of large-scale change programs in the corporate world has hovered around 70 percent for many years. Few companies have the necessary mix of skills, mindsets, and commitment, as their top executives are better at operating in stable environments. The best predictor of the success of a transformation is a leader who recognizes the need for a new approach and is willing to take a single self-confident leap instead of incremental steps.

University leaders face these challenges and more when attempting to transform their organizations. While they are gifted educators, researchers, fundraisers, and academics, they may have little experience leading the transformation of a large, complex enterprise. Complicating matters, stakeholders often cling to deep sentiments about their institutions and their school traditions, which impedes change. And the shared governance structures at most universities makes it even more difficult to act quickly and decisively. When leaders encounter inevitable resistance, it's not surprising that they often relent, and the project stalls, is abandoned, or becomes mired in a long implementation with poor results.

## A better way

Several leading institutions of higher education have developed effective strategies to avoid these common pitfalls and improve the odds of success. A key finding of our work is that while a reasonable degree of cost management is usually necessary, it's more important to focus on improving student outcomes and identifying new ways to diversify and grow revenues.

At McKinsey, our work in enterprise-wide transformations has led to a systematic approach that enables organizations of all types to use new operational levers to improve overall health and performance. In collaboration with our work in education, we identified strategies (Exhibit 2) that can help universities reduce their dependence on the typical two largest sources of revenue—tuition and government grants.

An institution that follows these steps can generate new revenues to invest in initiatives to attract more students, deliver on the mission of student success, and drive excellence in teaching and research in a sustainable manner. These schools can focus on preparing their students to excel in the world and on planning the school's future, rather than depleting their energy by worrying about their continued existence.

## Case study: A university at a crossroads

This transformational approach is illustrated by the turnaround undertaken by a midsize liberal-arts university that was facing a crisis reflecting the challenges of many small, private institutions.

In 2013, the university's entering first-year class fell nearly 30 percent and continued to shrink for the next three years. To attract students, the university offered high levels of institutional aid and scholarships well above benchmark levels for peer universities, which eroded net tuition revenue.

Exhibit 2

## There are several ways to expand revenues and improve efficiency at universities.

**Grow and diversify revenues**



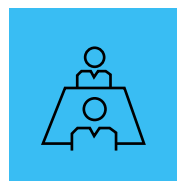| Enrollment and net tuition-revenue management | Completion and persistence | Program portfolio (new program launch) | Research funding | New business ventures (online, executive education, adult learning) | Auxiliary revenues |

**Capital and investments**  **Operating efficiencies**



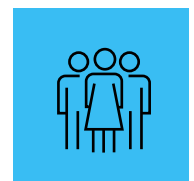| Capital productivity | Endowment returns | Faculty and instructional staff | Student support and service | Facilities utilization | Administrative efficiencies |

Exacerbating the problem, the school had trouble holding onto the students it had. Too many were dropping out or failing to complete their degrees, leading to low student-persistence and completion rates compared with peer institutions. At the same time, the quality of the educational experience suffered, as the university couldn't make needed investments in student-support services.

Significant operating deficits forced the university to double its endowment draw from 2014 to 2017. Continuing on this path would have meant depleting its unrestricted endowment in two to three years. Because of these financial concerns, the university's accreditation agency alerted it of the need for immediate action to avoid the risk of probation and possible loss of accreditation thereafter.

The university's leaders attempted to contain costs; a few administration members led the effort. But they failed to fix the problem over two attempts. The board realized that it needed a strategy tailored to the unique nature of institutions of higher education that would enable it to make rapid and significant changes without sacrificing the quality of the education.

### The board takes the lead
In this new effort, the board led from the front and took responsibility for shaping the transformation goals, unifying key stakeholders, and building momentum throughout the university. (Board support is one of five critical elements; see Exhibit 3.) This required a substantial, ongoing commitment from board members. To continually reinforce its crucial role in this process, the board committed to meet biweekly to monitor progress over the entire transformation period.

As a first step, the board oversaw a short review of the school's key metrics on enrollment, retention, student satisfaction, and other student outcomes and of its overall operations. Select faculty and staff were also interviewed at length. The board then plotted a course that placed as much emphasis on student success and enrollment-driven revenue growth as cost management. Next, it had to

persuade stakeholders not just to embrace but also to play active roles in this transformation plan over a period of two years.

This was a daunting challenge. Most universities have vocal and opinionated faculty, staff, and students who aren't easily persuaded to fall in line for massive change dictated from above. Making matters more difficult here, the school's previous efforts to cut costs had left lingering anxiety and distrust. To recruit faculty, staff, and students to support this ambitious project, the school's leaders created a compelling change story to inspire people to think and behave differently. The story explained where the institution is headed, why it's changing, and why this change is vital.

The board relayed this change story through carefully planned internal and external communications. These included open town halls, meetings with faculty and staff leaders and student government bodies, as well as targeted public-relations efforts with the press.

Just as important, the board was transparent about the school's finances. By sharing this information at monthly town halls, the board made a compelling case for the urgent need for transformative change.
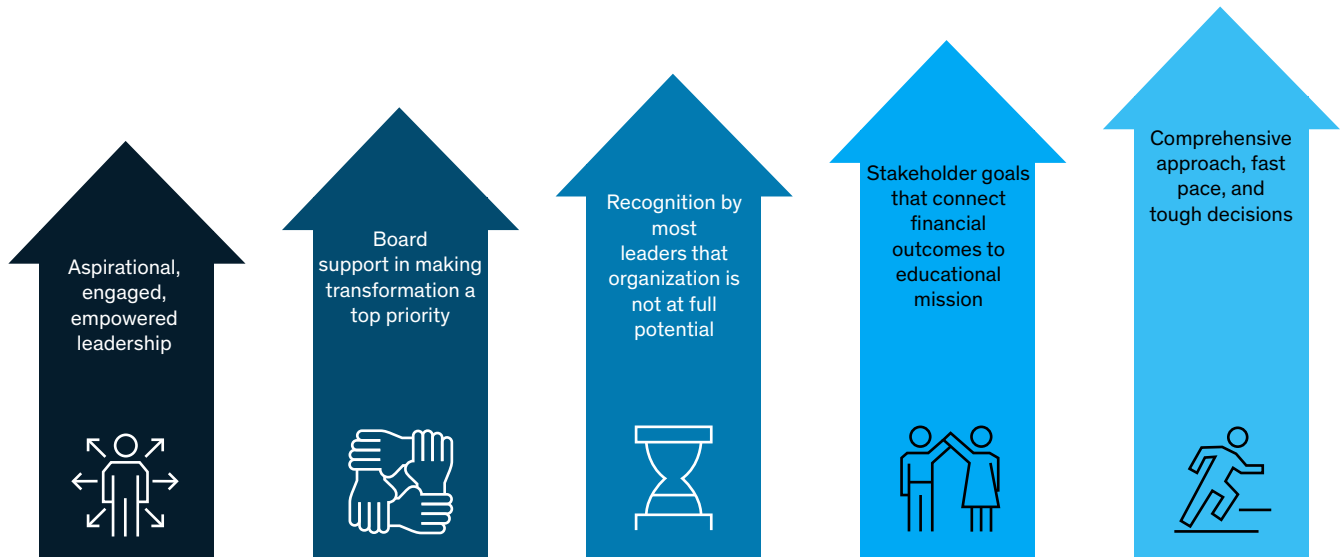
To support informed and decisive decision making, the school created a centralized governance structure that was tasked with key decisions. This group included members from across campus operations to encourage collaboration. Everyone was trained to use metric dashboards so that they could all work from the same sets of data and focus on improving student outcomes. Eventually, this governance structure and the regular use of dashboards became integrated into the university's new way of operating.

### Boosting revenue by furthering the school's mission
The board also overcame initial skepticism and resistance by launching new revenue-generating initiatives that sparked excitement. As part of that plan, the school developed a multifaceted approach

Exhibit 3

## Five factors are essential to successful transformations in higher education.

**Top 5 factors**

Aspirational, engaged, empowered leadership

Board support in making transformation a top priority

Recognition by most leaders that organization is not at full potential

Stakeholder goals that connect financial outcomes to educational mission

Comprehensive approach, fast pace, and tough decisions

to improve student recruiting and persistence and to reinvigorate its online and continuing-education programs. It also examined data on spending decisions to make more informed choices.

Enrollment was overhauled to include more targeted outreach, including materials that highlighted specific educational programs. To align the university's message with the habits and preferences of young people, the school improved its social-media presence. It also created virtual campus tours aimed at potential recruits who might not be able to visit in person or those needing more incentive to visit. Most important, everyone on campus—students, faculty, and staff—was engaged in connecting with students and sharing why they loved the university. The result: the university's first-year class increased by 30 percent in the first year of the transformation, and similar increases the following two years.

In another successful initiative, the school expanded its online and continuing-education programs. But

it first had to overcome initial concerns from faculty who worried about diluting the quality of education. Their sentiment shifted when the school translated financial goals into aspirations that resonated with them. By emphasizing the educational and societal benefits of reaching a more diverse group of students who couldn't enroll full time, the school won over most of the faculty. The school's leaders also put measures in place to ensure institutional support for the traditional programs and ensure that faculty or staff aren't concerned about online programs taking away from the value of on-ground programs.

While this initiative required a seven-figure invest-ment, it has paid off. The online program is on track to enroll several hundred students, while continuing education is generating a new, independent revenue stream. Both are growing rapidly.

One of the most critical and galvanizing initiatives on campus centered on student success, persistence, and completion rates. A group of faculty and staff was tasked with creating and monitoring initiatives

to improve these outcomes. Just as important, the school impressed on all faculty and staff that each of them can play a role in their own way to help students succeed and to fulfill the school's mission. Creating this shared endeavor played a critical role in bringing the whole campus together to improve student success.

The university also thought creatively about other ways to increase revenue. For example, the school wasn't taking advantage of the full potential of its housing stock and other real estate. Through renovations and improved marketing, dorm rooms once left vacant were filled, leading to nearly 100 percent occupancy. These efforts, which included attracting short-term residents during summer breaks, boosted revenue in a way that the university had never considered. The school also leveraged the potential of its attractive campus by booking more conferences and attracting filmmakers to shoot on location there.

To improve the university's organizational health, the school introduced new professional-development programs for faculty and staff. To enable individuals in different departments and with differing jobs to work together more efficiently, the school introduced new collaborative norms, processes, and expectations. And to ensure successful implementation of the entire project, team members filed weekly reports that allowed visibility into performance so that any issues could be swiftly escalated to senior leadership for resolution.

### Using data to make better decisions
The school learned that it could address many of its issues with better use of available data. For instance, it tapped into data on academics and behaviors—including midterm grades, class-registration data, and faculty observations—to predict students at risk of attrition.

At the beginning of the transformation, only 77 percent of first-year students returned for their next year, which was much worse than benchmarks for peer universities. This not only sapped tuition

revenue but also made it difficult for the university to allocate its resources and invest further in student support. This figure also indicated that too many students were dissatisfied with their campus experience.

The school tackled this problem with several initiatives. It created a Student Success team that pulled together select counselors, administrators, students, and faculty, enabling them to work in a more coordinated way to target and help students at risk of leaving. The school also implemented more personalized one-on-one success coaching for first- and second-year students.

As a result, retention from the first to second year of school improved to 85 percent. The success flowed into the more senior classes, as persistence from the second to third years improved to 92 percent, compared with 86 percent the prior year. That meant that within two years of the transformation effort, roughly 4 percent of the student population had a better chance of graduating, a result that advances the university's mission while improving its revenues.

Another area of scrutiny was the university's high tuition-discount rate. When the school examined its discounting decisions and compared them to benchmarks, it found that it was not providing aid to students most in need and that it could reallocate financial aid in a better way.

Some cost reduction was unavoidable. The university studied faculty and staff productivity to bring the school more in line with peer benchmarks. Adjustments to student-faculty ratios and student-staff ratios freed further funds that put the school on a stronger foundation.

This approach left no room for sacred cows. For example, school leaders were persuaded that they could renegotiate contracts with the companies that provided their food service and campus maintenance, which led to substantial savings while maintaining service levels.

This transformation effort is ongoing, but the results so far have been impressive. The university's financial health has significantly improved, and for the first time since 2012 it has balanced its budget. It is now beginning to return cash from operations to grow the endowment and invest further in student-support services and growth initiatives, as well as in the development of its faculty and staff.

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We know that a successful transformation must be hugely aspirational. For this reason, it will often create tension and friction in an organization, requiring special techniques to keep progress moving forward. This approach will test a school's leaders.

But the effort will be worth it. Instead of worrying about the decline or demise of their institutions, leaders can focus on improving the well-being of individuals and society through inspired learning, growth, and change. By implementing an ambitious set of projects to inspire the entire team, foster new areas of growth, and change the trajectory at every level, these institutions can continue to influence generations of learners and their communities.

**Claudio Brasca** is a partner in McKinsey's San Francisco office, **Li-Kai Chen** is a partner in the Kuala Lumpur office and leads McKinsey's Education Practice, **Mark Hojnacki** is a partner in the Stamford office, and **Charag Krishnan** is an associate partner in the Washington, DC, office.

# How to transform your airline

Airline transformations are often necessary—and always difficult. We lay out five rules for success.

*by Jaap Bouwer, Sybren Hahn, Dominic Maxwell, and Jakob Rüden*

**Major transformations** of airlines are common, and frequently disappointing.

They are common for good reason: the industry is structurally difficult. Unit revenues have declined an average of 2 percent per year over the past 20 years as a result of intensifying competition and commoditization. The battle to reduce costs has continually run up against the substantial bargaining power of both labor unions and suppliers, along with the market whims of fuel prices. Meanwhile, governments have often prevented their national champions from exiting the market when times were tough. And, even in good times, airlines must base their plans on the assumption that a downturn is around the corner, as we recently discussed in our article "Winter is coming: The future of European aviation and how to survive it."

Perhaps not surprisingly, these transformations are also hard—harder than in many other industries. Inertia can come from employees' transformation fatigue, as many have already gone through multiple programs. It can come from strong functional silos that push back on transformation initiatives. It can result from the safety imperative, which should never be compromised—but whose name is often taken in vain. And it can come from the frequent risk of industrial action. As a result, leaders can be left feeling frustrated when their ambitions for fast-paced change run into a sluggish and change-resistant reality.

Nonetheless, airline transformations can succeed, and their effects can last. And by "transformation" here, we want to be clear: we mean an enterprise-wide, comprehensive performance improvement effort, not a thematic transformation around a specific topic, such as digital or procurement.

Based on our experience, we have identified five core rules for effective transformation in the airline industry: find the "Goldilocks" targets, leave no stone unturned, locate and mobilize different sources of meaning, track by the inch, and build a new culture—not just a new cost base.

## Find the 'Goldilocks' targets

Transformation targets that are too low won't spur employee ambitions or provoke the difficult trade-offs required for successful change. Targets that appear too high, without the facts to support them, will create employee skepticism, soon followed by a sense of failure and disengagement—and a talent exodus. Of the two, aiming too low is most common; in fact, we have found that targets two to three times a company's initial estimate are routinely achievable.

To find the Goldilocks targets, neither too low nor too high, both ambitious and demonstrably achievable, airlines should begin by doing the following:

— Start with a top-down assessment to set a challenge for what can be achieved, without focusing too early on exactly how it will be achieved.

— Base the assessment on benchmarks that are the most granular available and intelligently applied across the entire business. For example, only when airlines break down marketing and sales costs into their underlying drivers,[1] a process that includes benchmarking and defining realistically achievable potential, do the opportunities become clear and irrefutable (Exhibit 1).

— Boldly evaluate the business model. For example, airlines could choose to become a hybrid that combines full-service and low-cost models or to fly fewer long-haul routes. Such bold moves may not be necessary, but should be among the options considered. Decisions here will, in turn, guide the more detailed assessment.

— Assume the mindset of an activist investor or private-equity acquirer: be ambitious, disruptive, and unconcerned about maintaining the status quo.
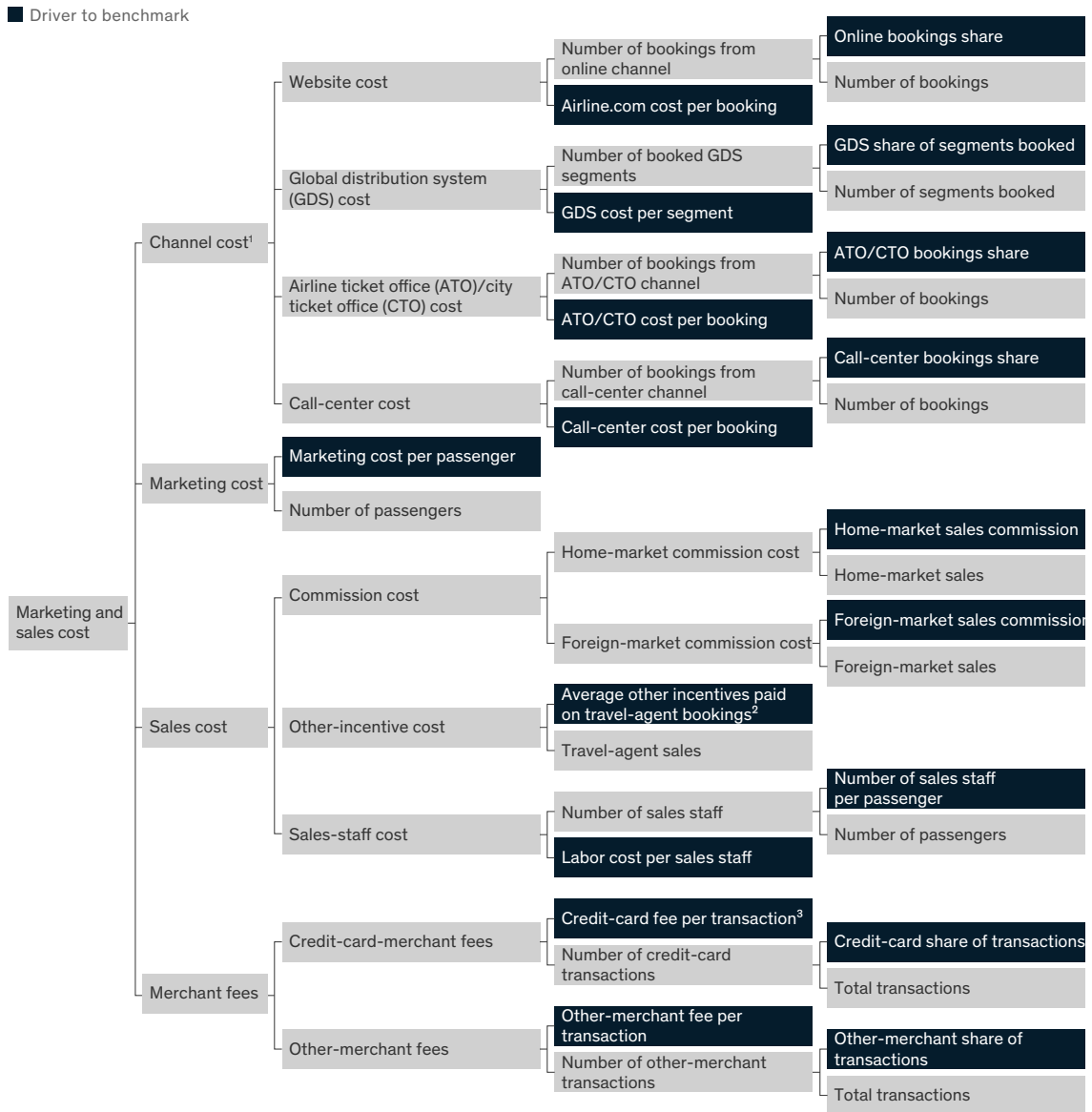
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[1] See Steve Saxon and Mathieu Weber, "A better approach to airline costs," July 2017, McKinsey.com.

Exhibit 1

## Create a granular assessment of cost performance by going to the driver level.

Driver tree: marketing and sales cost, illustrative

EXAMPLE — MARKETING & SALES

■ Driver to benchmark

| | | | |
|---|---|---|---|
| | Website cost | Number of bookings from online channel | Online bookings share |
| | | | Number of bookings |
| | | Airline.com cost per booking | |
| | Global distribution system (GDS) cost | Number of booked GDS segments | GDS share of segments booked |
| | | | Number of segments booked |
| | | GDS cost per segment | |
| Channel cost[1] | Airline ticket office (ATO)/city ticket office (CTO) cost | Number of bookings from ATO/CTO channel | ATO/CTO bookings share |
| | | | Number of bookings |
| | | ATO/CTO cost per booking | |
| | Call-center cost | Number of bookings from call-center channel | Call-center bookings share |
| | | | Number of bookings |
| | | Call-center cost per booking | |

Marketing cost
- Marketing cost per passenger
- Number of passengers

| | | |
|---|---|---|
| Commission cost | Home-market commission cost | Home-market sales commission |
| | | Home-market sales |
| | Foreign-market commission cost | Foreign-market sales commission |
| | | Foreign-market sales |
| Other-incentive cost | Average other incentives paid on travel-agent bookings[2] | |
| | Travel-agent sales | |
| Sales-staff cost | Number of sales staff | Number of sales staff per passenger |
| | | Number of passengers |
| | Labor cost per sales staff | |

Marketing and sales cost → Channel cost / Marketing cost / Sales cost / Merchant fees

| | | |
|---|---|---|
| Credit-card-merchant fees | Credit-card fee per transaction[3] | Credit-card share of transactions |
| | Number of credit-card transactions | Total transactions |
| Other-merchant fees | Other-merchant fee per transaction | Other-merchant share of transactions |
| | Number of other-merchant transactions | Total transactions |

[1] Needs to be balanced with revenue by channel; some channels are higher cost but also drive higher yields.
[2] Includes noncommission incentives.
[3] Helpful to break down by credit-card supplier.

## Leave no stone unturned

There is no silver bullet—no one opportunity that everyone has somehow overlooked. Instead, a successful transformation takes on 500 to 1,000 or more initiatives across the entire airline, all of which need to be identified, planned, prioritized, approved, executed, and refined. While larger themes provide strategic coherence and allow the CEO to focus, small initiatives are needed to capture all the value. The initiatives, once sized, should total 130 percent of the top-down target, given that some leakage will occur during implementation.

This effort will require some difficult trade-offs. Typically, most airlines have covered the low-hanging-fruit improvements, and the remaining potential lies in areas that require trade-offs. Reducing complementary in-flight service, for instance, shaves off costs but has customer-experience implications. Trimming scheduled block time to improve aircraft utilization and reduce costs may endanger on-time performance. Such trade-offs are common in the airline world. Making those difficult choices is an important part of the process.

Four recent case examples of airline transformation, shown in Exhibit 2, illustrate the breadth of action required and the differences in size and source of impact from one airline to the next. A few big-ticket items typically generate the greatest impact, such as increases in ancillary revenues and fleet utilization. We normally find a similar aggregate opportunity from identifying 500 smaller initiatives.

## Find and mobilize different sources of meaning

Airline employees often love their airline. Many are "lifers." They are emotionally invested, with decades of commitment. They identify their airline with the flag, glamour, and service. What doesn't get them out of bed, except in the rarest of cases, is a commitment to corporate earnings beating the cost of capital on a through-cycle risk-adjusted basis … and who can blame them?

As success is impossible without employee commitment, airlines should leave nothing to chance. We recommend they take the following steps:[2]

— Spend the time to establish a common vision and purpose on the executive team, with a clear sense of urgency.

— Help each member of the executive team to tailor their own personal and compelling "change story." Five common sources of meaning are

helpful cues: the company's survival or success, the individual's own ability to contribute to society, customer support through superior products and service, a sense of belonging to and supporting a team, and personal development or empowerment.

— Engage different communities of employees—pilots, cabin crew, support staff, ground-service personnel, and maintenance staff—early in the transformation by making sure they understand the need for change, know their roles in the transformation, and feel the responsibility required to make the change happen. Ways to do this include asking employees for input into the change story and asking them to write and share their own versions.

— Embed change stories into the regular cadence of the transformation work. In weekly meetings, one team member at any level should describe why the airline transformation matters to him or her. While these testimonials could seem awkward and forced if done badly, they are often deeply moving and can reenergize the team.

— Celebrate team and individual efforts far more frequently than normal. There are many well-known and productive ways to reward success, from badges for exceptional results and a photo on an office "wall of fame" to a cake or dinner to celebrate important milestones. Other small and unexpected rewards, such as the chief experience officer dropping by the employee's desk for a handshake and a "well done" or a handwritten note thanking someone for a specific action, can also be highly motivational.

## Track progress by the inch

Successful transformation programs establish thorough, persistent, and focused implementations. These implementations should include a rigorous stage-gate process, line-owned initiatives, and a relentless cadence to ensure rapid value creation.
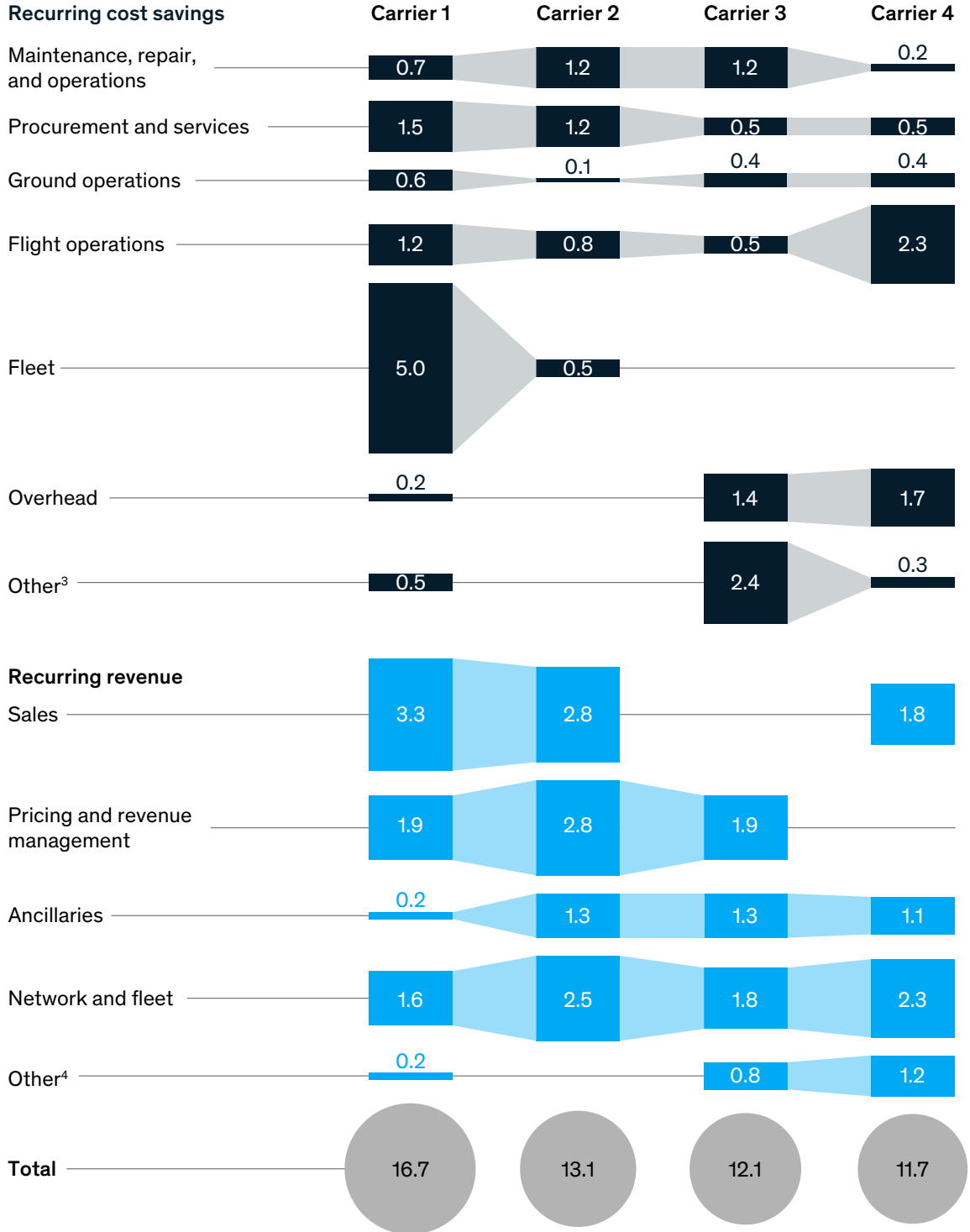
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[2] See Susie Cranston and Scott Keller, "Increasing the 'meaning quotient' of work," *McKinsey Quarterly*, January 2013, McKinsey.com.

Exhibit 2

# Four airline-turnaround cases provide examples of impact by category.

Recurring revenue and cost, net impact of airline turnaround by category,[1] share of preturnaround revenue, %[2]

| Recurring cost savings | Carrier 1 | Carrier 2 | Carrier 3 | Carrier 4 |
|---|---|---|---|---|
| Maintenance, repair, and operations | 0.7 | 1.2 | 1.2 | 0.2 |
| Procurement and services | 1.5 | 1.2 | 0.5 | 0.5 |
| Ground operations | 0.6 | 0.1 | 0.4 | 0.4 |
| Flight operations | 1.2 | 0.8 | 0.5 | 2.3 |
| Fleet | 5.0 | 0.5 | | |
| Overhead | 0.2 | | 1.4 | 1.7 |
| Other[3] | 0.5 | | 2.4 | 0.3 |
| **Recurring revenue** | | | | |
| Sales | 3.3 | 2.8 | | 1.8 |
| Pricing and revenue management | 1.9 | 2.8 | 1.9 | |
| Ancillaries | 0.2 | 1.3 | 1.3 | 1.1 |
| Network and fleet | 1.6 | 2.5 | 1.8 | 2.3 |
| Other[4] | 0.2 | | 0.8 | 1.2 |
| **Total** | 16.7 | 13.1 | 12.1 | 11.7 |

[1] Impact achieved after 18–30 months.
[2] Figures may not sum to totals listed, because of rounding.
[3] For example, sales and marketing cost.
[4] For example, cargo and loyalty.

### A rigorous stage-gate process

As transformation tends to involve a few larger themes and hundreds of individual initiatives, airlines should follow a strict stage-gate process that, driven by a transformation office (TO),[3] moves each idea step by step through five levels of review and decision making (Exhibit 3).

### Line-owned initiatives

Hundreds of line managers need to take ownership as they push through the hundreds of transformation initiatives. Ownership is characterized by complete engagement and a personal drive to do everything possible to complete the initiative, from idea to realization. The TO and senior leaders provide decision making and other support for the initiative owners via coaching, training, and tools. Making line managers bear the responsibility for individual initiatives is also a great way to identify "superstar" talent in the organization.

### A relentless cadence

A transformation is a marathon—not a sprint. To keep this lengthy process moving, airlines need to establish an unrelenting cadence with a clear focus on impact. We recommend setting up weekly TO meetings in which workstream leaders and their teams review progress on the tasks to which they committed the previous week—then make measurable commitments for the subsequent week in front of their peers. All relevant departments should attend these meetings to help break down any silos and create an atmosphere of joint problem solving.

We note that carriers shouldn't run these meetings just to please some central entity. On the contrary, the meetings should be pragmatic, helpful, and energizing for the business. There are several ways to accomplish this. First, carriers should ensure that meeting preparations are efficient and informal: elaborate visual presentations are unnecessary; spreadsheets and handwritten whiteboard notes are effective enough. Next, the meetings should focus on resolving issues and immediately clearing

any bottlenecks—either directly in the meetings or within hours thereafter. In fact, a sure sign that meetings are going off course is that they are dominated by process updates, not problem solving. Finally, leadership should work with the managers to perform a detailed analysis of each initiative on a rotating basis; in this way, carriers can enable meetings between third- or fourth-level managers and their senior executives, reinforcing feelings of ownership and accountability.

At one major airline, the CEO made a point of attending the TO meetings regularly, as he found the TO process the most effective way of shifting the company's culture and creating long-term, sustainable change.

## Build a new culture—not just a new cost base

To create lasting results in a transformation, carriers must understand that their performance and health are closely linked. This means that carriers must not only become more agile, more efficient, and better at cross-functional decisions and actions than ever before, but they must also tackle some of their most deeply ingrained behaviors and practices while ensuring that employees have the capabilities they need to be effective. Airlines that focus on both will outpace those that look only at performance.[4]

At one airline, for example, a high-level assessment of the organization's health revealed major improvement needs in four broad areas: accountability, direction, leadership, and motivation. Digging deeper, many employees' comments touched on a "silo mentality," "slow decision making," "lack of training," "bureaucracy," and "lack of accountability."
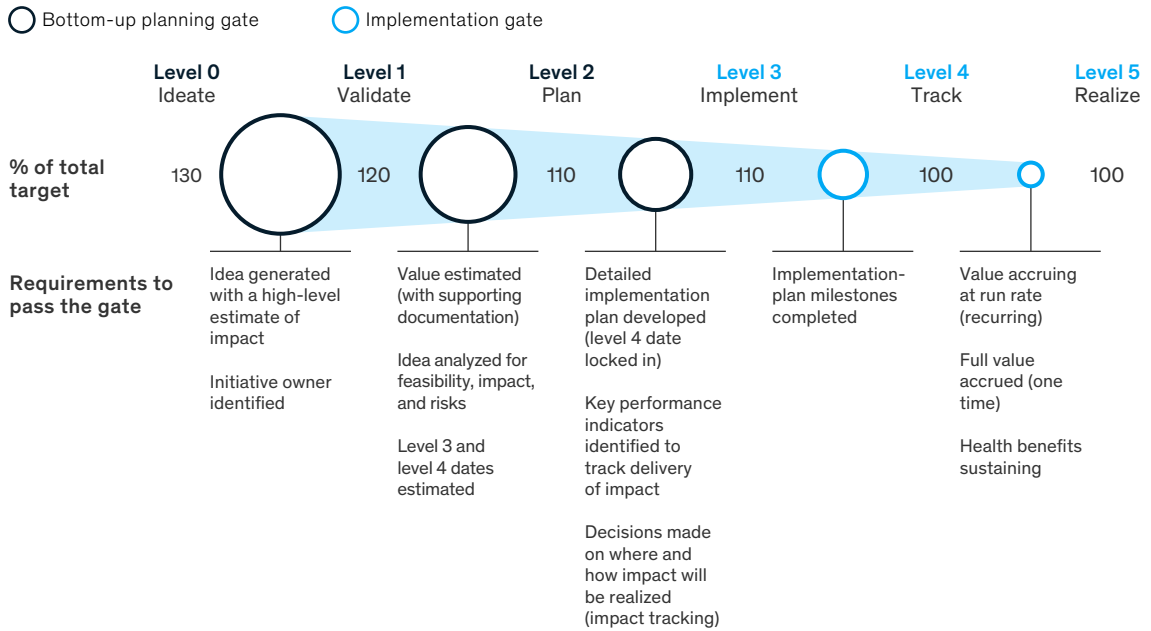
As a result, the carrier required some essential organizational changes. First, it implemented a select number of specific health interventions over time—not aiming to change every mind at once, but instead tackling one or two major themes per year. It split these themes into a high-double-digit

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[3] The TO focuses on active program management and problem solving—for example, by accelerating decision making or resolving resource conflicts—while a classic program-management office focuses on progress tracking and reporting.

[4] See Chris Gagnon, Elizabeth John, and Rob Theunissen, "Organizational health: A fast track to performance improvement," *McKinsey Quarterly*, September 2017, McKinsey.com, and Lili Duan, Rajesh Krishnan, and Brooke Weddle, "The yin and yang of organizational health," *McKinsey Quarterly*, November 2017, McKinsey.com.

Exhibit 3

## Follow a strict stage-gate process for implementation initiatives.

◯ Bottom-up planning gate ◯ Implementation gate

| | Level 0 Ideate | Level 1 Validate | Level 2 Plan | Level 3 Implement | Level 4 Track | Level 5 Realize |
|---|---|---|---|---|---|---|

% of total target: 130 · 120 · 110 · 110 · 100 · 100

**Requirements to pass the gate**

**Level 1:**
Idea generated with a high-level estimate of impact

Initiative owner identified

**Level 2:**
Value estimated (with supporting documentation)

Idea analyzed for feasibility, impact, and risks

Level 3 and level 4 dates estimated

**Level 3:**
Detailed implementation plan developed (level 4 date locked in)

Key performance indicators identified to track delivery of impact

Decisions made on where and how impact will be realized (impact tracking)

**Level 4:**
Implementation-plan milestones completed

**Level 5:**
Value accruing at run rate (recurring)

Full value accrued (one time)

Health benefits sustaining

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number of initiatives in all areas of the business and pursued them with the same rigor as it did performance initiatives.

Second, the carrier embedded elements of its long-term health into its performance initiatives. For example, to reduce the number of acceptable deferred defects in maintenance, the company not only implemented a new tracking and follow-up procedure but also initiated trainings for certified engineers in handling these defects, for planners in making sure more time was reserved and parts were available (via improved forecasting tools), and for team leads and managers in modeling the correct behavior. Only when the engineers' mindsets regarding the importance of every single deferred defect changed did the real transformation take hold.

Airlines that have followed these five rules for success have been able to pursue ambitious targets and generate powerful results. One airline, for example, implemented more than 1,000 initiatives, with an average impact of $1 million apiece; as a whole, these initiatives allowed the airline to boost revenues and cut costs by a total equivalent to 15 percent of its preturnaround revenue. The airline not only met its targets for the 18-month transformation but also was able to overcome transformation fatigue, increase employee satisfaction, work across functional silos, strengthen safety focus, and avoid the kind of industrial action that sometimes accompanies major airline change—setting itself up to move ahead of the pack in this challenging sector.

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# Transformation with a capital T

Companies must be prepared to tear themselves away from routine thinking and behavior.

*by Michael Bucy, Stephen Hall, and Doug Yakola*

**Imagine.** You lead a large basic-resources business. For the past decade, the global commodities supercycle has fueled volume growth and higher prices, shaping your company's processes and culture and defining its outlook. Most of the top team cannot remember a time when the business priorities were different. Then one day it dawns on you that the party is over.

Or imagine again. You run a retail bank with a solid strategy, a strong brand, a well-positioned branch network, and a loyal customer base. But a growing and fast-moving ecosystem of fintech players— microloan sites, peer-to-peer lenders, algorithm-based financial advisers—is starting to nibble at your franchise. The board feels anxious about what no longer seems to be a marginal threat. It worries that management has grown complacent.

In industry after industry, scenarios that once appeared improbable are becoming all too real, prompting boards and CEOs of flagging (or perhaps merely drifting) businesses to embrace the T-word: *transformation*.

Transformation is perhaps the most overused term in business. Often, companies apply it loosely—too loosely—to any form of change, however minor or routine. There are organizational transformations (otherwise known as org redesigns), when businesses redraw organizational roles and accountabilities. Strategic transformations imply a change in the business model. The term transformation is also increasingly used for a digital reinvention: companies fundamentally reworking the way they're wired and, in particular, how they go to market.

What we're focused on here—and what businesses like the previously mentioned bank and basic-resource companies need—is something different: a transformation with a capital *T*, which we define as an intense, organization-wide program to enhance performance (an earnings improvement of 25 percent or more, for example) *and* to boost organizational health. When such transformations succeed, they radically improve the important business drivers, such as topline growth, capital productivity, cost efficiency, operational effectiveness, customer satisfaction, and sales excellence. Because such transformations instill

the importance of internal alignment around a common vision and strategy, increase the capacity for renewal, and develop superior execution skills, they enable companies to go on improving their results in sustainable ways year after year. These sorts of transformations may well involve exploiting new digital opportunities or accompany a strategic rethink. But in essence, they are largely about delivering the full potential of what's already there.

The reported failure rate of large-scale change programs has hovered around 70 percent over many years. In 2010, conscious of the special challenges and disappointed expectations of many businesses embarking on transformations, McKinsey set up a group to focus exclusively on this sort of effort. In six years, our Recovery & Transformation Services (RTS) unit has worked with more than 100 companies, covering almost every geography and industry around the world. These cases—both the successes and the efforts that fell short—helped us distill a set of empirical insights about improving the odds of success. Combined with the right strategic choices, a transformation can turn a mediocre (or good) business into a world-class one.

## Why transformations fail

Transformations as we define them take up a surprisingly large share of a leadership's and an organization's time and attention. They require enormous energy to realize the necessary degree of change. Herein lie the seeds of disappointment. Our most fundamental lesson from the past half-dozen years is that average companies rarely have the combination of skills, mindsets, and ongoing commitment needed to pull off a large-scale transformation.

It's true that across the economy as a whole, "creative destruction" has been a constant, since at least 1942, when Joseph Schumpeter coined the term. But for individual organizations and their leaders, disruption is episodic and sufficiently infrequent that most CEOs and top-management teams are more accomplished at running businesses in stable environments than in changing ones. Odds are that their training and practical experience predominantly take place in times when extensive, deep-rooted, and rapid changes aren't

necessary. For many organizations, this relatively placid experience leads to a "steady state" of stable structures, regular budgeting, incremental targets, quarterly reviews, and modest reward systems. All that makes leaders poorly prepared for the much faster-paced, more bruising work of a transformation. Intensive exposure to such efforts has taught us that many executives struggle to change gears and can be reluctant to lead rather than delegate when they face external disruption, successive quarters of flagging performance, or just an opportunity to up a company's game.

Executives embarking on a transformation can resemble career commercial air pilots thrust into the cockpit of a fighter jet. They are still flying a plane, but they have been trained to prioritize safety, stability, and efficiency and therefore lack the tools and pattern-recognition experience to respond appropriately to the demands of combat. Yet because they are still behind the controls, they do not recognize the different threats and requirements the new situation presents. One manufacturing executive whose company learned that lesson the hard way told us, "I just put my head down and worked harder. But while this had got us out of tight spots in the past, extra effort, on its own, was not enough this time."

## Tilting the odds toward success

The most important starting point of a transformation, and the best predictor of success, is a CEO who recognizes that only a new approach will dramatically improve the company's performance. No matter how powerful the aspirations, conviction, and sheer determination of the CEO, though, our experience suggests that companies must also get five other important dimensions right if they are to overcome organizational inertia, shed deeply ingrained steady-state habits, and create a new long-term upward momentum. They must identify the company's full potential; set a new pace through a transformation office (TO) that is empowered to make decisions; reinforce the executive team with a chief transformation officer (CTO); change employee and managerial mindsets that are holding

the organization back; and embed a new culture of execution throughout the business to sustain the transformation. The last is in some ways the most difficult task of all.

### Stretch for the full potential

Targets in most corporations emerge from negotiations. Leaders and line managers go back and forth: the former invariably push for more, while the latter point out all the reasons why the proposed targets are unachievable. Inevitably, the same dynamic applies during transformation efforts, and this leads to compromises and incremental changes rather than radical improvements. When managers at one company in a highly competitive, asset-intense industry were shown strong external evidence that they could add £250 million in revenue above what they themselves had identified, for example, they immediately talked down the proposed targets. For them, targets meant accountability—and, when missed, adverse consequences for their own compensation. Their default reaction was "let's underpromise and overdeliver."

To counter this natural tendency, CEOs should demand a clear analysis of the company's full value-creation potential: specific revenue and cost goals backed up by well-grounded facts. We have found it helpful for the CEO and top team to assume the mindset, independence, and tool kit of an activist investor or private-equity acquirer. To do so, they must step outside the self-imposed constraints and define what's truly achievable. The message: it's time to take a single self-confident leap rather than a series of incremental steps that don't lead very far. In our experience, targets that are two to three times a company's initial estimates of its potential are routinely achievable—not the exception.

### Change the cadence

Experience has taught us that it's essential to create a hub to oversee the transformation and to drive a cadence markedly different from the normal day-to-day one. We call this hub the transformation office.

What makes a TO work? One company with a program to boost EBITDA[1] by more than $1 billion

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[1] Earnings before interest, taxes, depreciation, and amortization.

set up an unusual but highly effective TO. For a start, it was located in a circular room that had no chairs—only standing room. Around the wall was what came to be known, throughout the business, as "the snake": a weekly tracker that marked progress toward the goal. By the end of the process, the snake had eaten its own tail as the company materially exceeded its financial target.

Each Tuesday, at the weekly TO meeting, work-stream leaders and their teams reviewed progress on the tasks they had committed themselves (the previous week) to complete and made measurable commitments for the next week in front of their peers. They used only handwritten whiteboard notes—no PowerPoint presentations—and had just 15 minutes apiece to make their points. Owners of individual initiatives within each work stream reviewed their specific initiatives on a rotating basis, so third- or fourth-level managers met the top leaders, further increasing ownership and accountability. Even the divisional CEO made a point of attending these TO meetings each time he visited the business, an experience that in hindsight convinced him that the TO process was more crucial than anything else to shifting the company's culture.

For senior leaders, distraction is the constant enemy. Most prefer talking about new customers, M&A opportunities, or fresh strategic choices—hence the temptation at the top to delegate responsibility to a steering committee or an old-style program-management office charged with providing periodic updates. When top management's attention is diverted elsewhere, line managers will emulate that behavior when they choose their own priorities.

Given these distractions, many initiatives move too slowly. Parkinson's law states that work expands to fill the time available, and business managers aren't immune: given a month to complete a project requiring a week's worth of effort, they will generally start working on it a week before the deadline. In successful transformations, a week means a week, and the transformation office constantly asks, "how can you move more swiftly?" and "what do you need to make things happen?" This faster clock speed is one of the most defining characteristics of

successful transformations.

Collaborating with senior leaders across the entire business, the TO must have the grit, discipline, energy, and focus to drive forward perhaps five to eight major work streams. All of them are further divided into perhaps hundreds (even the low thousands) of separate initiatives, each with a specific owner and a detailed, fully costed bottom-up plan. Above all, the TO must constantly push for decisions so that the organization is conscious of any foot dragging when progress stalls.

**Bring on the CTO**
Managing a complex enterprise-wide transformation is a full-time executive-level job. It should be filled by someone with the clear authority to push the organization to its full potential, as well as the skills, experience, and even personality of a seasoned fighter pilot, to use our earlier analogy.

The chief transformation officer's job is to question, push, praise, prod, cajole, and otherwise irritate an organization that needs to think and act differently. One CEO introduced a new CTO to his top team by saying, "Bill's job is to make you and me feel uncomfortable. If we aren't feeling uncomfortable, then he's not doing his job." Of course, the CTO shouldn't take the place of the CEO, who (on the contrary) must be front and center, continually reinforcing the idea that this is my transformation.

Many leaders of traditional program-management offices are strong on processes but unable or unwilling to push the CEO and top team. The right CTO can sometimes come from within the organization. But one of the biggest mistakes we see companies making in the early stages is to choose the CTO only from an internal slate of candidates. The CTO must be dynamic, respected, unafraid of confrontation, and willing to challenge corporate orthodoxies. These qualities are harder to find among people concerned about protecting their legacy, pursuing their next role, or tiptoeing around long-simmering internal political tensions.

What does a CTO actually do? Consider what happened at one company mounting a billion-dollar productivity program. The new CTO became

exasperated as executives focused on individual technical problems rather than the worsening cost and schedule slippage. Although he lacked any background in the program's technical aspects, he called out the facts, warning the members of the operations team that they would lose their jobs—and the whole project would close—unless things got back on track within the next 30 days. The conversation then shifted, resources were reallocated, and the operations team planned and executed a new approach. Within two weeks, the project was indeed back on track. Without the CTO's independent perspective and candor, none of that would have happened.

### Remove barriers, create incentives

Many companies perform under their full potential not because of structural disadvantages but rather through a combination of poor leadership, a deficient culture and capabilities, and misaligned incentives. In good or even average times, when businesses can get away with trundling along, these barriers may be manageable. But the transformation will reach full potential only if they are addressed early and explicitly. Common problematic mindsets we encounter include prioritizing the "tribe" (local unit) over the "nation" (the business as a whole), being too proud to ask for help, and blaming the external world "because it is not under our control."

One public utility we know was paralyzed because its employees were passively "waiting to be told" rather than taking the initiative. Given its history, they had unconsciously decided that there was no advantage in taking action, because if they did and made a mistake, the results would make the front pages of newspapers. A bureaucratic culture had hidden the underlying cause of paralysis. To make progress, the company had to counter this very real and well-founded fear.

McKinsey's influence model, one proven tool for helping to change such mindsets, emphasizes telling a compelling change story, role modeling by the senior team, building reinforcement mechanisms, and providing employees with the skills to change.[2] While all four of these interventions are important in a transformation, companies must address the change story and reinforcement mechanisms (particularly incentives) at the outset.

**An engaging change story.** Most companies underestimate the importance of communicating the "why" of a transformation; too often, they assume that a letter from the CEO and a corporate slide pack will secure organizational engagement. But it's not enough to say "we aren't making our budget plan" or "we must be more competitive." Engagement with employees and managers needs to have a context, a vision, and a call to action that will resonate with each person individually. This kind of personalization is what motivates a workforce.

At one agribusiness, for example, someone not known for speaking out stood up at the launch of its transformation program and talked about growing up on a family farm, suffering the consequences of worsening market conditions, and observing his father's struggle as he had to postpone retirement. The son's vision was to transform the company's performance out of a sense of obligation to those who had come before him and a desire to be a strong partner to farmers. The other workers rallied round his story much more than the financially based argument from the CEO.

*Incentives.* Incentives are especially important in changing behavior. In our experience, traditional incentive plans, with multiple variables and weightings—say, six to ten objectives with average weights of 10 to 15 percent each—are too complicated. In a transformation, the incentive plan should have no more than three objectives, with an outsized payout for outsized performance; the period of transformation, after all, is likely to be one of the most difficult and demanding of any professional career. The usual excuses (such as "our incentive program is already set" or "our people don't need special incentives to give their best") should not deter leaders from revisiting this critical reinforcement tool.

Nonmonetary incentives are also vital.[3] One CEO made a point, each week, of writing a short handwritten note to a different employee involved in the transformation effort. This cost nothing but

[2] See Tessa Basford and Bill Schaninger, "The four building blocks of change," *McKinsey Quarterly*, April 2016, McKinsey.com.
[3] See Susie Cranston and Scott Keller, "Increasing the 'meaning quotient' of work," *McKinsey Quarterly*, January 2013, McKinsey.com.

had an almost magical effect on morale. In another company, an employee went far beyond normal expectations to deliver a particularly challenging initiative. The CEO heard about this and gathered a group, including the employee's wife and two children, for a surprise party. Within 24 hours, the story of this celebration had spread throughout the company.

**No going back**

Transformations typically degrade rather than visibly fail. Leaders and their employees summon up a huge initial effort; corporate results improve, sometimes dramatically; and those involved pat themselves on the back and declare victory. Then, slowly but surely, the company slips back into its old ways. How many times have frontline managers told us things like "we have undergone three transformations in the last eight years, and each time we were back where we started 18 months later"?

The true test of a transformation, therefore, is what happens when the TO is disbanded and life reverts to a more normal rhythm. What's critical is that leaders try to bottle the lessons of the transformation as it moves along and to ingrain, within the organization, a repeatable process to deliver better and better results long after it formally ends. This often means, for example, applying the TO meetings' cadence and robust style to financial reviews, annual budget cycles, even daily performance meetings—the basic routines of the business. It's no good starting this effort near the end of the program. Embedding the processes and working approaches of the transformation into everyday activities should start much earlier to ensure that the momentum of performance continues to accelerate after the transformation is over.

Companies that create this sort of momentum stand out—so much that we've come to view the interlocking processes, skills, and attitudes needed to achieve it as a distinct source of power, one we call an "execution engine." Organizations with an effective execution engine conspicuously continue to challenge everything, using an independent perspective. They act like investors—all employees treat company money as if it were their own. They ensure that accountability remains in the line, not in a central team or external advisers. Their focus on execution remains relentless even as results improve, and they are always seeking new ways to motivate their employees to keep striving for more. By contrast, companies doomed to fail tend to revert to high-level targets assigned to the line, with a minimal focus on execution or on tapping the energy and ideas of employees. They often lose the talented people responsible for the initial achievements to headhunters or other internal jobs before the processes are ingrained. To avoid this, leaders must take care to retain the enthusiasm, commitment, and focus of these key employees until the execution engine is fully embedded.

Consider the experience of one company that had realized a $4 billion (40 percent) bottom-line improvement over several years. The impetus to "go back to the well" for a new round of improvements, far from being a top-leadership initiative, came out of a series of conversations at performance-review meetings where line leaders had become energized about new opportunities previously considered out of reach. The result was an additional billion dollars of savings over the next year.

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Nothing about our approach to transformations is especially novel or complex. It is not a formula reserved for the most able people and companies, but we know from experience that it works only for the most willing. Our key insight is that to achieve a transformational improvement, companies need to raise their ambitions, develop different skills, challenge existing mindsets, and commit fully to execution. Doing all this can produce extraordinary *and* sustainable results.

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# The numbers behind successful transformations

Crunching the numbers on transformations suggests good news for companies that go broad, move fast and renew often, prioritize health, and keep stretching their aspirations.

*by Kevin Laczkowski, Tao Tan, and Matthias Winter*

**"What gets measured,"** Peter Drucker famously observed, "gets managed." One might add a corollary that what goes unmeasured—or gets measured only superficially—risks being mismanaged or, at least, undermanaged.

So it is with transformations. As we've noted before, the term "transformation" can be vague, and it too often refers only to minor or isolated initiatives.[1] What should define a transformation is in fact the opposite: an intense, well-managed, organization-wide program to enhance performance and to boost organizational health. And the results should always be measured.

As part of an analysis we term "transformatics," we've assembled and scrutinized a data set of more than 200 large transformations stretching back nearly a decade. More recently, we isolated the 82 public companies that had undertaken a full-scale transformation and had an observable 18-month transformation track record to see what we could learn from a statistical analysis of their experiences. The research highlighted four indicators that showed a statistically significant correlation with top-quartile financial performance during the 18-month test period (for more about the methodology, see sidebar "Transformatics: Inside the metrics of transformation"). Taken together, the four indicators suggest some potential lessons for senior managers seeking to maximize the odds of a successful transformation. Let's look at each in turn.

## 1. Go big, go broad

The first indicator of top-quartile transformation is the scope of the effort itself. Successful companies, our findings suggest, typically favor an all-in, enterprise-wide transformation, rather than constraining the transformation to individual business units or functions. A more comprehensive scope increases the chances of creating value-generating opportunities across functions. This was the case for the basic-materials company whose story is described in more detail in the sidebar "The power of scope: A case study." It also proved effective for a consumer-goods company we know

whose leaders designed a series of transformation processes to harvest the fruits of improved integration across the company's supply-chain, manufacturing, and sales units.

Outperformers address both the bottom and top lines. Our data show that 41 percent of transformation value is generated from growth initiatives (Exhibit 1). That's a reminder that "transformations" are not just about cost cutting. In fact, we found that reducing general and administrative expenses, including head-count reductions, comprised on average just 9 percent of gross transformation targets.

Another important aspect of scope appears to be the number of people involved. Whether targeting the bottom line or the top, companies that scored in the top quartile mobilized a substantial chunk of their workforce—at least 8 percent—to drive transformation initiatives. Some top performers deployed 20 percent or more. Mass mobilization allows organizations to pursue large numbers of granular efforts under the umbrella of well-defined workstreams that can, collectively, generate big results. In the transformations we studied, 68 percent

Exhibit 1

**Growth can be as transformative as cost cutting.**

~40%

of transformation value comes from growth initiatives

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[1] See Michael Bucy, Stephen Hall, and Doug Yakola, "Transformation with a capital T," *McKinsey Quarterly*, November 2016, McKinsey.com.

# The power of scope: A case study

**In a business, the parts link together and compose the whole.
To improve the whole, then, you have to improve the parts—right?**

*by William Fookes, Ignacio Marcos, and Alejandro Sandoval*

That's the conventional wisdom: improve one part at a time, then move to the next part, methodically and consistently. This traditional view sounds sensible but appears to be wrong. Research by our colleagues shows that the most successful performance-transformation efforts cut across business units and functions, target both the top and bottom lines, and engage a substantial share of the workforce. Those findings are consistent with our experience, which is that cross-functional operations transformations—emphasizing the interactions between product development, procurement, manufacturing, supply chains, capital expenditures, and services (exhibit)—typically outperform their single-function counterparts by between 30 and 40 percent.

The experience of a company in the basic-materials industry vividly illustrates the power of scope in transformation efforts. The company started with a seemingly narrow problem: a need to optimize the way it used its fleet of trucks, which carried raw materials to manufacturing centers. The executive team hoped improvements would save the company $5 million.

By taking a broader perspective on ways to maximize truck usage, the leaders found that every string they pulled and every question they asked connected the trucks to some other part of their operation. Truck use would be better if the company redesigned its internal road system and loaded materials more thoughtfully, in ways that matched the production process for different feedstocks.

In the end, the executives realized, no part of the company stood by itself. Every function connected to other functions. And that meant the company needed to scrutinize not just its truck fleet but also its entire end-to-end process, from understanding its customer needs through to the delivery of the finished product. Addressing the entire chain of value, in turn, would open up larger opportunities to grow the business by delighting customers: providing them with a mix of products better suited to their needs, for example, thereby helping them to boost quality and reduce inventory levels.

As the basic-materials manufacturer identified the places where each piece of its operations intersected with other pieces, leaders also recognized opportunities to introduce systems that shared raw-material information more broadly, and highlighted additional possibilities. By applying advanced analytics, for example, the company optimized the positioning of raw-material processing equipment—a step that brought an additional productivity increase of 20 percent.

New management practices guaranteed the execution of new standard operational procedures, while also transitioning company culture toward becoming a continuous-improvement organization, constantly looking for ways to improve safety, performance, and quality. The result: more than $60 million in bottom-line benefits, approximately 12 times more than the project the company had initially envisioned.

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## Transformative change typically combines deep functional expertise with cross-functional initiatives.
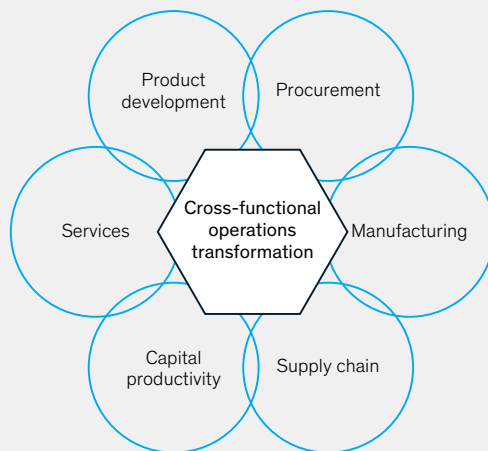


Unlocking a company's full operational potential means building new institutional capabilities and organizational muscle.

of initiatives were worth $250,000 or less, and only 16 percent were worth $1 million or more. What's more, 50 percent of transformation value came from smaller initiatives (which we define as less than 0.5 percent of the total value achieved from the transformation value)—little gains that rolled up to big wins.

As we've noted before, smaller initiatives are typically easier to deliver and also more empowering because they tend to be led by frontline employees. Their efforts give the employees more of a stake in the transformation's success.[2] For example, one global industrial company empowered its frontline manufacturing workers to own portfolios of many small (less than $25,000) lean-operations projects in targeted locations. Precisely because of the initiatives' small size, the responsible employees were able to deliver them more quickly, with fewer layers of approval. Granular initiatives and renewal under well-defined workstreams can collectively add up to big moves over time.

## 2. Move fast, renew often

Top-quartile transforming companies, our findings suggest, move fast and renew often. In successful transformations, companies typically sprint out of the gates, turning their initial burst of idea generation into an achievable, rigorous plan within a few short months. Execution follows at an equally fast clip. That said, every transformation is unique; some by nature will take longer (for example, significant portfolio changes or major shifts in business models). When we drilled down into a subset of our data to get a sharper picture, we found that successful transformations typically implemented initiatives that ultimately corresponded to 28 percent of fully ramped-up value in the first three months, 57 percent in the first six months, and 74 percent in the first 12 months (Exhibit 2).

That makes sense. When companies can snag "quick wins"—such as more efficient use of working capital and better management of discretionary spending—early in the transformation process, they can then use the savings to fund longer-term ambitions such as organic growth and building employee capabilities. In this way, transformation becomes a virtuous cycle. To maintain momentum, companies in the top quartile restocked their number of initiatives by 70 percent after the first year, often backfilling initiatives that had been canceled or downsized. Some companies even make this a part of their annual planning process. A chemicals company we know tasks key members of its finance and operations leadership to conduct an annual, internal due diligence, as if it were an outside buyer, and then involves frontline leaders

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[2] See Michael Bucy, Tony Fagan, Benoît Maraite, and Cornelia Piaia, "Keeping transformations on target," March 2017, McKinsey.com.

Exhibit 2

## The first few months of a transformation pack a powerful punch.

Share of transformation value achieved by top-quartile companies over the first year, %



| Time elapsed since transformation launch | 28 | 57 | 66 | 74 |
| --- | --- | --- | --- | --- |
| | 3 months | 6 months | 9 months | 12 months |
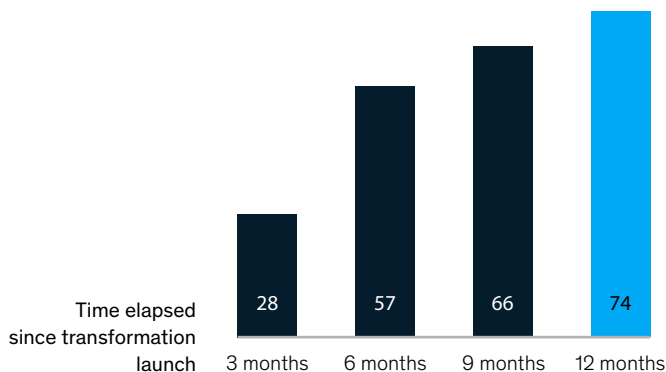
to develop and implement initiatives addressing the identified opportunities. We observed that less successful transformations, on the other hand, were not only less likely to start strong but also less likely to keep going. Companies in the bottom quartile failed to renew their initiatives. That, too, makes sense because a lack of momentum can cause portfolios to stagnate, which impedes value creation.

## 3. Embrace organizational health

As easy as it is to overlook health in the quest for rapid performance improvement, it's also a mistake. For more than 15 years, our Organizational Health Index (OHI) has been monitoring health across a hundred countries and well over a thousand companies, aggregating the views of millions of employees and managers on management practices that drive outcomes along nine dimensions, including leadership, accountability, and innovation and learning. We score the results, allowing a company to see how it compares with others in the database. Companies with a healthy culture consistently outperform their peers. In fact, publicly traded companies in the top OHI quartile generate three times the total returns to shareholders (TRS) achieved by those in the bottom quartile.

We observe a similar relationship when it comes to transformations. When we compared the returns generated by transforming companies that fully implemented a defined set of health-improvement measures for enterprise-wide behavioral change with those that did not, the results were stark. The companies that fully implemented these health-improvement measures saw nearly double the excess TRS of companies that did not (Exhibit 3).

Outperforming companies set clear, measurable organizational-health targets in conjunction with their financial objectives, prioritizing elements that relied on measurable results, not buzzwords. Top executives themselves buy in and empower a dedicated team to help address deficiencies when they arise. Healthy companies put a premium on engagement from day one—they instill a norm of transparency and encourage dialogue right from the start.

## 4. Stretch your aspirations

Normally, you think of starting with aspirations. We close with them, because in our experience companies that achieve the most successful transformations often evolve their performance aspirations, making them more aggressive as the transformation gets rolling and accomplishing more than they thought possible at the outset. Our colleagues commented on this phenomenon in an article a few years ago, noting that, "In our experience, targets that are two to three times a company's initial estimates of its potential are routinely achievable—not the exception."

## Transformatics: Inside the metrics of transformation

For close to a decade, we've been tracking the results of hundreds of transformations that collectively include more than 100,000 employees responsible for more than 250,000 distinct initiatives that collectively generated billions of dollars in bottom-line impact. To stress-test our thinking and control for externalities, we identified the 82 publicly listed companies that went through such a transformation for a measurable 18-month period and whose total returns to shareholders (TRS) could be paired with a representative off-the-shelf sector and geographic stock index, allowing us to measure excess TRS against the index for an 18-month period following the launch of a transformation. As a key part of that research, we conducted a "random forest" analysis that tested the characteristics of some 20 hypotheses against our data set. Of these hypotheses, the analysis isolated four indicators that proved to be statistically significant and often correlated with top-quartile excess TRS: the scope of the effort, its speed and renewal, the extent to which it implemented a defined set of health measures for enterprise-wide behavioral change, and the presence of bold aspirations and targets.

Exhibit 3

## Committing to organizational health as part of your transformation can be a difference maker.

Alpha of total returns to shareholders, based on whether companies fully implemented organizational-health measures[1]



CAGR[2]

| | | CAGR[2] |
|---|---|---|
| 135 | Health measures fully implemented | 22% |
| 118 | Health measures not fully implemented | 12% |
| 100 | Selected index | |

Months
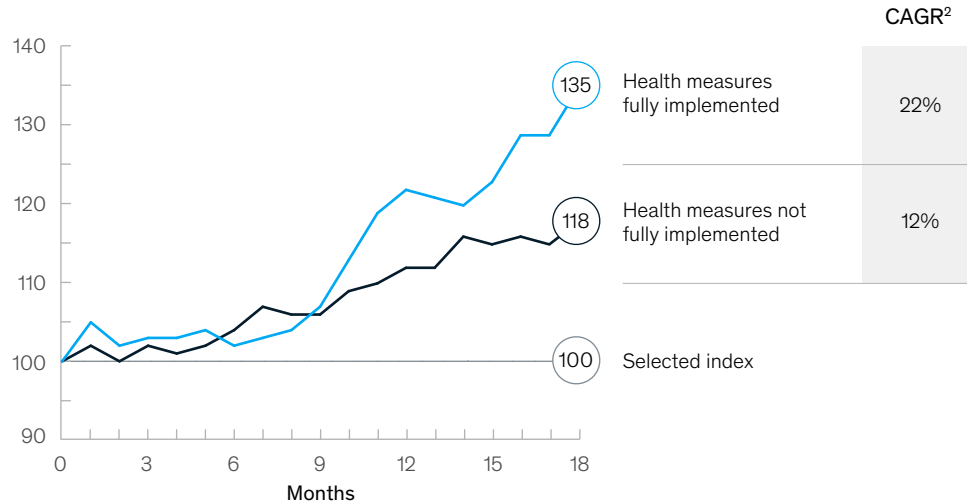
[1]In this analysis, alpha measures the performance of an investment against an off-the-shelf sector and geographic stock index. Stock price reflects total returns to shareholders and is (1) adjusted for dividends, (2) adjusted for splits, and (3) weighted on a market-capitalization basis; n = 14 for companies that fully implemented organizational-health measures and 68 for those that did not.
[2]CAGR = compound annual growth rate.

Our research shed some intriguing light on this view. We observed that successful transformations typically started with internal due diligence aiming to anchor the company's potential for massive improvements in objective, discernable evidence. Companies that, based on what the due diligence showed, set gross transformation targets at 75 percent or higher of trailing earnings were more likely to realize outsized TRS gains. On the other hand, we also saw that many of the companies with weaker transformation performance (the bottom half of excess TRS) had set their targets at 25 percent or less of trailing earnings. We are struck that the 3:1 ratio is consistent with the pattern recognition of our colleagues, and with our own. Bold performance aspirations do seem to matter, and, at the least, executives should not lock in on initial estimates that may be too low. There may even be a "Pygmalion effect" at work, with high expectations lifting results up and low expectations holding them down.

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We often hear that "transformations are a crapshoot." Certainly, every transforming company faces unique challenges, and there are variables that no company can control. Still, the indicators surfaced by our research suggest that leaders have significant influence over the success (or failure) of their company's transformations. Lessons from these findings suggest that organizations that go broad, move fast and renew often, prioritize health, and keep stretching their aspirations can significantly outperform their peers. The numbers tell the story.

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# The role of the transformation office

Pace and rhythm are important in planning and execution.

*by Kurt Chauviere, Ben Maritz, and Jasper van Halder*

**Many companies** set up a project-management office (PMO), led by a spreadsheet-savvy analyst charged with tracking myriad transformation initiatives. Their transformation leaders attend PMO meetings, tick boxes, and generate reports. At one North American company, we know a key executive announced stubbornly, "We can't move the data center, because we haven't gotten the server list from IT." The conversation stopped there with no follow-up, and the PMO leader called a time-out.

When leaders like the North American executive announce delays, they typically cite extrinsic factors, create new timelines, and talk about root-cause analysis, deflecting and delaying the day of reckoning. Even when PMO projects move ahead, the organization itself remains unchanged and continues to work at the same slow speed, anchored in the same old structures.

Cue an independent transformation office (TO), a very different unit that, when organized well, brings a different pace and rhythm to planning and execution. The best of these are the beating heart of a transformation, propelling the company forward at a new speed and instilling a new culture of delivery. A good TO identifies and captures value in the same way a highly effective PMO does. But it breaks out of the PMO mold by changing the metabolic rate of the organization and setting new rules of engagement.

## Increasing the working metabolism of the organization

Importantly, the transformation office drives results through standardized, weekly, action-oriented meetings. Attendees include a sponsor for each work stream and other key initiative owners, plus a representative from finance and the chief transformation officer (CTO). Meeting agendas are tightly defined and action items rigorously tracked.

The best TO meetings bear no resemblance to ordinary meetings dominated by presentations, debates, and "show-off" items. They are fast-paced, 60- to 90-minute sessions led by the CTO

and designed to encourage action and remove roadblocks. As one CTO told us, "The TO is emotionless and fact based. The TO coaches and

pushes initiative owners with questions like 'What would you do if it were your money?' and 'Have you handed over your initiative so that it doesn't fall behind while you are on leave?'"

The TO's role was particularly important in helping the working-capital team at a global dairy company we worked with. The team had been struggling for years to reduce inventory at its hundred or more plants around the world. The operations group, however, felt customers would be better and more fully served if the buffer remained. Only through TO probing were the facts highlighted and the business case brought to the attention of the CFO. When he saw the numbers and the value at stake, he quickly adjusted the existing limits, thereby freeing up hundreds of millions of dollars in capital in such a way that it did not adversely affect delivery performance.

The TO team needs a mandate from the CEO to challenge upward as well as downward (including the CEO in the event that he or she falls behind set targets and milestones). It must be able to impose consequences on over- and underdelivering sponsors and initiative owners.

## Setting the rules of the game

The TO not only sets the schedule and the tone of the transformation but also keeps score. A simple, consistent way of defining and tracking value (in dollars) gives it clear credibility when it comes to commending those who have made good progress and to calling out laggards. The TO ensures everyone has access to the same simple rulebook and is trained to understand it.

Every initiative should link to the same value measure and in cases of doubt the TO should give the final answer.

We've seen how tough it is to get everyone on the same page. But we've also seen the power of those TOs that succeed: an end to arguments, explicit agreement that the number is the number, the visibility of an unambiguous process, and clear goals.

With clear rules, there can be no debate about which valuation is right or what assumptions should go into a business case. People know their work must stand

up to external scrutiny and therefore will not spend time on pet projects or substandard ideas.

## Creating a single source of truth

Any organization undergoing a transformation will have a pipeline of improvements, subdivided into actions, owners, and dollars at stake. An important role of the transformation office is to ensure that all participants have a "single source of truth," a transparent view of what flows through the pipeline and a central record of the progress of each initiative owner.

For better or worse, that single source of truth extends to the TO terminology that rapidly becomes the language of the transformation. We recommend tracking and approving initiatives through a structured stage-gate process that goes through five steps, from initial identification to final realization.

Armed with the truth, the TO has the credibility to spot potential conflicts or overlaps among work streams, raise the issues with stakeholders in its regular meetings, and work with owners and executives to achieve the best outcome for the business. Without this sort of planning and intervention by the TO to remove bottlenecks, one or two support teams can cost an organization millions of dollars.

## Reinforcing the change-management goals

An effective transformation office will reinforce the transformation culture at all times: during weekly TO meetings, at executive-committee meetings, in reports and updates, during problem-solving discussions, and in communications to the rest of the organization. Everyone should see its messages, and initiative owners need to follow the TO's lead. It should encourage appropriate behavior and acknowledge achievements, insisting that the CEO or CTO personally makes weekly calls to frontline employees to celebrate success. Such actions can have a profound impact on owners and executives alike, especially in organizations where positive recognition is not the norm.

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The success of a transformation depends on the regular drumbeat of the transformation office, on clear communication and an action-oriented tone. In our experience, TOs are critical to the organization accomplishing its goals. The best ones have such a profound impact that they become part of a new way of working, long after the transformation is complete.

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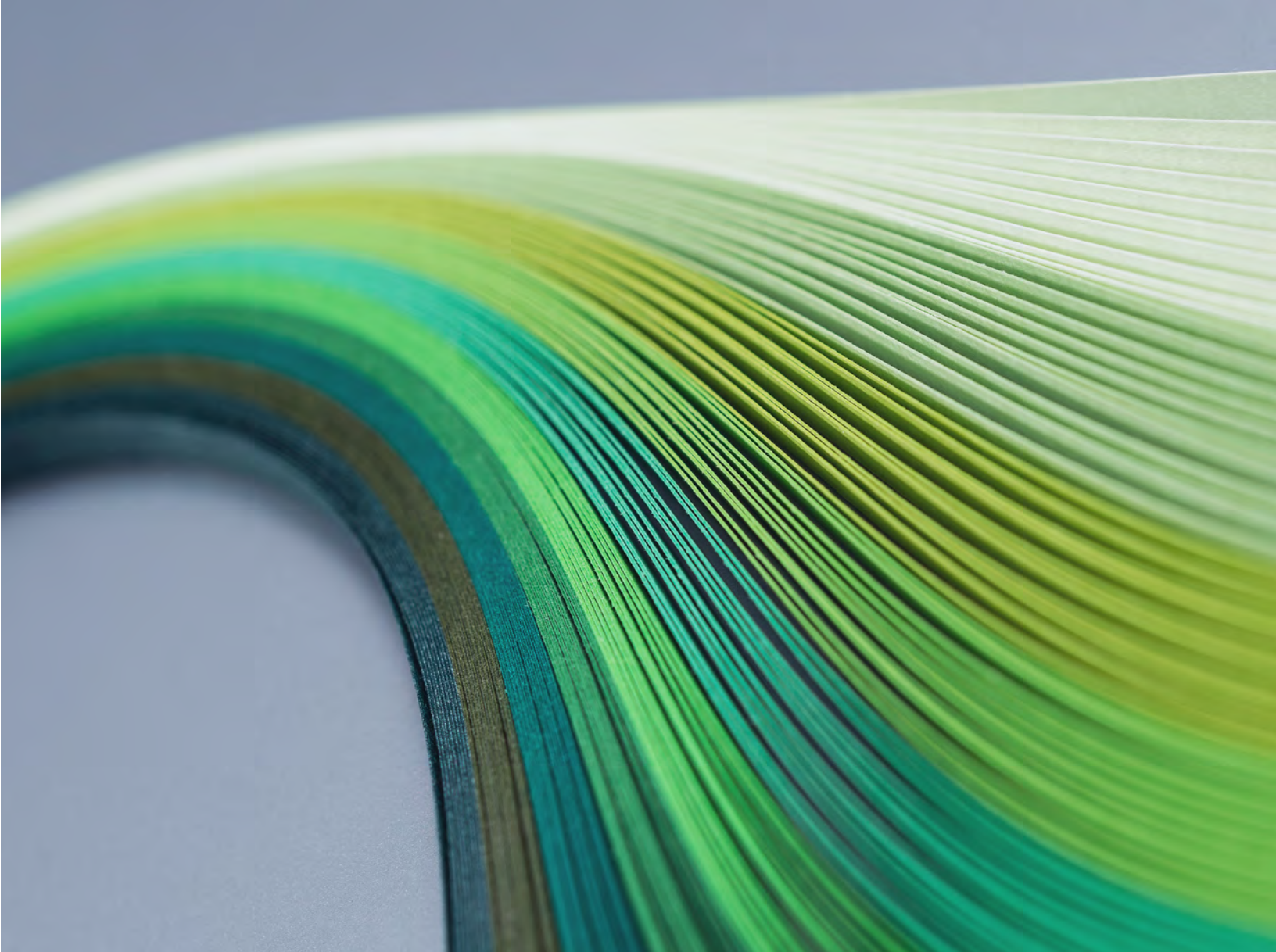
# A primer in resilience: Maximizing value beyond earnings

Empowering the finance organization to take decisive action to strengthen the balance sheet is critical to achieving organizational resilience.

*by Kevin Carmody, Clifford Chen, and Sam Jacobs*

A new mantra echoes in corporate C-suites and boardrooms: resilience. While the largest global economic expansion in history continues, the outlook is uncertain, with US manufacturing growth recently declining to its lowest point in a decade.[1] In McKinsey's latest survey on economic conditions, executives' views on the current global economy and expectations of future global growth are less favorable than they have been in years.[2]

What makes a company resilient in the face of shifting economic conditions? In a recent study, McKinsey traced the paths of approximately 1,100 publicly traded companies and found that during the last economic downturn, roughly 10 percent fared materially better than the rest.[3] One of the key characteristics shared by these "resilients" was their willingness to take decisive action to strengthen their balance sheets and improve cash flow before the downturn hit, often by divesting non-core assets, reducing debt, and improving the efficiency of their working capital.

Companies looking to build resilience today can take three important steps. First, they can enhance the role of their finance teams in strategic planning, business analytics, and decision making at all levels of the organization. The best way to do this is to embed finance managers alongside business-unit leaders and empower them to be partners in running the business. Second, companies can pressure test their capital structure and cash flows using a range of scenarios, from an economic crisis to other disruptive events, and then adjust their position accordingly. Finally, companies can take immediate action to harvest hidden value from their balance sheets by employing a disciplined approach to managing assets and liabilities. With some foresight, these three steps can fortify the balance sheet with greater capital reserves that can help ride out a downturn and even acquire assets at discounted prices from competitors that do not prepare as well.

Across the spectrum—from industry leaders to those experiencing financial distress—we have seen companies use these methods to strengthen their balance sheet and improve their cash flow. In fact, these actions typically generate hundreds of millions of dollars of cash, by prioritizing a disciplined, targeted approach to improving working capital, monetizing underutilized assets, and reevaluating long-term liabilities.

In one case, a leading global manufacturer took decisive action before the last downturn to reposition its balance sheet to be even more competitive in the medium to long term. The company refocused its portfolio by divesting certain businesses and product lines it considered less relevant to its core, and focusing its capital on the prioritized core product lines. It also took some tactical steps to improve liquidity by accessing the capital markets early enough to obtain favorable terms, before a credit crunch hit. The result was a substantial increase in capital that helped the company more effectively withstand the recession and improve its competitive position relative to its peers.

## Empowering the finance organization

While most CFOs have a role in setting company strategy, the rest of the finance organization is sometimes viewed as passive scorekeepers. Best-in-class organizations, in contrast, expect their finance professionals to play a substantial role with business-unit leaders to set strategic business priorities. In these organizations, finance teams utilize innovative performance management tools to help determine how the business is actually performing and suggest the steps that management could take to optimize results.

These tools support a performance dialogue by providing deep insights into the business; beyond the traditional metrics grounded in the income

[1] "IHS Markit Flash U.S. PMI," Purchasing Managers Index, IHS Markit, August 22, 2019, markiteconomics.com.
[2] "September 2019: McKinsey Global Survey results," McKinsey.com.
[3] Martin Hirt, Kevin Laczkowski, and Mihir Mysore, "Bubbles pop, downturns stop," *McKinsey Quarterly*, May 2019, McKinsey.com. The study examined approximately 1,100 publicly traded companies, across a range of industries and geographies, with annual revenue exceeding $1 billion.

# Resilient companies can't predict the future, but they can certainly prepare for it.

statement. They help communicate to the entire organization the importance of metrics such as return on invested capital, cash-conversion cycle, and other capital-structure ratios. In some cases, the finance function must also advocate against aggressive (and popular) growth plans, when a fact-based analysis of risk and return doesn't support a specific course of action. Done well, a set of performance dialogues creates a culture change throughout the enterprise in which every line manager understands how his or her actions will add cash to the balance sheet, or other benefits.

In addition, the finance organization can push the organization's thinking about how to measure and improve results. One company recently used machine learning to improve its management of accounts receivable by analyzing past and present contracts and customer financial profiles to identify those that were likely to generate late payments. This enabled it to adjust contractual relationships to provide stronger incentives for on-time payment—a simple fix that substantially improved its cash position.

Another company invested in a virtual inventory warehouse to improve inventory projections—a frequent pain point of CFOs. It created a single data pool across all global sites that incorporated on-site inventory, outstanding purchase orders, and real-time flow of products into and out of company locations. This allowed the company to manage inventory levels with a greater level of precision, which in turn unlocked the potential for substantial working capital improvement.

## Pressure testing against a wide range of risks

Resilient companies can't predict the future, but they can certainly prepare for it. They run sophisticated scenario-planning exercises that model how their organizations would fare under a range of changing conditions, from the loss of a major customer to a credit-rating downgrade or a global recession.

An essential factor in pressure testing a company's resilience is leverage. Too often, companies targeting short-term profitability add debt and future capital commitments, such as leases, without studying closely if they can service these obligations.

One example comes from the oil-and-gas support industry, which is prone to boom-and-bust cycles. During the first half of this decade, many companies rushed to maximize profits when oil prices were high. They borrowed heavily to expand their fleets of drilling rigs, helicopters, supply boats, and other critical infrastructure. When oil prices plummeted— from $100 a barrel to under $50—so did their cash flows, which couldn't support their debt and capital-expenditure commitments. In some subsectors of this industry, many companies have had to restructure or sell themselves to competitors on unfavorable terms.

A few far-sighted companies were tempered by an awareness of their industry's economic swings. They prioritized resilience by proactively managing leverage and other financial commitments, such as leases. To survive a downturn, they negotiated with lenders to extend and stagger debt maturities and revise covenants in lending agreements to include more flexible terms to accommodate dips in performance. When it became clear that a downturn was in progress, they paid down debt on their revolving credit lines, often with term loans, proceeds from asset sales, and other esoteric financing vehicles. This allowed them to use their

credit line for its intended purpose, which is to manage seasonal variations in revenue and working capital. In return, the companies accepted slightly higher interest rates and lower overall debt capacity, and they pledged additional assets as collateral.

While these companies didn't outperform competitors during the frenzied years of high oil prices, they avoided being wiped out in the downturn. They marshaled shareholder support by communicating a clear, long-term agenda, even with the painful trade-off of lower short-term profits. By planning for the downturn, these companies created an unquestionable competitive advantage over their rivals.

## Harvesting value from the balance sheet

When companies take aggressive action to improve resilience, they are often surprised by the amount of value they can unlock by better managing the assets and liabilities on their balance sheet. For example, our research shows that working capital management is surprisingly variable, even among companies in the same industry.  In the consumer discretionary sector—which includes travel, entertainment, and apparel—we have seen cash-conversion cycles vary from 13 to 101 days. In healthcare, it ranged from 49 to 179 days. We find that large companies that make a focused effort can typically free up more than $100 million from working capital and redeploy it to priority projects.

We also see a similar upside realized by companies that consistently track cash returns on an asset level and that make an ongoing effort to reevaluate and mitigate their liabilities. For example, many companies report P&L results at a granular level tracked by asset, location, and line of business, but few overlay a cash flow and return-on-capital view with the same specificity. By analyzing these metrics, companies can identify where to divest underperforming assets and redeploy the capital to strengthen the balance sheet or invest in higher yielding opportunities.

Companies can similarly use rigorous analytics to identify opportunities to better manage liabilities. For example, those with environmental liabilities should consider options to reduce remediation costs through better use of internal resources or liability transfer transactions. Companies with pension obligations can analyze methods to limit the risk of underfunded liabilities, such as making one-time lump-sum payments or transferring the risk through the purchase of a group annuity contract.

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Regardless of what lies ahead on the economic horizon, a company should not wait for indisputable signs of trouble to emerge before acting. In the last recession, some iconic companies failed while others emerged stronger than ever, and their paths took shape well before the slowdown. By acting now to develop a resilience plan, a company can gain a competitive advantage that could mean the difference between thriving and failing.

# Articles by Harry Robinson

# Inside a mining company's AI transformation

How copper-mining giant Freeport-McMoRan unlocked next-level performance with help from McKinsey data scientists and agile coaches.

*by Red Conger, Harry Robinson, and Richard Sellschop*

**The mood was apprehensive** as data scientists, metallurgists, and engineers from Freeport-McMoRan filed into the control room of a copper-ore concentrating mill in Bagdad, Arizona, on the morning of October 19, 2018. They had come to learn what would happen when they cranked the big mill up to a work rate that had never been tried.

The possibility of causing problems at the mill weighed on everyone's mind. The team members had initially resisted the idea of running the mill faster. They wanted to keep the stockpile of ore that feeds the mill from dropping below the minimum size they had long maintained. Their concern was that a too-small stockpile would hamper the mill's performance.

Whether the minimum stockpile size actually helped the mill run better was another matter. No one really knew for sure. Nor could the mill's managers and staff say what would happen if the stockpile shrank to less than the traditional minimum.

## As the weeks went by, the copper-ore concentrating mill sustained a faster pace with no loss of efficiency. The data model had been right: the mill could handle more ore than its operators thought.

What they did know is that a custom-built artificial-intelligence (AI) model, loaded with three years' worth of operating data from the mill and programmed to look for operational tweaks that would boost output, kept saying copper production would rise if the mill were fed with more ore per minute.

To the mill operators, that notion sounded logical enough—except that it didn't account for the minimum stockpile size they had in mind. But the model didn't know, or care, about minimum stockpile size or any of the mill operators' other ideas about how the mill ought to be run.

With permission from company executives, the crew members at the Bagdad site decided to turn up the pace of the mill as the model had suggested. They also prepared to ramp up mining and crushing activities so the stockpile of ore wouldn't run out.

At ten o'clock in the morning, a technician clicked a control on his computer screen to speed up the system of conveyor belts carrying chunks of ore from the crusher to the stockpile and from the stockpile to the mill.

Everyone in the room kept watch on the 13 oversize monitors in the control room, which were lit up with readings from hundreds of performance sensors placed around the mill. The quantity of ore grinding through the mill rose. No warnings went up.

Twelve hours passed. The mill held steady. Even when its stockpile of ore dipped below the usual minimum, the accelerated delivery of ore from the crusher and the mine allowed the mill to keep going. As the weeks went by, the mill sustained the faster pace with no loss of efficiency. The data model had been right: the mill could handle more ore than its operators thought.

"That was the breakthrough we'd been looking for," Justin Cross, the Bagdad site's general manager, told us. "Once we started to run the mill at full speed, we knew we could get results from more of the recommendations that the model was making."
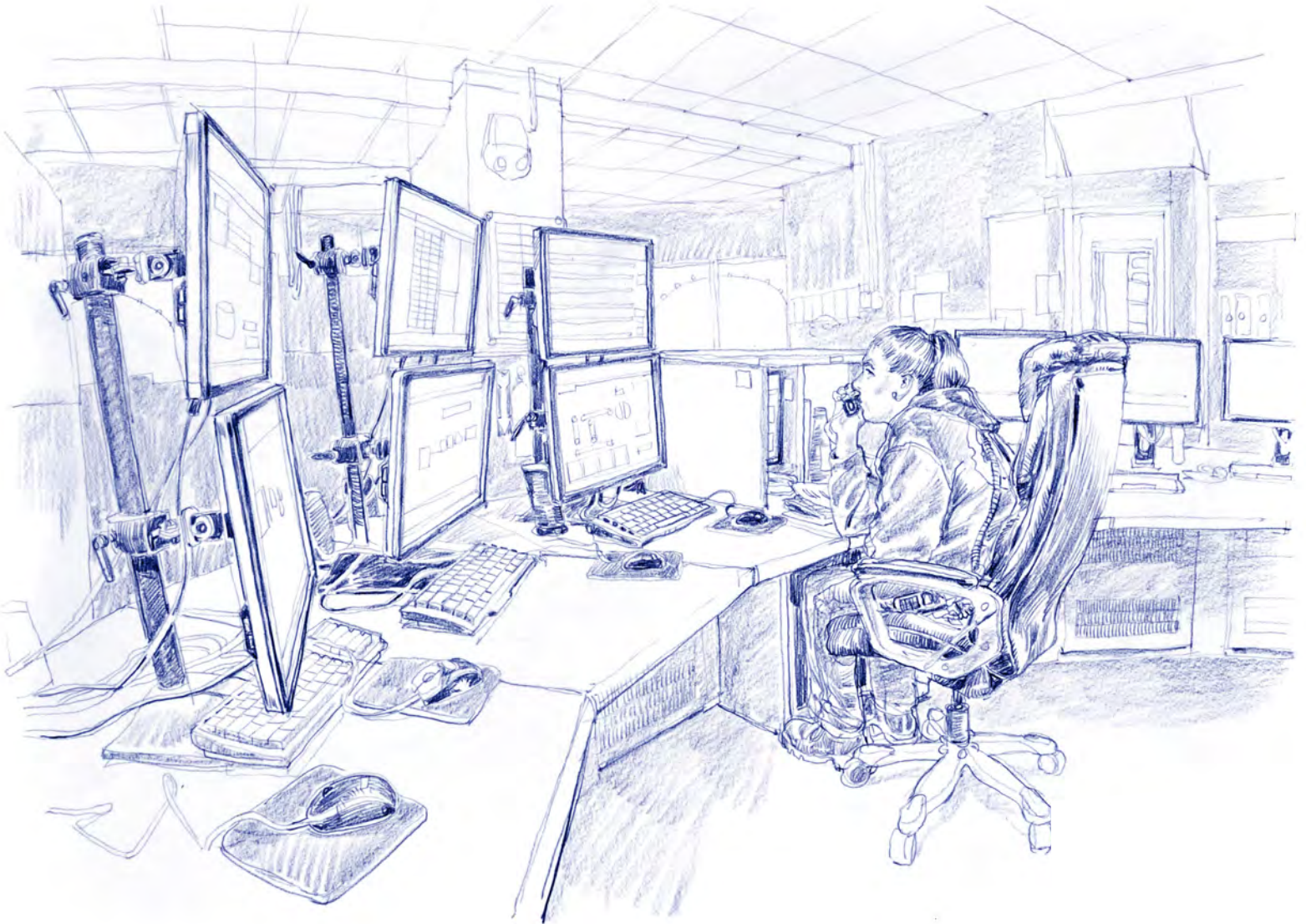


Grinding-mill operator Megan Alford monitors the bank of screens displaying details of the copper ore churning in the main mill just beyond the glass.

### The 'age of the operator'

The story of how Freeport-McMoRan learned to rely on an AI model as much as the intuition of veteran mining engineers and metallurgists might not raise eyebrows outside the tech industry.

For mining companies, though, it illustrates a quiet but profound shift into an era we think of as the "age of the operator," when the best-run businesses wring profits out of low-grade ore that miners would have waved off as waste just ten years ago.

One mine where Freeport-McMoRan had been processing declining ore grades is Bagdad, a sprawling Arizona complex where prospectors staked their first claims in 1882. Bagdad's reserves of higher-grade ore have been depleted for some time, but Freeport-McMoRan has sustained the mine's production of copper by making various process improvements.

By the end of 2017, executives believed that Bagdad had gotten as efficient as it could get with its existing equipment, so they reasoned that adding capacity would be the surest way to get even more copper out of the site. Early in 2018, they started planning a $200 million capital expansion of Bagdad's ore-concentrating mill that would lift production by 20 percent.

Copper prices were high at the time. The investment looked certain to pay off.

Then copper prices dropped from a five-year peak of around $3.30 per pound in early June to $2.75 or so a month later. All of a sudden, investing $200 million to expand Bagdad no longer seemed practical.

Instead, Freeport-McMoRan's leaders resolved to find new process changes that would increase Bagdad's copper output without a massive injection of capital.

Discovering improvements at an efficient mine wouldn't be easy. But Freeport-McMoRan had plenty of high-quality information to study. Around ten years before, Bert Odinet, Freeport-McMoRan's chief information officer, coordinated an effort to standardize the way that each site measures and reports its performance and to build a central data warehouse for storing those measurements.

Several years later, maintenance teams lobbied for the installation of additional network equipment and performance sensors on the company's trucks, power shovels, and stationary machines. The teams would manually download data from those sensors to the data warehouse so they could further sharpen their maintenance practices and improve the functioning of equipment.

# Freeport-McMoRan's leaders resolved to find new process changes that would increase the site's copper output without a massive injection of capital.

When wireless mesh networks became cost effective and reliable, Freeport-McMoRan installed them at all its sites. Now the company could capture and correlate second-by-second performance readings in the data warehouse, all in real time.

"We learned things we'd have never predicted," Odinet said. "That project taught us to be more receptive to what the data was telling us. And it gave us the confidence to try more complicated analyses."

With advanced analytics and AI techniques, Freeport-McMoRan could scan the vast quantity of data it collected, identify even more operational changes that might raise performance, and put them to the test in the field.



Allison (Allie) Naltazan is in training to become a mill operator on the ore-grinding line. Around her, the ore chutes and barrels create a constant grinding, clanging roar as the rock tumbles and breaks. This is her office. She has to shout to be heard.
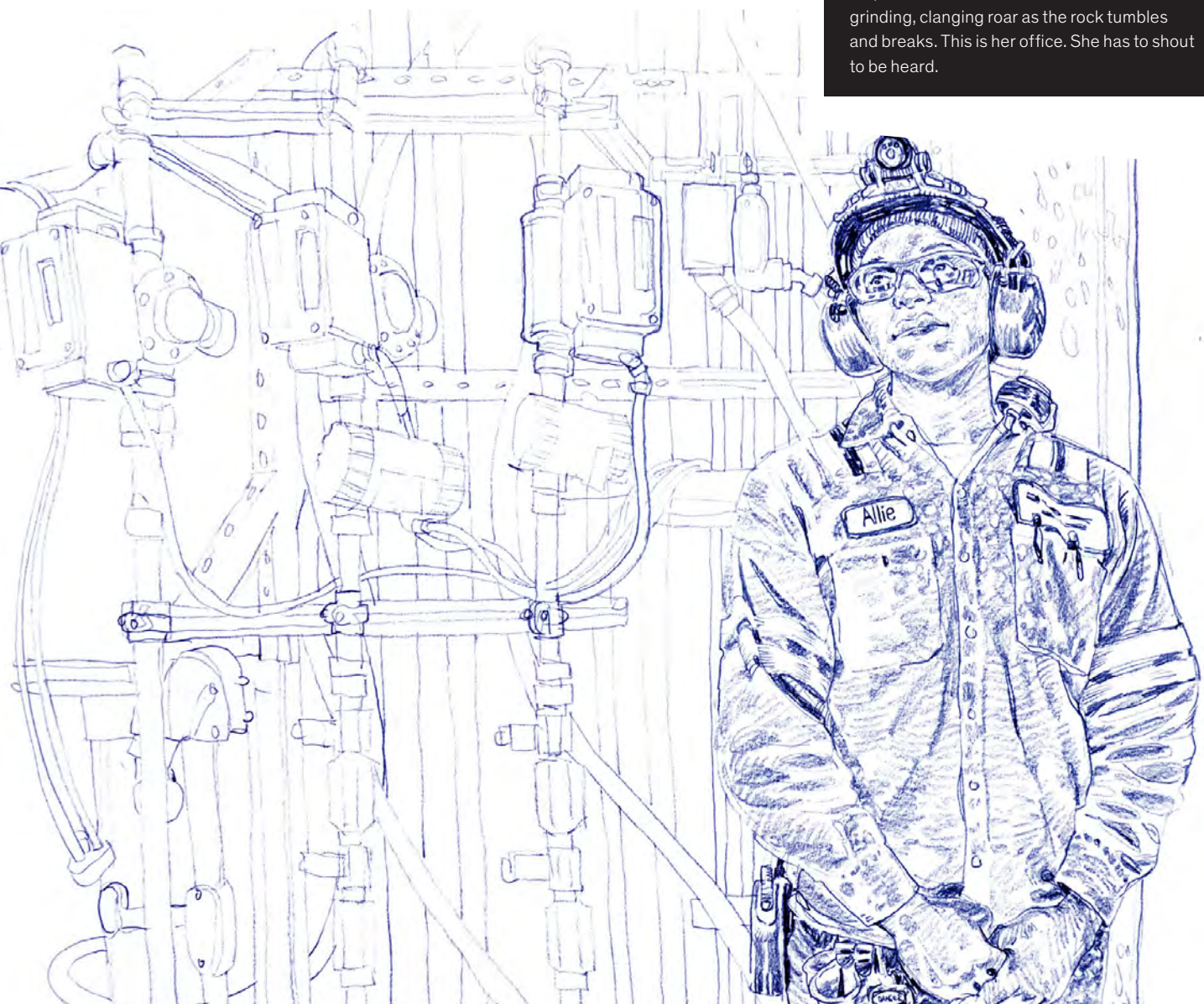
Bagdad looked like a good proving ground for this method. The site is staffed with creative, open-minded engineers, metallurgists, and equipment operators who stood out at Freeport-McMoRan for their willingness to try new things. Their earlier efforts to enhance Bagdad's metallurgical processes, for example, had resulted in higher copper recovery.

And Cross, Bagdad's general manager, was a natural tinkerer who liked to spend his free time outfitting his pickup truck for off-road use and milling mesquite logs into lumber for a house he planned to build himself. Since joining Freeport-McMoRan in 2006, Cross had led a series of projects to streamline operations at the company's mines.

It also helped that Bagdad's operations were stable. With few equipment problems or process hiccups to straighten out, workers would have time to help increase copper production.

Executives felt that promising opportunities to boost Bagdad's production could be found in one part of the operation: the ore-concentrating mill, a noisy facility where huge milling machines and flotation cells bubbling with chemical solutions turn grapefruit-size rocks containing around 0.4 percent copper into a fine-ground mix of 25 percent copper and 75 percent rock.

The mill's technicians ran the facility strictly by the book, a set of operating instructions that Freeport-McMoRan engineers in Phoenix had developed. There had to be ways of building on those instructions that would better the mill's performance.

After talking things over with engineers and operations specialists from Bagdad and from headquarters, Freeport-McMoRan CEO Richard Adkerson and CFO Kathleen Quirk decided to let the crew at Bagdad work with McKinsey on a new kind of mining project: data mining in an agile way.



## Learning agile

The project called for more than sophisticated data science. It also called for a new approach to solving tricky operational problems.

"Usually when we run operational projects, we overengineer them. We test every conceivable scenario, build in safeguards, and do everything we can to ensure that a process change will result in an improvement before we make it," Cross observed. "It's a dependable way to get good results. But it takes a huge amount of time, effort, and capital investment."

McKinsey's consultants reckoned that the crew at Bagdad might get better results, more quickly, by carrying out the analytics project differently. They introduced the idea of working under agile principles, which emphasize quick development of functional solutions that teams then improve, little by little, according to feedback from users.

# The general manager assembled a team of people representing every division of the mill, along with other parts of the organization they would need to work with, such as the mine and Freeport-McMoRan's central data-science group.

Another essential feature of agile methods is face-to-face collaboration within well-rounded teams. Cross assembled a team of people representing every division of the mill, along with other parts of the organization they would need to work with, such as the mine and Freeport-McMoRan's central data-science group.

The composition of the team allowed it to tap the expertise and account for the interests of each division of Bagdad that its work might affect. It also enabled the team to contend better with challenges that involved different divisions and couldn't be solved by one division alone.

The team's agile approach was to work in "sprints"—two-week bouts of activity in which the team conceived a data-modeling function or operational change, tested it, and learned what would make it better.

As improvements came to light, the team would add them to a backlog. Then it would plow through the items on the backlog in subsequent sprints, starting with the easiest, most beneficial tasks.

For Bagdad's crew members, this agile style of working wasn't just different from business as usual. It represented a radical departure from the way they'd been doing things.

"It took us a while to get comfortable with agile," Cross said. "We had to let go of a lot of old habits."

McKinsey brought in agile coaches to help. The coaches explained the rudiments of agile—building a backlog, deciding what to accomplish in each sprint, holding morning meetings to agree on the work the crew would perform each day and to note any difficulties that might slow it down—but were mainly there to join the team's activities and teach its members to work together in agile ways.

Shannon Lijek, a McKinsey partner who specializes in helping organizations apply agile methods, was one of the coaches who came to help the Bagdad team get the hang of agile.

# "We've found that the best way to learn agile is to jump right in," said McKinsey partner Shannon Lijek.

"Agile can be tricky to adopt at first because it isn't a process you can memorize. It's a set of principles for minimizing wasted effort and getting more work done. And we've found that the best way to learn agile is to jump right in," Lijek said.

One way that Bagdad's agile team cut out needless effort was by introducing solutions as soon as it had built "minimum viable products," or MVPs, that were good enough to use, rather than laboring to perfect those products first.

"If we'd built the model ourselves, we'd have tried to get it 100 percent right before doing anything with it," Cross told us.

"Shannon and the McKinsey coaches encouraged us to work with solutions that weren't finished. They'd say, 'You can get 60 percent of the improvement with an MVP, and that's a lot. So just start using it. Then you can worry about making it better.'"

## From predicting to optimizing

Once the team Cross formed came together, it began investigating the possibility of improving the mill's performance. The idea was to spend a month examining data from the mill for patterns that revealed potential improvements. If those improvements looked promising enough, the team would pursue them.

Beginning in late June, the Bagdad team and data scientists from McKinsey built a machine-learning model to check whether the mill truly ran as efficiently as people believed. The model, a type of extreme gradient-boosting model, consisted of an ensemble of thousands of decision trees that had been engineered to include a great deal of metallurgical knowledge.

The staff at Bagdad and Freeport-McMoRan's central operations group believed all the ore entering the mill was of the same type. Consequently, they had defined a single "recipe" of lower and upper parameters for the mill's 42 control settings: the mix of differently sized ore chunks being fed into the mill, the pH level in the flotation cells, and so on.

But when the agile team at Bagdad ran the data from the mill's performance sensors through its model, the members of the team learned something new. From the mill's perspective, the mine was actually producing seven distinct types of ore.

What's more, the mill's standard recipe for control settings didn't match the properties of all those ore types. Ore containing more iron pyrite, for example, would yield more copper if the pH level in the flotation cells were set higher than the recipe prescribed.

"Thinking about ore clusters in terms of data from the mill's instruments, rather than classifications from traditional geology, was a major mindset shift—and it opened up many new possibilities for improving performance," said Sean Buckley, a McKinsey partner who led the analytics work.

All told, the team's analysis suggested that adjusting the mill's controls to suit each of the seven ore types could increase copper production by 10 percent or more.

That prospect convinced Freeport-McMoRan's leaders to let the agile team at Bagdad build an AI model that would look at the ore coming into the mill and suggest control settings to heighten production of copper from that ore.

# To determine just how much copper Bagdad could yield, staff decided to establish a new mandate—maximizing copper production at a reasonable cost, with little new capital investment.



Mill operator II Floyd (George) Mocaby and senior metallurgist Rahul Singh review the alarms on the gantry system.

Team members wrote algorithms to discern the connections among the ore type, the operational readings from the plant's sensors, the amount of ore running through the mill, and the amount of copper recovered. Next, they developed more algorithms to predict the plant's performance based on measurements from the sensors.

After several weeks of development sprints, the team had raised the accuracy of the model's performance predictions to 96 percent— high enough to know that the model was properly interpreting the data streaming in from the mill's sensors and relating it to the mill's control settings.

The team then turned its attention from predicting performance to improving it. Staff began by asking a simple question that no one had asked in some time: What measure of performance do we want to optimize?

For years, the team at Bagdad had oriented its decisions and activities toward particular targets for copper production and operating cost. That approach made a certain kind of sense. It meant that Bagdad consistently generated profits.

Now, to determine just how much copper Bagdad could yield, the team decided to establish a new mandate—*maximizing* copper production at a reasonable cost, with little new capital investment.

## Introducing AI and agile to mining operations: Lessons from Bagdad

*by Red Conger*

**Freeport-McMoRan's effort** to increase copper production at Bagdad taught us a good deal about how to use agile methods and AI tools at our sites, where it can be difficult to alter accepted routines. Here are a few things we're keeping in mind as we expand the use of agile and AI to more of Freeport-McMoRan's operations:

— Don't wait for the "perfect" product or solution to begin using it. Once it's working well enough, implement it right away. Immediate action brings immediate results.

— Be willing to reconsider and discard long-standing assumptions and processes if you find better ways to do things. That means validating your new ideas through data analysis and fieldwork.

— Empower frontline teams to take risks. That's how testing and learning happens. Set clear boundaries on what teams can try. Make it clear they won't be blamed if their experiments come up short or incur extra costs.

— Use data science to catalyze decision making. Human judgment and intuition are hard to replace, but people can make better decisions when they're informed by analytical findings.

— Once you create value with agile and AI, spread the word about what you did and how you did it. Showcasing success will attract interest in these capabilities and motivate colleagues to adopt them.

**Red Conger** is president and COO, Americas, of Freeport-McMoRan.

# Maximizing production could lessen performance in other areas. Nonetheless, executives agreed that if Bagdad could increase production as the model predicted, the short-term cost would be worth it.

Cross and Cory Stevens, Freeport-McMoRan's vice president of operational improvement, knew that maximizing production could lessen Bagdad's performance in other areas. The mill's recovery rate—the percentage of copper extracted from the ore—might drop. Or the whole operation could come to a halt for hours.

Stevens went to other executives to explain that Bagdad's experiment could be costly. The performance numbers they'd see for the next few months might be dismal, he warned.

Nonetheless, the executives agreed with Stevens that if Bagdad could achieve the 10 percent increase in production that the model predicted, the short-term cost would be worth it. They gave him the go-ahead to try maximizing production.

With that approval, Cross granted Bagdad's staff the latitude to make operational changes that deviated from standard procedures and could cause the mill to miss its performance targets. Worker safety and equipment integrity were the only areas where no compromises or experiments would be allowed. Any other changes were fair game.

### A big breakthrough
Over a series of iterations during the next month or so, the team conceived, tested, and refined algorithms that would look at sensor-generated data and recommend control settings to maximize copper output. The new algorithms, known as genetic algorithms, used the principles of natural selection to "evolve" settings that would produce the most copper, given a particular type of ore.

## Most challenging were the model's recommendations to depart from the operational recipe that the staff at Bagdad had been following for years. The agile team spent a lot of time debating what to do with those.



Metallurgist I Alaina Mallard, senior metallurgist Rahul Singh, and mill operator II Floyd (George) Mocaby discuss the expert system inside the ore crusher's control room.

By early September, the team had expanded the prediction model into an MVP of an optimization model, dubbed TROI, that was capable of issuing recommendations every 12 hours, once for each of the mill's two daily shifts.

When each new set of recommendations came out, the engineers, equipment operators, and metallurgists on the team would huddle and decide what do to with them.

TROI was a work in progress, so its earliest recommendations weren't entirely reliable. At every shift, metallurgists from Freeport-McMoRan and from McKinsey would study the model's recommendations and question whether they were credible. Then the metallurgists would take note of the problem recommendations so the agile team could look into them.
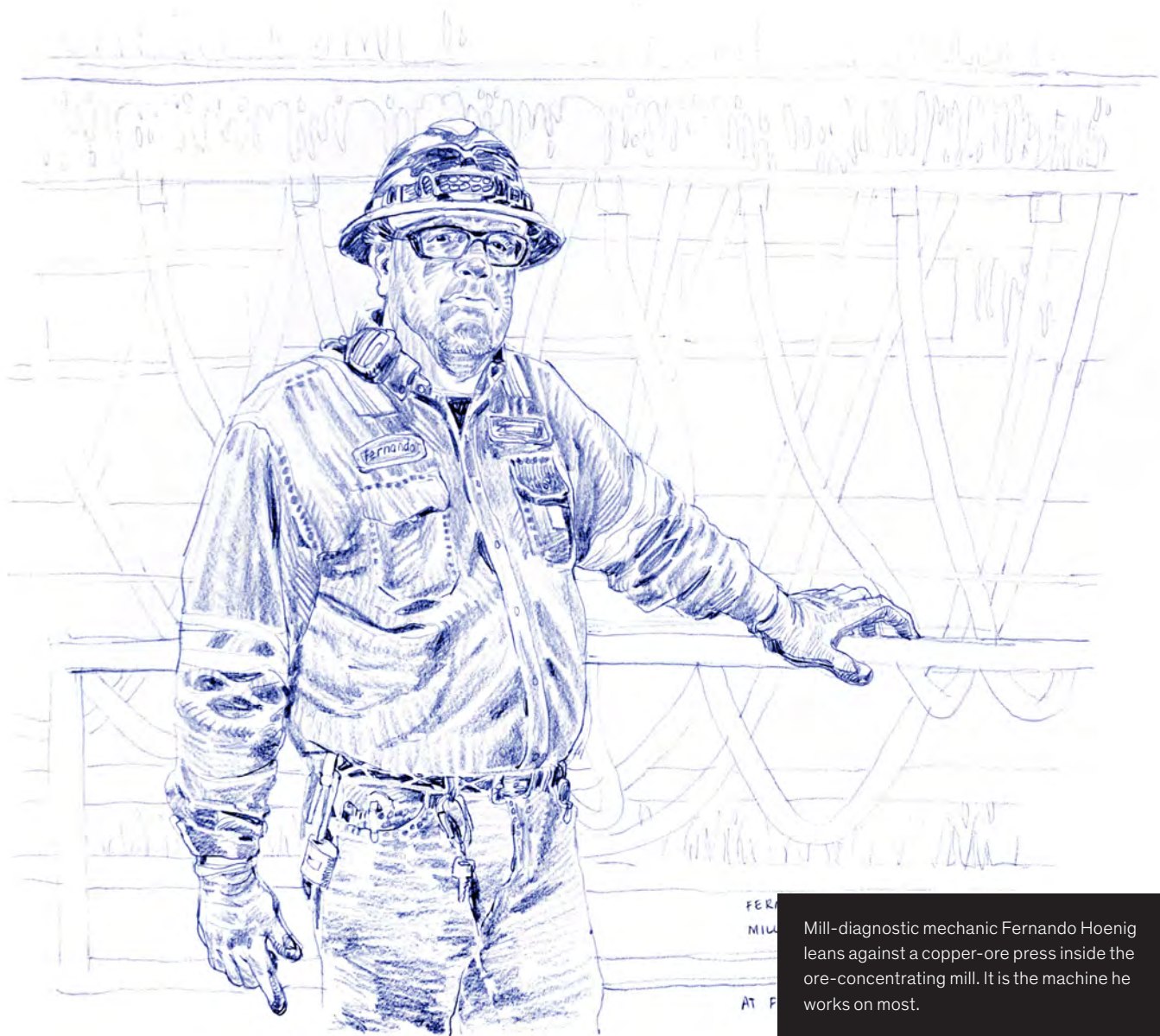
Mill-diagnostic mechanic Fernando Hoenig leans against a copper-ore press inside the ore-concentrating mill. It is the machine he works on most.

Some recommendations led the team members to discover flaws in TROI's logic, which they added to their backlog and corrected in subsequent development sprints. Others indicated that the underlying performance data were faulty and prompted the team to look for fixes.

"TROI helps us to improve the quality of our instrumentation and highlights sensors that need attention," said Frank Ochoa, one of Bagdad's process-control and instrumentation engineers.

Most challenging were the recommendations to depart from the operational recipe the staff had been following for years. The agile team spent a lot of time debating what to do with those.

Gradually, as the team fine-tuned TROI, its recommendations became more plausible, and the staff at Bagdad began following them. Yet many of those recommendations resulted in slim performance gains, if any.

Mid-October arrived. The team was nowhere close to the 10 percent production boost it thought possible.

Cross and Stevens decided it was time to act on a weighty recommendation that no one was especially eager to try: speeding the flow of ore from the mine and the crusher to the mill. Cross asked the mine operators to redline their activities—and reassured them that they wouldn't be blamed for spending more money or triggering operational breakdowns.

The mine operators ramped up blasting, even though they had to use more explosives. They queued up trucks to carry rocks to the crushing plant, in violation of a long-standing directive to keep trucks from standing idle. They choke-fed the giant crusher with run-of-mine, or unprocessed, ore to find out how much it could handle.

Finally, on October 19, the team pushed up the mill's processing rate. Right away, copper production jumped 5 percent. TROI had helped the team unlock a record level of performance.



### Small gains add up

Having achieved a major performance gain, Bagdad's agile team turned to enhancing the model's ability to recommend mill-control settings that would increase copper production.

TROI could already identify which type of ore was running through the mill at any moment. In the next round of sprints, the team added functions to account for other incoming operational data.

Each time TROI recommended a set of control settings, the metallurgists at the plant would consider the recommendations, choose which ones to accept, and pass them to shift supervisors and operators, who would adjust the mill's controls accordingly.

Letting the metallurgists decide which recommendations to follow helped the agile team learn more quickly. Occasionally, the metallurgists applied settings that looked questionable just to find out whether they would work. And when the metallurgists rejected the recommended settings, they typed notes into the model to explain their decisions.

"TROI doesn't always give fully accurate recommendations, but it provides a new perspective on how to manage the plant and challenges our assumptions," said Lulu Raymond, a senior metallurgist at Bagdad.

## As soon as the team pushed up the mill's processing rate, copper production jumped 5 percent. The model had helped the team unlock a record level of performance.
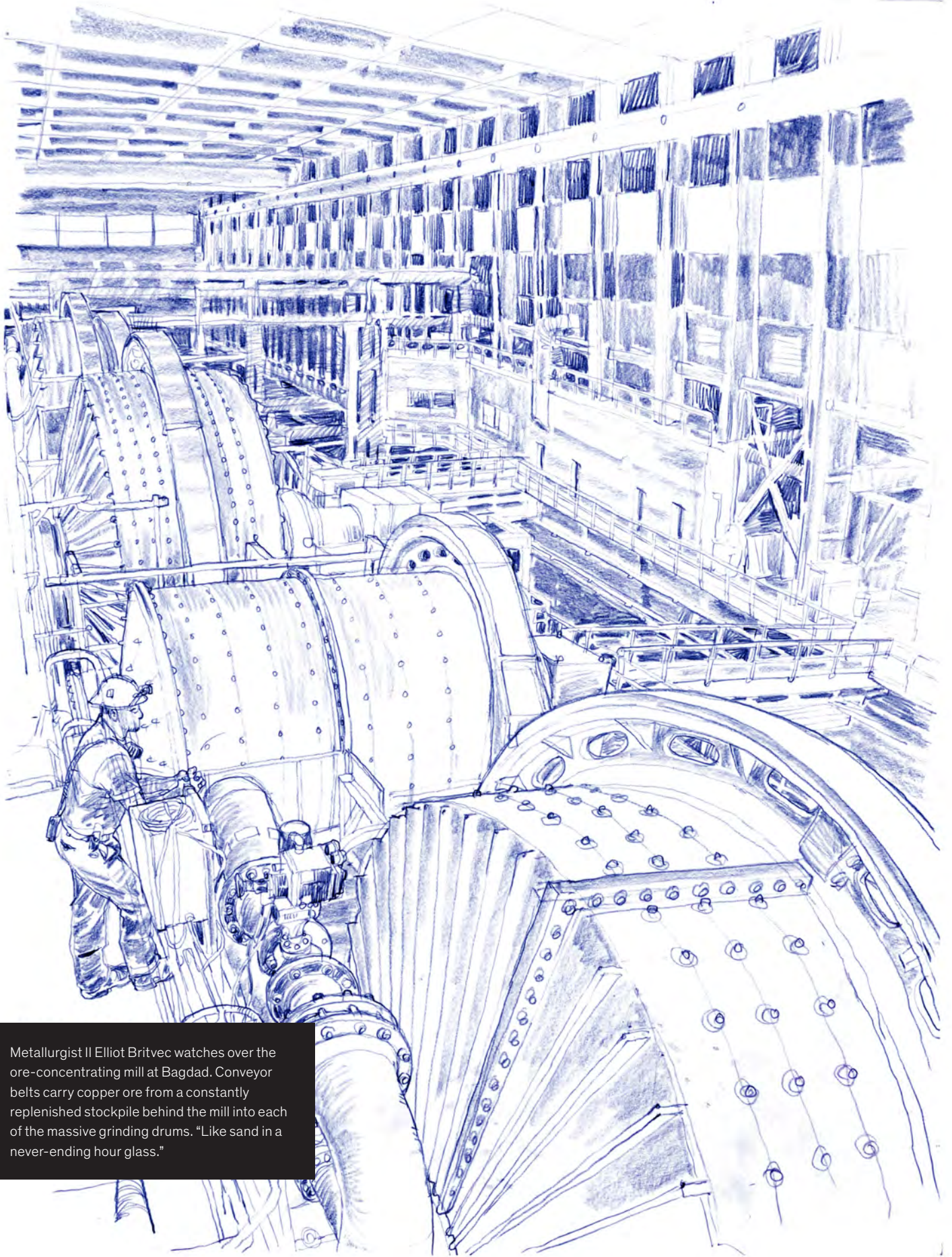
Metallurgist II Elliot Britvec watches over the ore-concentrating mill at Bagdad. Conveyor belts carry copper ore from a constantly replenished stockpile behind the mill into each of the massive grinding drums. "Like sand in a never-ending hour glass."

**The agile team reviewed the data model's recordings and the metallurgists' notes every day and kept working through a backlog of upgrades. Within several weeks, the team had refined the model to the point that metallurgists were accepting more than 80 percent of its recommendations.**



All the while, sensors gauged the mill's performance. The model's machine-learning algorithms recorded which settings improved performance and which ones didn't, and whether the recommendations were helping.

The agile team reviewed the model's recordings and the metallurgists' notes every day, added items to the backlog of upgrades it planned to make, and kept working on those upgrades. By early December, the team had refined TROI to the point that metallurgists were accepting more than 80 percent of its recommendations.

It wasn't long before the metallurgists and mill operators began trying to outsmart TROI. They would monitor the type of ore passing into the mill, anticipate the control settings that the model might suggest, and apply those settings before the model made its twice-daily recommendations (later increased to every three hours). This became a kind of competition: Who can run the mill better than TROI would?

Most important, the mill's production increased substantially. In the fourth quarter of 2018, Bagdad's throughput exceeded 85,000 tons of ore per day—10 percent more than the previous quarter—while its copper-recovery rate rose by one percentage point and its operations became more stable (exhibit). The following quarter, copper production at Bagdad went up yet again.

Those gains should lift Bagdad's copper production by 20 million pounds per year, an increase that has allowed Freeport-McMoRan to avoid most of the $200 million capital expansion of the Bagdad concentrator complex.

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## By following recommendations from the artificial-intelligence model, a copper mill's operators increased throughput by 10 percent.

**Average Bagdad mine dry ore milled daily,**
thousand tons
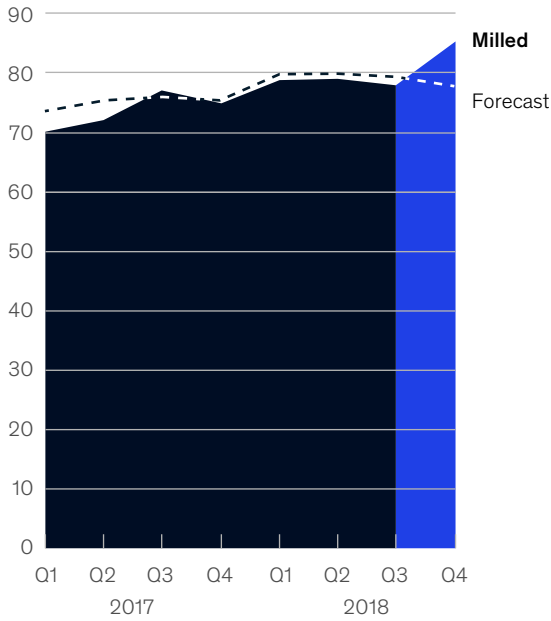


Source: Freeport-McMoRan

We think this is just the beginning for Freeport-McMoRan.

Having learned to maintain TROI during the project, the company's metallurgists and data scientists now run the model themselves, without ongoing support from McKinsey. They study daily and weekly reports that compare the mill's performance with TROI's predictions, and they continue enhancing the model's ability to make recommendations.

Freeport-McMoRan executives have also sponsored the creation of a second agile team at Bagdad to test and make process improvements at the mine. This team, too, is working without help from McKinsey, using the agile methods that it learned on the mill project.

At another one of Freeport-McMoRan's Arizona copper mines, Morenci, managers have kicked off an agile and analytics effort like Bagdad's. And the company will soon launch its most ambitious program of this kind at Cerro Verde, a copper mine in Peru with five times the capacity of Bagdad.

The age of the operator is here, and Freeport-McMoRan is adapting to it with agile methods and AI tools.

**Red Conger** is president and COO, Americas, of Freeport-McMoRan. **Harry Robinson** is a senior partner in McKinsey's Southern California office, and **Richard Sellschop** is a partner in the Stamford office.

# Why do most transformations fail? A conversation with Harry Robinson

When 70 percent of transformations fail, a company needs a proven strategy to beat the odds.

Failed transformations share common problems. In this video, McKinsey senior partner Harry Robinson explains how McKinsey has reverse engineered these failed efforts to create a recipe for success. An edited version of his remarks follows.

### Interview transcript

The academic research is really clear that when corporations launch transformations, roughly 70 percent fail.

The root causes of those failures are straightforward. As we built the Transformation Practice, we studied why transformations go off the rails. And we've found there's a number of factors that commonly crop up.

Often the CEO doesn't set a sufficiently high aspiration. During the early stages of the transformation, he or she doesn't build conviction within the team about the importance of this change or craft a change narrative that convinces people they need to make the transformation happen. People throughout the organization don't buy in, and they don't want to invest extra energy to make change happen.

Or the CEO or the leadership team doesn't address the skills in their organization. They don't have the capabilities to drive their transformation, or the key capabilities sit with people who have other day jobs, and they don't get freed up to be able to work on the transformation.

And companies often miss all sorts of procedural elements that make a transformation thrive. They don't put the right change-management infrastructure in place, or they don't establish a cadence of leadership-oversight meetings. They don't create a transformation office or set regular performance-management discussions to track progress.

When an initiative delivers half its targeted goal, how do you replenish the lost impact?

McKinsey has devised a recipe to support transformations by reverse engineering the failures and taking out bad behaviors. We've created a bulletproof plan so that if the leadership team follows the recipe we've created, those defeating behaviors won't creep into your transformation efforts.

**Harry Robinson** is a senior partner in McKinsey's Southern California office.

Why do most transformations fail? A conversation with Harry Robinson

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# Acknowledgments