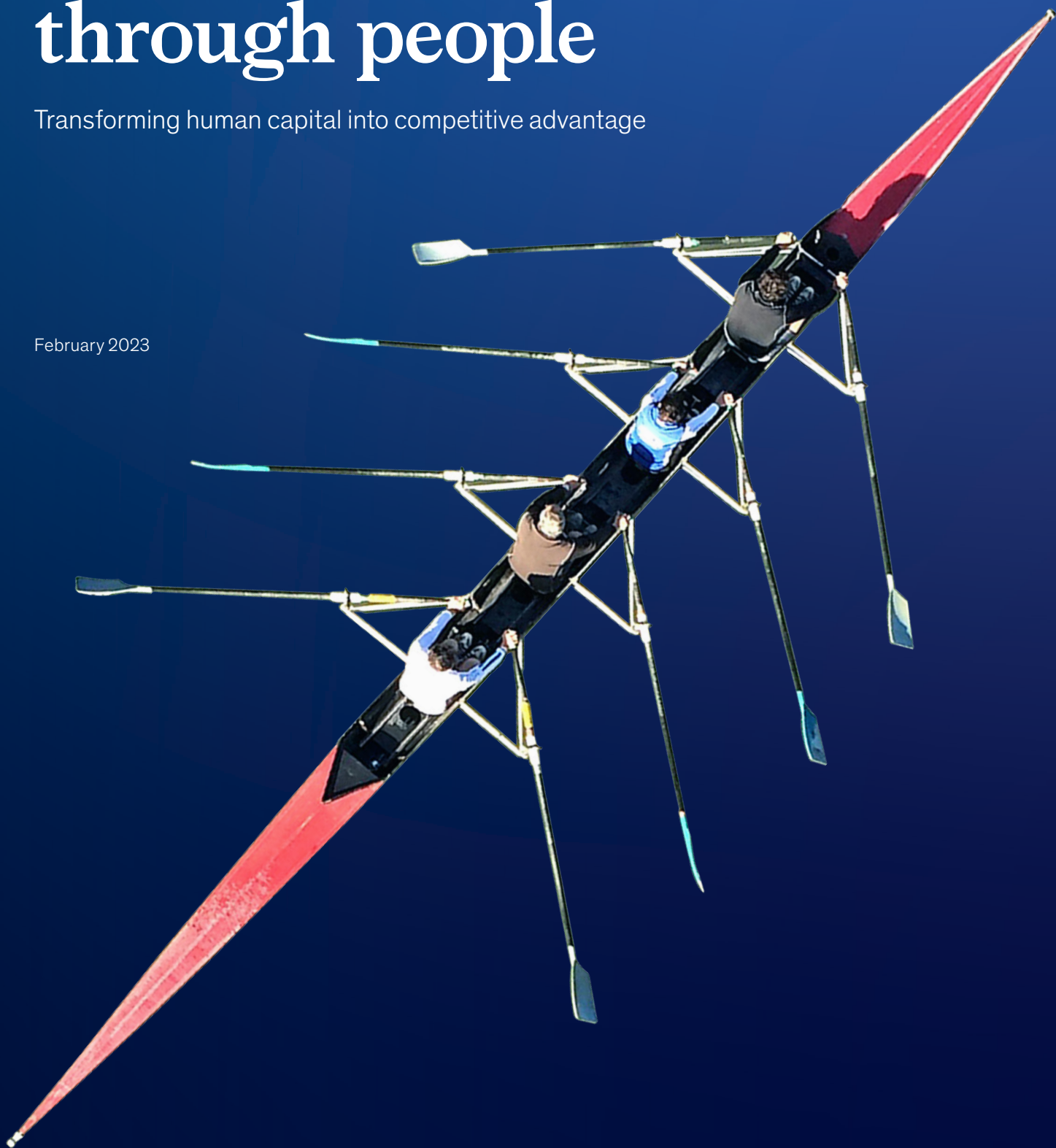


People & Organizational Performance Practice

Performance through people

Transforming human capital into competitive advantage

February 2023



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Contents

In brief	iv
1. The companies that make people development pay off	2
2. How organizational capital activates human capital	14
3. A blueprint for leaders: How to transform organizational capital	24
Acknowledgments	32

Performance through people: Transforming human capital into competitive advantage

How does developing talent affect financial returns for firms? This research finds that companies with a dual focus on developing human capital and managing it well have a performance edge. These People + Performance Winners rank among the most profitable firms within their industries. They further stand out in two important ways: greater earnings resilience and a superior ability to attract and retain talent, key advantages as businesses face economic headwinds and a war for talent. In addition to building skills, these companies have distinctive organizational capital—that is, their management practices, systems, and culture. They challenge and empower employees while fostering bottom-up innovation to make their human capital investments pay off. While focusing solely on financial returns is one path to success, choosing the P+P model of emphasizing people and performance can yield the longer-term benefits of resilience and talent retention.

People + Performance Winners develop talent and deliver top-tier financial returns in tandem. We analyze 1,800 large companies across all sectors in 15 countries, sorting them into four categories based on markers of human capital development and financial performance over the prepandemic decade relative to sector peers. P+P Winners excel on both dimensions. They average high economic profit and returns on invested capital, similar to firms in our second category, Performance-Driven Companies. But P+P Winners put a greater emphasis on talent, with a higher share of internal role moves and more training for employees. Members of our third group, People-Focused Companies, also emphasize talent development but are unable to translate that into strong financials. Typical Performers stand out on neither dimension.

Firms that invest in human capital have greater resilience and more consistent earnings relative to their peers. P+P Winners closely track Performance-Driven Companies on profitability and shareholder returns. Yet they are roughly 1.5 times more likely to remain high performers over time and have about half the earnings volatility. When the pandemic hit, they maintained profitability and grew revenues twice as fast as Performance-Driven Companies. Even beyond the top-quintile financial performers, investing in talent development seems to pay off: People-Focused Companies showed more consistency and resilience than Typical Performers.

Developing human capital helps firms retain talent and deliver a better payoff for their people. P+P Winners are talent magnets, with attrition rates almost five percentage points lower than those of Performance-Driven Companies. Their employees report higher job satisfaction, and they are 1.3 times more likely to move into higher lifetime

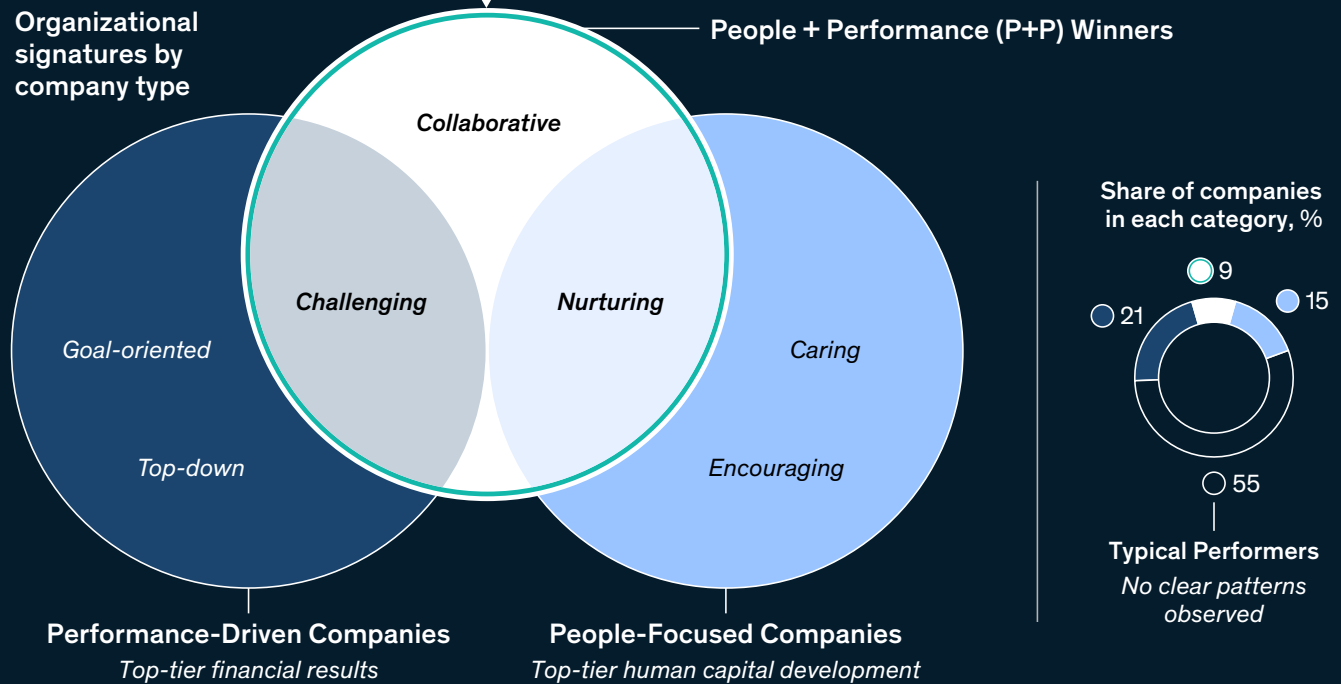
earnings brackets than those of Performance-Driven Companies. People-Focused Companies have similarly high levels of employee satisfaction and even lower attrition than P+P Winners, although not with the same stellar financial performance.

P+P Winners achieve higher returns on human and organizational capital investment. Firms invest in different types of capital to boost revenues: physical capital, human capital, organizational capital, and other varieties of intangible capital (such as intellectual property and brand). P+P Winners achieve roughly 30 percent higher revenue growth than both Performance-Driven and People-Focused Companies for every dollar they invest in human and organizational capital (spending that amounts to one-third of all firms' revenue, on average). By contrast, Performance-Driven Companies generate higher return on R&D and sales and marketing investment (typically one-eighth of all firms' revenue) but may stand to gain by making their human and organizational capital spending more productive.

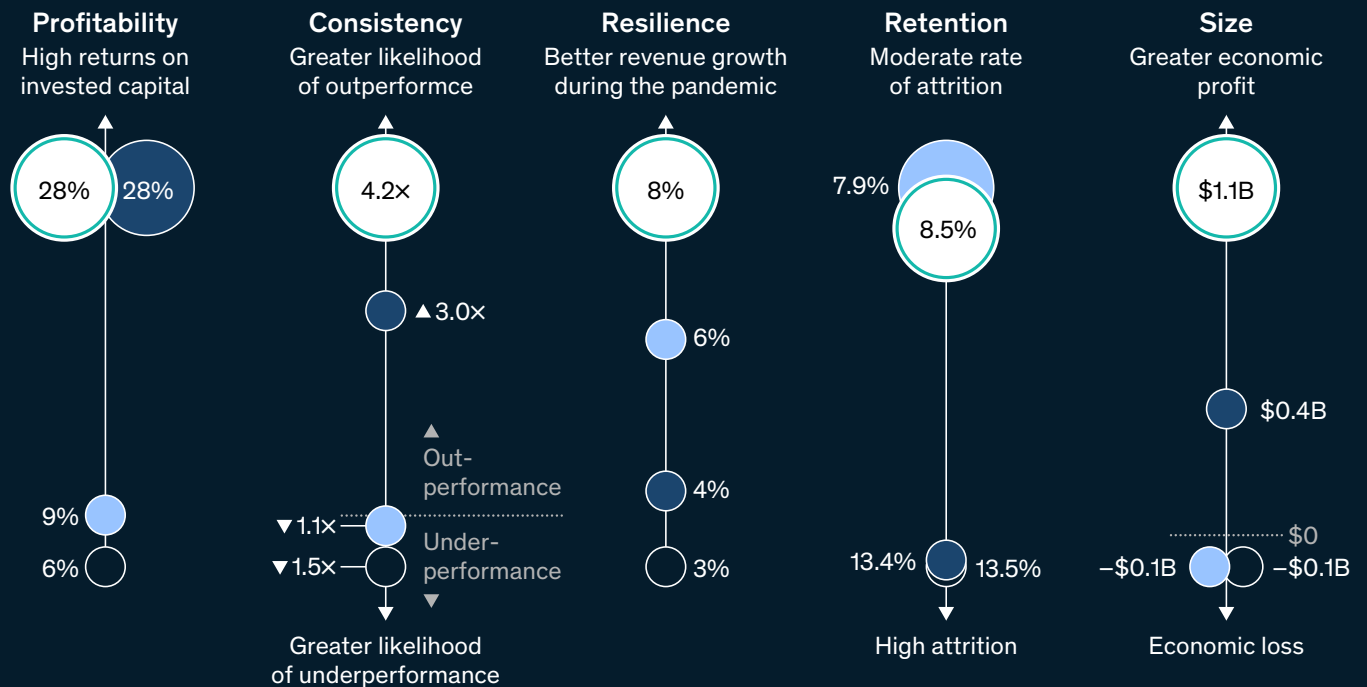
Certain mixes of organizational practices are more effective at activating human capital. Organizational capital is the fabric that surrounds employees, and its pattern matters. We compare the practices of each group using McKinsey's Organizational Health Index diagnostic and other firm-level metrics. P+P Winners achieve higher returns with a signature characterized by consultative and challenging leadership; bottom-up innovation and collaboration; positive, inclusive work environments; and rewards and advancement opportunities for employees. Performance-Driven Companies have similar leadership styles but are more externally oriented to customers and competitors, with less emphasis on company-wide innovation, motivation, work environment, and on-the-job coaching. While People-Focused Companies have many practices in common with P+P Winners (such as motivating employees and creating positive work environments), their leadership is less results-oriented, and they do not emphasize bottom-up innovation.

Leaders can transform their organizational capital to drive sustained outperformance. People are a company's core asset, and the organizing principles governing how they work are crucial to realizing their potential. While some organizations have a singular focus on financial results, supporting talent with effective organizational practices does not come at the expense of performance. Companies that make their systems more people-centric stand to boost their bottom lines over the long term—while delivering for employees as well. At a time of uncertainty and talent scarcity, leaders can choose to capture lasting benefits by ensuring that their organizations truly work for their people.

Companies can gain a competitive edge with a dual focus on people and performance



P+P Winners excel across a range of business outcomes



Other firms can transform to emulate the “P+P Way”

- ✓ Empowering and challenging leadership style
- ✓ Support for entrepreneurship and initiative-taking
- ✓ Widespread ownership and alignment with vision
- ✓ Inclusive work environment
- ✓ Transparent performance expectations and incentives
- ✓ Effective on-the-job coaching and training
- ✓ Companywide innovation and collaboration



1. The companies that make people development pay off

Recent research from the McKinsey Global Institute (MGI) found that employers that excel at building skills, create more options for internal mobility, and have better overall organizational health help their employees maximize the value of their own human capital. These effects persist long after individuals move on. Time spent early in a career in a positive workplace setting that emphasizes learning is the best predictor of whether employees eventually propel themselves into a higher lifetime earnings bracket relative to their starting point.¹

Yet business leaders sometimes naturally ask: while human capital development pays off for workers, does it actually benefit companies? Most agree that developing people is the right thing to do. But they are less clear on how those efforts relate to the bottom line—and why some organizations are so much more effective than others at turning human capital investment into a real competitive advantage.

To explore these questions, we analyzed a large data set of companies from varied countries and sectors. One subset in particular stands out. People + Performance Winners manage to create opportunities for their employees to build skills while consistently clearing a high bar for financial performance.

We find that achieving these dual goals requires effective organizational capital—that is, the management practices, systems, and culture that make a workplace unique. When this organizational fabric works effectively, it creates a productive workplace that becomes a magnet and an incubator for talent. While every company has its own unique form of organizational capital, P+P Winners have a distinctive signature, particularly in their leadership styles and how they empower employees. In subsequent chapters, we will examine the specific organizational practices that set them apart—and how other companies might be able to replicate their “secret sauce.”

Not every company will choose to follow the P+P Winner template. Some are singularly driven by financial results; focusing on people may not be in their DNA. Remaking organizational culture is a difficult undertaking that requires sustained engagement and a willingness to change familiar patterns. But companies that do shift in this direction have a lot to gain. In addition to financial returns, they can improve their consistency, resilience, talent attraction, employee loyalty, and reputation—the hallmarks of companies that are equipped to thrive over the long term.

¹ *Human capital at work: The value of experience*, McKinsey Global Institute, June 2022.

We identify a set of People + Performance Winners that deliver exceptional value to both shareholders and employees

MGI's research on human capital has focused on how talent develops in the workplace. After exploring the benefits of building skills for the individual in our previous report, we now investigate the effects on financial returns for companies—and how organizational capital influences that process. We analyzed roughly 1,800 companies across sectors in 15 countries, benchmarking them along two dimensions: financial results and human capital development for their employees. (See Box 1, “Data sources and methodology,” for details.)

Box 1

Data sources and methodology

We gathered data on financial performance and indicators of human and organizational capital for some 1,800 companies with annual revenue of more than \$100 million. They span 15 countries: Australia, China, France, Germany, India, Japan, South Korea, the United Kingdom, the United States, and multiple countries in Southeast Asia (Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam). These companies represent all sectors, including communication services, consumer discretionary goods, consumer staples, energy, financials, healthcare, industrials, information technology, materials, utilities, and others, as defined by the Global Industry Classification Standard (GICS).

We rely on multiple data sources to measure financial performance, human capital development, and elements of organizational capital across companies. These include metrics from company balance sheets and profit-and-loss statements from 2010 to 2021, drawing on McKinsey's Corporate Performance Analysis Tool powered by Capital IQ; and data from Refinitiv, which looks at more than 600 environmental, social, and governance (ESG) metrics for thousands of global companies spanning 2017 to 2021. In addition, we used results from McKinsey's proprietary Organizational Health Index (OHI), which employs surveys to assess management practices and workplace outcomes. OHI has been used to gauge the state of more than 1,500 companies (based on more than seven million responses). We also draw on the database from our previous human capital research, which includes licensed, de-identified data from millions of online public professional profiles through 2019 in Germany, India, the United Kingdom, and the United States.

We classify companies into four categories based on two dimensions: financial performance and human capital development.

To characterize financial performance, we focus on economic profitability, measured as average economic profit as a share of revenue from 2010 to 2019. We pick out true outperformers by identifying the top

quintile among some 22,500 companies with data on economic profitability, rather than the smaller subset of 1,800 companies for which we also have human capital development indicators.

To evaluate human capital development, we focus on three metrics: internal moves as a share of all moves (measured from 2015 to 2019 for companies based in the United States), average training hours per full-time employee (averaged over 2017 to 2019), and the overall OHI score (latest available since 2016). We regard companies as top performers in human capital development if they are in the top quintile within their sector on at least one of these three metrics. We verified that these three inputs move together; a company in the top quintile in one of the three is likely to be in the top quintile in the other two metrics, and vice versa.

To account for differences between industries, we evaluate each company against peers within its own industry. The threshold benchmark for what constitutes a top-quintile performer in each metric therefore differs across industries. The share of companies in the top quintile on either of these dimensions may add up to more than 20 percent depending on data availability.

To substantiate the robustness of our approach, we tested several different approaches for classifying companies (for example, excluding internal moves as a measure of human capital development), country-level variations, threshold sensitivities (for example, using top-quartile instead of top-quintile companies), and causalities between financial performance and human capital development. Our findings remained valid across all the tests. Finally, we reweighted all findings by industry to avoid potential sectoral bias and also checked for statistical significance.

For more detail on methodology (including sector thresholds), robustness, and statistical checks, see the technical appendix, which can be downloaded as a stand-alone document.

We analyze a decade's worth of financial results, setting a high bar for what constitutes outperformance and using economic profit as a share of revenue as the primary benchmark. Separately, we measure human capital development by considering three metrics: average training hours per full-time employee, internal role moves as a share of all employee moves, and overall organizational health as measured by a proprietary, survey-based McKinsey diagnostic.² We choose these metrics intentionally, since our previous research established their correlation with the likelihood of employees moving into higher earnings brackets over their careers. In other words, companies that emphasize human capital building and create healthy cultures are engines of upward mobility for the individual.

We sort companies into one of four categories, reflecting whether they rank within the top quintile in their sector for financial performance and the human capital metrics described above (Exhibit 1). The four groups are:

- **People + Performance (P+P) Winners.** Just under 10 percent of companies in our data set outperform on both financials and human capital development.
- **Performance-Driven Companies.** Twenty-one percent of all companies post financial results in the top quintile for their sector but fall short on developing people.
- **People-Focused Companies.** Fifteen percent of all companies emphasize human capital development but are unable to translate talent into strong financial performance.
- **Typical Performers.** More than half of the companies in our sample (55 percent) do not stand out on either dimension.

P+P Winners exist in all sectors. They are not just the products of superstar industries such as technology and finance that are more profitable and knowledge-intensive by nature.³ Our categorization looks at the best performers relative to their peers within each sector so that these effects do not obscure the picture.

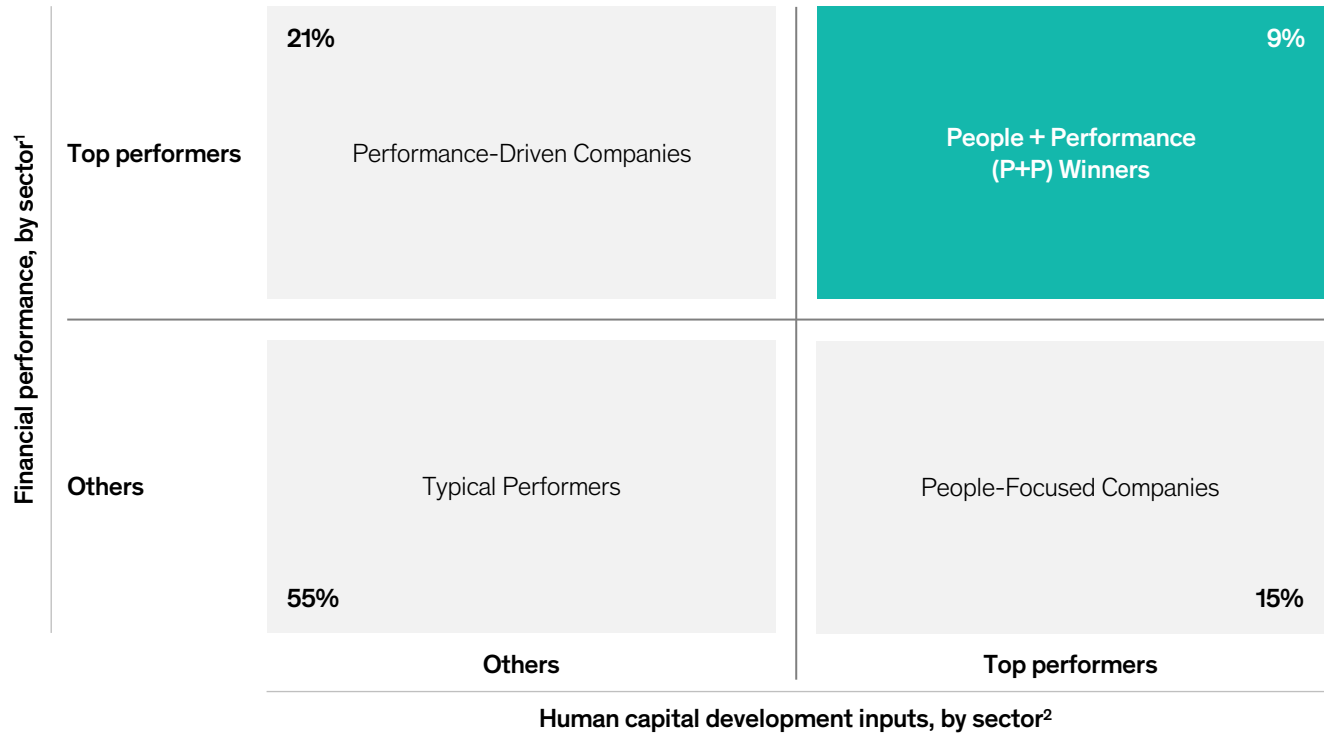
P+P Winners manage to create opportunities for their employees to build skills while consistently clearing a high bar for financial performance.

² The second metric considers people taking on new roles within a company (whether promotions or transfers) as a share of total moves (which also includes people leaving the company, whether voluntarily or involuntarily). For more information about the Organizational Health Index, see "How OHI works," McKinsey.com.

³ *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018. This research defines a "superstar sector" as having a substantially greater share of income than others (measured in this case as gross value added and gross operating surplus accruing to various activities that cut across business establishments), with a gap that has grown over time. Superstar sectors include financial services; professional services; real estate; pharmaceuticals and medical products; and internet, media, and software. Although P+P Winners are present in all sectors, they are more common in healthcare, consumer staples, and technology while less so in capital-intensive sectors such as utilities and energy. In addition, P+P Winners are found in all countries covered in our data set (more commonly in India and the United States; less so in France, the United Kingdom, Japan, and Southeast Asia).

We categorize P+P Winners as companies that outperform on both financial results and human capital development.

Sample size: 1,793 companies across sectors in 15 countries



¹ Measured as economic profit (EP) as a share of revenue averaged over 2010 to 2019. "Top performers" are top-quintile companies among the ~22,500 companies for which this data is available (95 percent have data for all 10 years, and the remaining have data for at least 7 years).

² Measured using three input metrics: annual training hours per employee (averaged over 2017–19); internal moves as a share of all moves (as of 2019 for only US companies); and overall scores from the Organizational Health Index (OHI), which is a proprietary McKinsey diagnostic (latest available data since 2016). "Top performers" are top-quintile companies in any of the three metrics, among ~2,200 companies with at least one of the three data points available.

Note: Companies are benchmarked against peers within their own sector to account for differences between industries when evaluating financial and human capital development metrics. All companies are later combined by category.

Source: Organizational Health Index by McKinsey; Refinitiv; McKinsey's Corporate Performance Analytics; S&P Global; McKinsey's proprietary Organizational Data Platform, which draws on licensed, de-identified public professional profile data; McKinsey Global Institute analysis

Companies that invest in human capital achieve more consistent and resilient financial performance than their peers

Considering financial performance over a decade, we find that investing in human capital provides an edge to all types of companies, although in different ways.

Both P+P Winners and Performance-Driven Companies are top performers on economic profitability by definition. As Exhibit 2 shows, they have similarly strong results in terms of return on invested capital (ROIC). Yet comparing People-Focused Companies and Typical Performers reveals a large gap in economic profitability (negative 5 percent versus negative 14 percent). People-Focused Companies also slightly top Typical Performers in ROIC and revenue growth. Additionally, they have somewhat higher growth in EBITDA (7 percent versus 5 percent) and ten-year total returns to shareholders (8 percent versus 7 percent). Our segmentation shows that investing in human capital clearly pays off for companies regardless of whether they are in the top band of financial performance.

While the top-performing companies in our data set—the P+P Winners and Performance-Driven Companies—have very similar profitability and shareholder returns (13 percent and 15 percent, respectively), a key difference emerges in the quality of their earnings. P+P Winners have an added edge: resilience that tends to smooth out the ups and downs of business cycles and helps these companies withstand disruptive events. This attribute is increasingly valuable in an era of heightened uncertainty.⁴ Focusing on people development alongside financial performance seems to offer some protection from volatility.

P+P Winners were

4.3x

more likely than the average company to maintain top-tier financial performance for 9 out of 10 years

P+P Winners were 4.3 times more likely than the average company to remain in the top quintile of their sectors in ROIC for at least nine out of the ten years from 2010 to 2019. Performance-Driven Companies also topped the average company, but their likelihood of maintaining outperformance for nine out of ten years was smaller, at 2.7 times. This implies that P+P Winners were 1.6 times more likely than Performance-Driven Companies to consistently outperform on ROIC over time (see Exhibit 2). They also exhibited lower earnings volatility across the decade, with a 9 percent standard deviation in ROIC, versus 16 percent for Performance-Driven Companies.

P+P Winners grew revenues

2x

faster than Performance-Driven Companies during the pandemic

When the pandemic struck, P+P Winners were better able to weather the crisis and avoid taking major hits. Only 54 percent of P+P Winners saw a reduction of more than 0.5 percentage point in ROIC from 2019 to 2020, compared to 65 percent of Performance-Driven Companies. In fact, 36 percent of P+P Winners saw an increase of more than 0.5 percentage point (versus 29 percent of Performance-Driven Companies). More P+P Winners found growth opportunities in the crisis years as well. From 2019 to 2021, they grew revenue twice as fast as Performance-Driven Companies (8 percent versus 4 percent). Organizations that had spent years building reserves of loyalty, goodwill, and innovative capacity by investing in people may have had more internal resources to draw on when the chips were down.

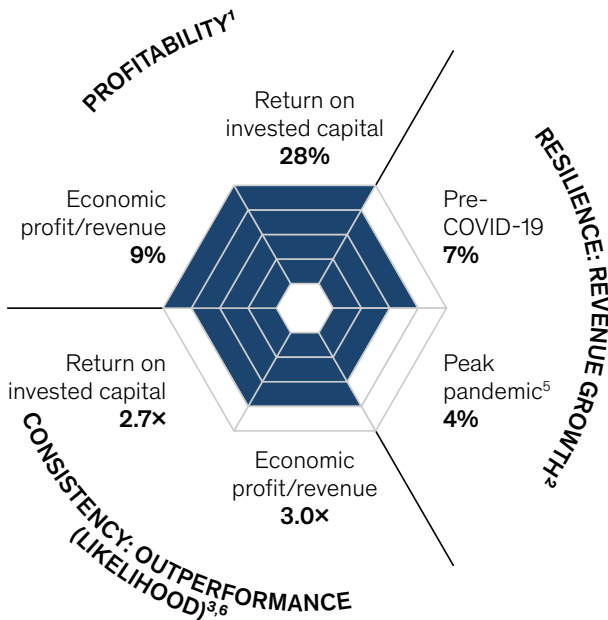
Investing in human capital is associated with consistency and resilience for other companies, too. Focusing on the two segments that are not top performers financially, People-Focused Companies demonstrated greater stability than Typical Performers. Typical Performers were 1.5 times more likely than an average firm in our sample to remain in the bottom quintile of profitability in nine out of ten years, while People-Focused Companies were only 1.1 to 1.3 times as likely. They also demonstrated greater resilience during the pandemic, growing their revenue twice as fast as Typical Performers (6 percent versus 3 percent) from 2019 to 2021.

⁴ *On the cusp of a new era?* McKinsey Global Institute, October 2022.

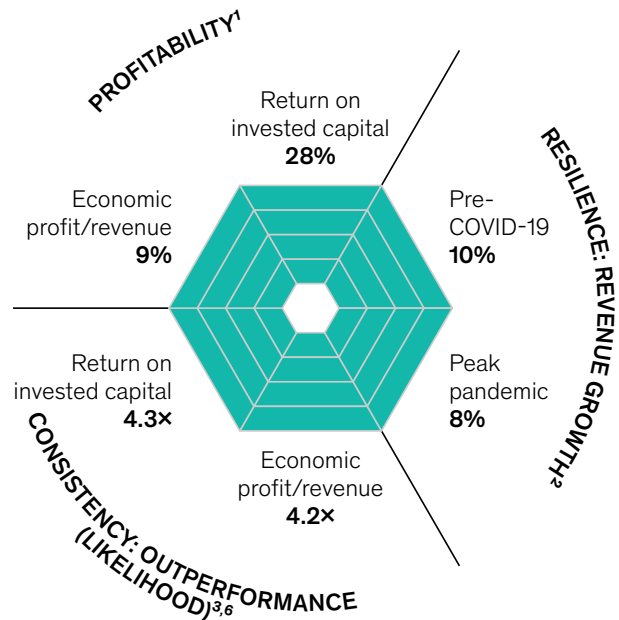
Companies that emphasize human capital development are more consistent and resilient than their sector peers.

Ranking of company categories across six performance metrics Rank: Top  Bottom

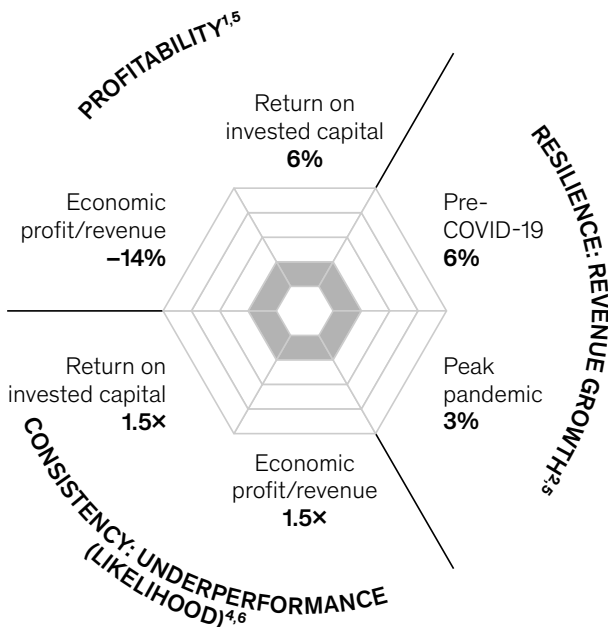
Performance-Driven Companies



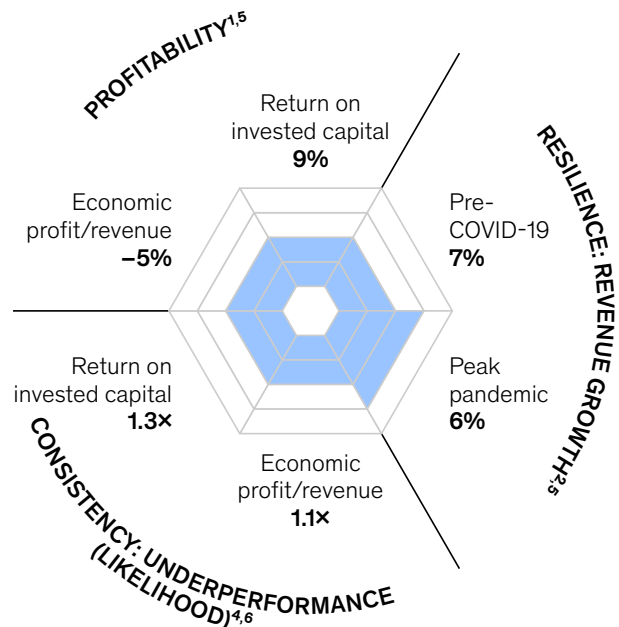
People + Performance Winners



Typical Performers



People-Focused Companies



¹Averaged over 2010–19. ²Compounded annual growth rate; pre-COVID-19 covers 2010–19; peak pandemic covers 2019–21. ³Likelihood of companies in the category having stayed in the top quintile of financial metric for at least 9 out of 10 years between 2010 and 2019, relative to an average company in the sample. ⁴Likelihood of companies in the category having stayed in the bottom quintile of financial metric for at least 9 out of 10 years between 2010 and 2019, relative to an average company in the sample. Rank based on the inverse of the likelihood. ⁵Values represent statistically significant differences with respect to corresponding values of P+P Winners (at confidence interval of 95 percent with p-value <0.05). ⁶Likelihood is significantly different from 1 (at confidence interval of 95 percent with p-value <0.05).
 Note: Numbers are rounded. All values are sectorally reweighted.
 Source: McKinsey’s Corporate Performance Analytics; S&P Global; McKinsey Global Institute analysis

P+P Winners are

3.6x

more likely than the average company to be “superstars”

Along with consistency and resilience, P+P Winners also seem to have a superior ability to build scale. Their average economic profit is \$1.1 billion, well above the \$400 million average for Performance-Driven Companies. Many of them rank among the world’s “superstar” firms. Previous McKinsey research on companies identified about 600 superstars among 6,000 of the world’s largest public and private firms with revenues greater than \$1 billion. In this group, the top 10 percent of firms capture 80 percent of the economic profit. Furthermore, the gap between superstar and median firms has widened over the past two decades. Relying on technological advantage, productivity, and market power, many superstars are giants in their markets, with marginal costs of expansion.⁵ P+P Winners are 3.6 times more likely than an average firm in our sample to be superstars, while Performance-Driven Companies have a smaller likelihood (1.9 times) of ranking among the superstars.

While investing in talent provides a meaningful performance edge, it is not sufficient to propel a company into the top tier. Both P+P Winners and People-Focused Companies emphasize human capital development, but P+P Winners are more effective at translating their investment into profitability. Over the prepandemic decade (2010–19), P+P Winners posted an average economic profit of 9 percent of revenue, while People-Focused Companies averaged negative 5 percent. They also have sharply higher ROIC (28 versus 9 percent), faster revenue growth (10 versus 7 percent), higher total returns to shareholders (13 versus 8 percent), and more robust EBITDA margins (28 versus 14 percent).

Although human capital development metrics indicate that People-Focused Companies are doing the right things when it comes to helping their employees learn and grow, something is lacking when it comes to channeling their efforts toward effective business outcomes. They seem to be missing some crucial elements of organizational capital that would harness their employees’ potential more fully. In addition to development opportunities and a positive workplace environment, employees need effective management to be as productive as possible. (The following chapter will explore the management practices and leadership styles that set P+P Winners apart.)

P+P Winners generate greater payoffs for employees, which helps their talent attraction and retention

Our previous research on human capital found that people were most likely to move into higher lifetime earnings brackets if they spent time early in their careers working for organizations that devoted more time to training, created internal pathways for people to advance, and had healthier and more effective working environments.⁶ We consider companies to be top performers in human capital development overall if they have top-quintile metrics in at least one out of these three areas.⁷ P+P Winners as well as People-Focused Companies stand out here.

By definition, P+P Winners and People-Focused Companies provide more training for their employees than other companies. But the size of the gap is remarkable. P+P Winners provided 74 hours of annual training per employee on average, equivalent to a four-credit semester-long university course; some offer as much as 140 hours annually. Compared to this, Performance-Driven Companies offer just 19 hours per employee on average. Beyond formal training programs, P+P Winners also emphasize informal on-the-job coaching. In McKinsey’s Organizational Health Index surveys, employees from 44 percent of these companies (and from 49 percent of People-Focused Companies) ranked talent development among the top 15 management practices in their workplaces. It is a lower priority for many Performance-Driven Companies; only 33 percent of their employees rank it among the top 15 practices.

74

hours of annual training per employee provided by P+P Winners on average

⁵ *Superstars: The dynamics of firms, sectors, and cities leading the global economy*, McKinsey Global Institute, October 2018.

⁶ *Human capital at work: The value of experience*, McKinsey Global Institute, June 2022.

⁷ Human capital input metrics data available for 1,793 companies, with training hours data available for 808 companies, internal moves data available for 782 companies, and OHI data available for 479 companies, with some overlaps (see the technical appendix for further details).

35%

of employees who work for P+P Winners go on to move into higher earning brackets

Companies that prioritize human capital development help employees grow by making promotions and internal transfers more readily available; those that do not create internal opportunities and pathways often force their employees to leave if they want to find a better fit or boost their earnings. In a June 2021 Gallup survey of 15,000 US workers, 61 percent said that the opportunity to learn new skills is an extremely or very important factor in deciding whether to stay at their current job.⁸

Forty-two percent of total employee moves at P+P Winners involve internal mobility.⁹ By creating opportunities for people to keep learning and reinventing themselves, these companies are better able to build their employees' skills. Our previous research found that people enhance the value of their human capital over a working life by adding skills obtained through varied work experience. Changing roles, whether internally or externally, fuels this process. Similarly, a report by the Burning Glass Institute also found that companies' hiring and mobility practices have a profound impact on the careers of their employees, including the speed with which they earn promotions and their ability to secure better jobs on leaving.¹⁰ P+P Winners are, therefore, engines of upward mobility for the employees who pass through them. Thirty-five percent of their workers go on to move into higher earning quintiles over their lifetimes relative to their starting points—a share that is 1.3 times higher than that of Performance-Driven Companies. Similarly, 33 percent of workers in People-Focused Companies are upwardly mobile, compared to 29 percent for Typical Performers (Exhibit 3).

Work makes up much of a life, so in addition to the training and long-term trajectory an employer provides, the day-to-day experience of a job is a major determinant of employees' happiness, life satisfaction, and even health.¹¹ P+P Winners also deliver on this front. They have a better reputation among employees. Their employees are more likely to describe their work environments as positive, with a net promoter score of 20 percent, similar to People-Focused Companies (19 percent). Both are ahead of Performance-Driven Companies (16 percent) and Typical Performers (14 percent).¹² P+P Winners are also four times more likely than an average firm to feature in Fortune's Best 100 Companies to Work For; Performance-Driven Companies are only 1.7 times more likely than the average firm to make the list.

P+P Winners deliver a better workplace experience, and they are engines of upward mobility for the employees who pass through them.

⁸ *The American upskilling study: Empowering workers for the jobs of tomorrow*, Gallup and Amazon, 2021.

⁹ This refers to internal role changes as a share of total employee moves (a metric that includes internal moves plus hires, quits, and separations).

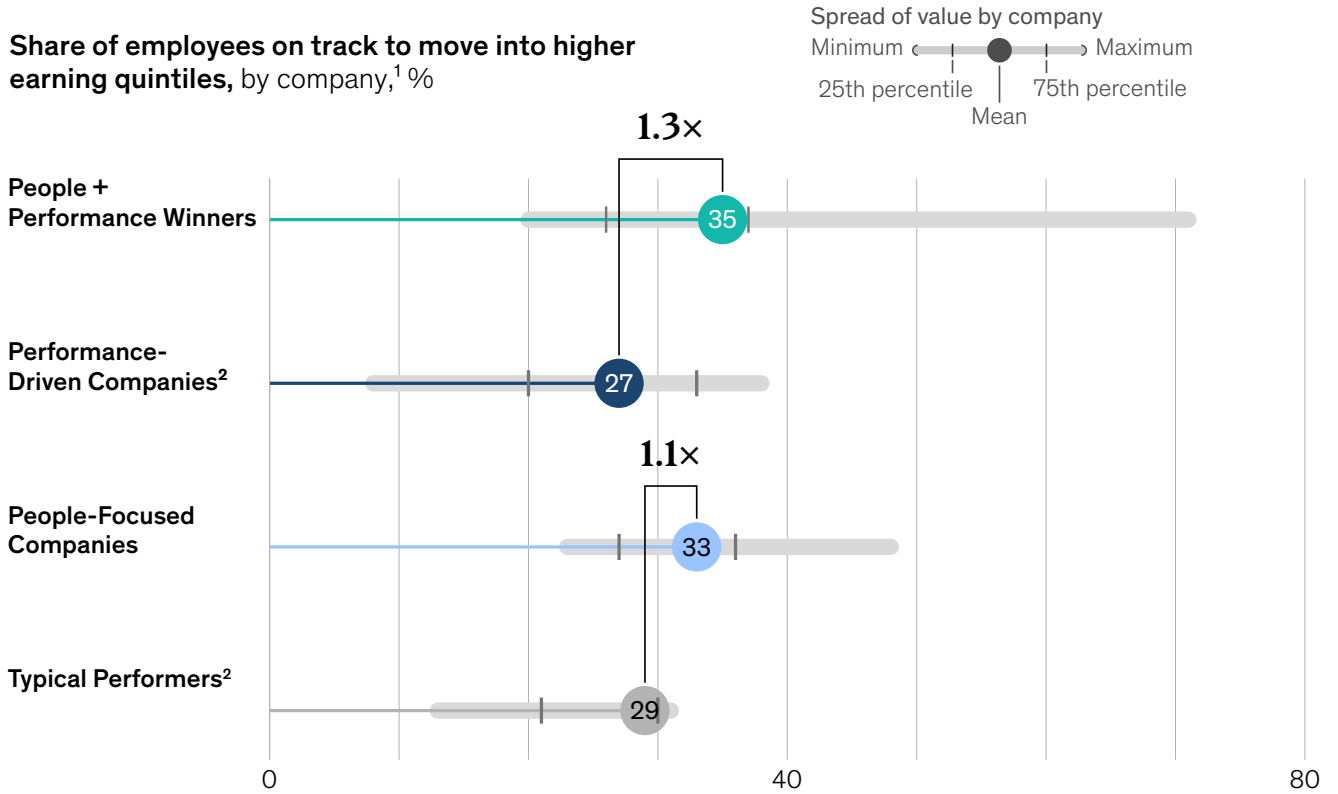
¹⁰ *The American Opportunity Index: A corporate scorecard of worker advancement*, The Burning Glass Institute, Harvard Business School, and Schultz Family Foundation, October 2022.

¹¹ See, for example, Jarrod M. Haar et al., "Outcomes of work-life balance on job satisfaction, life satisfaction and mental health: A study across seven cultures," *Journal of Vocational Behavior*, volume 85, issue 3, December 2014; and Berrin Erdogan et al., "Whistle while you work: A review of the life satisfaction literature," *Journal of Management*, volume 38, issue 4, January 2012. In addition, a recent McKinsey Health Institute analysis of the modifiable drivers of health found that productive activity—including work—is often tied to better health outcomes.

¹² We define a net promoter score as the share of people who express an overall positive sentiment about a company's work environment minus the share of people who express an overall negative sentiment on surveys from McKinsey's proprietary Organizational Data Platform, which draws on licensed data from several sources.

Employees of People + Performance Winners are more likely to be upwardly mobile over their careers.

Share of employees on track to move into higher earning quintiles, by company,¹ %



¹Based on projected lifetime earnings of employees, which are the sum total of the nominal salaries an individual receives over a 30-year working life. This combines estimates based on salaries of roles held by a person during the observed work history plus projections for the remaining years of that person's working life, applying historical rates of wage growth to the final observed role (assumes no further moves).
²Means represent statistically significant difference with respect to corresponding values of P+P Winners (at confidence interval of 95 percent with p-value < 0.05).
 Note: Sample sizes with data on employee earnings outcomes: People + Performance Winners = 31; Performance-Driven Companies = 43; People-Focused Companies = 30; Typical Performers = 84. Averages are sectorally reweighted.
 Source: McKinsey's proprietary Organizational Data Platform, which draws on licensed, de-identified public professional profile data; McKinsey Global Institute analysis

Almost
5 p.p.
 difference in total attrition between P+P Winners and Performance-Driven Companies before the pandemic

For companies, one of the biggest potential benefits from focusing on people is the ability to retain talented employees. P+P Winners had moderate levels of attrition, indicating that these companies strike a balance between generating payoffs for employees and applying consequence management principles (Exhibit 4). By contrast, attrition rates were roughly five percentage points higher at Performance-Driven Companies and Typical Performers from 2017 to 2019. This often has real financial and operational costs (see Box 2, "Attrition: Good, bad, or ugly?").

Not only do employees leave Performance-Driven Companies voluntarily at a greater rate, but these firms also fire more frequently, which seems to indicate that they are doing a less-than-optimal job of hiring candidates who will be a good fit. Even during the Great Attrition sparked by the pandemic, which affected all companies, P+P Winners were better able to retain their people. Their attrition levels rose to 11 percent from 2020 to 2021, but this was still lower than the 15 percent turnover experienced by Performance-Driven Companies. Interestingly, attrition is lowest of all among People-Focused Companies. While this seems positive at first blush, these companies could examine whether they need greater accountability and whether they are challenging employees to grow. They may be people-friendly places to stay but may lack enough flow to inject fresh ideas and energy.

P+P Winners seem to occupy a sweet spot of moderate turnover with healthy returns.



¹ Values represent statistically significant difference with respect to corresponding values of P+P Winners (at confidence interval of 90 percent with p-value < 0.1). Note: Sample size for total attrition: Typical Performers = 121, Performance-Driven Companies = 46, People-Focused Companies = 32, P+P Winners = 25. Sample size for voluntary attrition: Typical Performers = 136, Performance-Driven Companies = 52, People-Focused Companies = 36, P+P Winners = 31. Sample size for involuntary attrition: Typical Performers = 125, Performance-Driven Companies = 47, People-Focused Companies = 34, P+P Winners = 26. All values are sectorally reweighted. Source: Refinitiv; McKinsey's Corporate Performance Analytics; S&P Global; McKinsey Global Institute analysis

Box 2

Attrition: Good, bad, or ugly?

Attrition rates can deliver important signals to companies. But determining what level is optimal—and calculating the true cost of employee turnover—is more nuanced than it may seem on first reading.¹

The costs and risks associated with attrition are highly dependent on the state of the job market. An organization may be willing and able to absorb high levels of turnover

when labor is abundant. But in an environment of labor scarcity, that can suddenly turn problematic, as it did for many companies in the Great Attrition.² Turnover is also problematic for roles that require highly specialized skills or a specific geographic commitment. Corporate leaders may need to adjust their talent attraction and retention strategies based on whether they see structural shortages

¹ B. Latha Lavanya, "A study on employee attrition: Inevitable yet manageable," *International Journal of Business and Management Invention*, volume 6, issue 9, September 2017.

² "Great Attrition" or "Great Attraction"? The choice is yours," *McKinsey Quarterly*, September 2021. See also "The Great Attrition is making hiring harder. Are you searching in the right talent pools?" *McKinsey Quarterly*, July 2022; and "Gone for now, or gone for good? How to play the new talent game and win back workers," *McKinsey Quarterly*, March 2022.

Box 2 (continued)

persisting beyond the Great Attrition, perhaps driven by demographic changes and long-term business strategy and skill requirements.³

Part of finding a level of attrition that is sustainable involves assessing the cost of turnover. However, few studies exist on this topic, and no single rule of thumb applies. The cost of replacing a knowledge worker with specialized skills is far higher than the cost of replacing a frontline fast-food worker, for example. One study of turnover in the retail industry found that a 10 percent rise in turnover would be as costly as a 0.6 percent wage increase for the entire workforce.⁴

Turnover involves hard costs, such as severance; administration; recruiting; covering the vacant position with temporary help or overtime; and onboarding when a replacement is found. Depending on the dynamics of the talent market and the seniority levels involved, companies may be able to fill a role while offering a lower salary—or they may find themselves paying a premium. Beyond those quantifiable effects are hidden costs, including a potential hit to morale and productivity for the team members who remain as well as a lower-productivity learning curve for the replacement hire. Companies should consider the often-hidden opportunity costs of operating short-staffed or letting institutional knowledge depart.⁵

While no company likes to see valued employees go, some turnover is expected and healthy. When people know that it's time for a change of scenery, it can be beneficial for them to move on or retire before they become stale or discontented, even if they have been solid performers. In fact, if someone who has grown with the company lands an offer for a more senior position with another employer, their success is worth celebrating.

When it comes to involuntary attrition, companies that retain poor performers for too long not only accept lower productivity but also risk frustrating their strong performers, who may have to carry extra workload to compensate. Letting underperforming employees go, if handled fairly and compassionately, sends a message to the broader organization about expectations and accountability.

Departures, whether voluntary or involuntary, make room for new hires to bring dynamism and different skill sets to the organization. When no one leaves, there is no room for this kind of infusion to take place.

The variations in attrition rates across the company categories described in this research are striking. Performance-Driven Companies have high rates of both voluntary and involuntary attrition. This is not necessarily detrimental if the jobs that are turning over do not require highly specialized skills and are designed to enable new hires to ramp up quickly. But these companies do need to periodically reassess—and one major motivator for doing so is the fact that attrition seems to be linked to resilience.

While some companies can sustain higher attrition rates in normal times, those that stay loyal to their employees may be rewarded in return during times of crisis. Indeed, more people-oriented companies had better performance during the pandemic. As noted earlier, P+P Winners and People-Focused Companies had relatively low attrition levels of 8.0 to 8.5 percent before the pandemic struck; they went on to achieve 6 to 8 percent revenue growth during its peak. By contrast, Performance-Driven Companies and Typical Performers had relatively high attrition levels of about 13.5 percent before the pandemic, and revenue growth of only 3 to 4 percent from 2019 to 2021.

Examining the underlying causes of attrition can help identify whether it is sustainable or not—and what companies may want to do about it. Working conditions or burnout could drive high attrition. The people management skills of a direct supervisor can be a major factor causing employees to leave a particular office or unit.⁶ In a recent McKinsey Health Institute survey, many respondents linked mental-health struggles to the feeling of always being on call, unfair treatment, unreasonable workload, low autonomy, and lack of social support. Data suggests that improving workplace factors could be several times more predictive of employee well-being than providing access to resources alone.⁷ Alternatively, hiring criteria may be inadequate to the task of identifying candidates who are more likely to succeed over the long term. Companies can benefit from digging into what is driving their attrition numbers.

³ Helen Tupper and Sarah Ellis, "It's time to reimagine employee retention," *Harvard Business Review*, July 2022.

⁴ Peter Kuhn and Lizi Yu, "How costly is turnover? Evidence from retail," *Journal of Labor Economics*, volume 39, number 2, 2021.

⁵ Kevin Mendonsa et al., "Predicting attrition: A driver for creating value, realizing strategy, and refining key HR processes," *SMU Data Science Review*, volume 3, number 2, August 2020.

⁶ Mitchell Hoffman and Steven Tadelis, "People management skill, employee attrition, and manager rewards: An empirical analysis," *Journal of Political Economy*, volume 129, number 1, 2021. See also "Employee burnout: Are you solving the right problem?" McKinsey Health Institute, May 2022.

⁷ "Present company included: Prioritizing mental health and well-being for all," McKinsey Health Institute, October 2022.



2. How organizational capital activates human capital

Human capital is necessary to win, but it's not sufficient. The P+P Winners described in the previous chapter achieve results not only through hiring and developing talented people but also by creating the right conditions to unleash their potential. It takes effective management, systems, and culture to turn a collection of talented individuals into a cohesive team.

Every year, contending baseball teams set out with a single-minded mission: to go after a championship. It's up to the general manager to assemble the right human capital—in this case, players. His scouting department is continually on the lookout for raw young talent as well as underutilized players who can be acquired from other teams. He also decides when to offer big free-agent contracts to established superstars. The sum total of these efforts should be a roster with complementary skills and a balanced mix of seasoned veterans and hungry rookies.

While an enormous payroll is a clear advantage, it is notoriously difficult to simply buy a championship. Some free-spending teams crash and burn—and once in a while, low-budget teams defy expectations and create alchemy by combining the right people and approach.

Successful major-league teams sustain pipelines of talent over the longer term with minor-league affiliates and training camps geared to help players develop their skills. At the big-league level, the manager runs day-to-day operations and sets the tone. He juggles lineups to deploy the right mix of players against specific opponents on a given day. He maintains team norms, morale, and discipline over a grueling season. Everyone must buy into the organization's approach to preparation, playing time, the use of analytics, and game strategy. Individual players get pointers to improve their form in daily batting and fielding practice sessions. The clubhouse and home ballpark provide an energizing environment where every detail supports performance.

So it goes with companies. Like sports teams, some click on all cylinders and run like well-oiled machines, while others sputter and fail to live up to their potential. Part of the difference comes down to the talent and drive of the individuals involved. But another critical differentiator is organizational capital—that is, the processes, accumulated knowledge, norms, and layers of leadership that define the way people work. Every workplace is unique because every employer has its own organizational capital.

Organizational capital is hard to measure and easy to take for granted. Yet it is crucial for realizing the value of investment in human capital since it choreographs individual efforts. This chapter looks at what goes into organizational capital—and how P+P Winners take a distinctive approach to it.

An underappreciated asset for companies, organizational capital comprises the systems that make people productive

Companies have multiple types of capital at their disposal to help achieve their business goals. An organization's human capital is the cumulative knowledge, skills, attributes, experience, and health of its workforce. Workers in turn create value by interacting with their employer's other forms of capital, both tangible and intangible.

Physical capital is perhaps the most straightforward and easily quantified. Employees may work in a factory, for example, or use specialized machinery. Beyond this type of tangible asset, companies also have intangible capital.¹³ Broadly, this category includes innovation assets and intellectual property; digital and analytics assets (such as software, databases, and customer-facing digital platforms); and brands. It also includes organizational capital, or the practices and systems that define "the way a company works." Organizational capital is perhaps the most elusive—and human—of all intangible assets, since it relates to how people work, their relationships with and within the workplace, and their development.¹⁴

Each company has its own culture and mix of management practices; this organizational capital belongs to the company and stays with it. Yet, as previous MGI research showed, workers gain valuable knowledge and experience from interacting with it, and they carry these new capabilities wherever they go for the remainder of their career. The value of their human capital increases, and they are frequently able to command higher wages in the next role.

From the worker's perspective, organizational capital determines both the quality of their immediate day-to-day experience and their potential for longer-term development and earnings, among other things. Work is at the center of people's lives and well-being. The pandemic highlighted the importance of "good work"—that is, the access to good-quality, safe, and secure work—and the value of human skills.¹⁵ From the company's perspective, organizational capital is one of the crucial mechanisms for realizing the value of investment in human capital.¹⁶ It choreographs individual efforts and coordinates and channels it into productive activity and financial outcomes (Exhibit 5).

Many components go into organizational capital. It encompasses everything from training programs and talent-management and capability-building systems to workflows, department and team structures, business processes, employee communications, norms, culture, and leadership.

These systems constitute the interpersonal fabric of a company, determining whether it is thriving and productive or whether it wastes resources.¹⁷ Organizational capital is the invisible infrastructure of the workplace; it is the glue that makes the whole entity greater than the sum of its parts. Although it does not explicitly show up on corporate balance sheets, it is key to maximizing returns on human capital and on the physical, financial, and other intangible assets a company holds.¹⁸ In short, people need operating principles in order to be productive.

¹³ *Getting tangible about intangibles*, McKinsey Global Institute, June 2021.

¹⁴ The term "organization capital" was used by Edward Prescott and Michael Visscher in a 1980 article that emphasized the information that resides with a firm and its ability to match people with effective teams. See Prescott and Visscher, "Organization capital," *Journal of Political Economy*, volume 88, number 3, 1980.

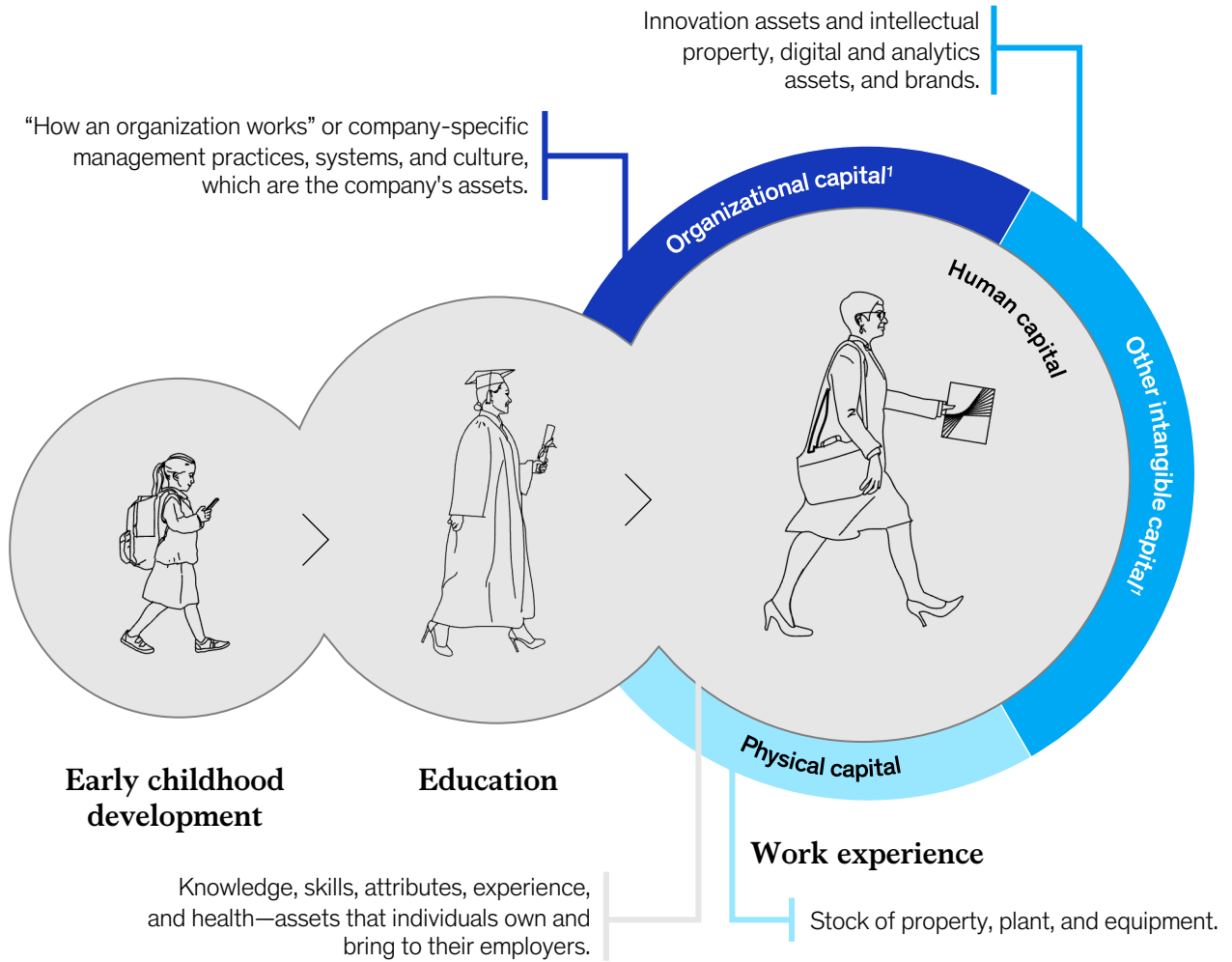
¹⁵ *The good work monitor*, Institute for the Future of Work, January 2021.

¹⁶ John F. Tomer, *Organizational capital: The path to higher productivity and well-being*, Praeger, 1987.

¹⁷ Oliver Ludewig and Dieter Sadowski, "Measuring organizational capital," *Schmalenbach Business Review*, volume 61, October 2009.

¹⁸ Baruch Lev and Suresh Radhakrishnan, "The valuation of organizational capital," in *Measuring capital in the new economy*, Carol Corrado, John Haltiwanger, and Daniel Sichel, eds., University of Chicago Press, 2005.

Organizational capital is one of the key activators of human capital in the workplace.



¹Part of intangible capital.
Source: McKinsey Global Institute analysis

Organizational capital manifests itself in every corner of a company. Most large organizations pour considerable effort into crafting and reinforcing mission statements. They may have formal onboarding programs for new employees and periodic training courses for existing employees. Many undertake initiatives to make their workforce more motivated and cohesive. They establish performance standards, performance management processes, and internal career pathways. Technologies and communication platforms that help employees share information and do their jobs more efficiently are part of the equation. So are design choices in physical offices, which can promote collaboration or concentration. Crucially, organizational capital includes the art of matching the right people to the right tasks and providing them with guidance and structure—which means that frontline and middle managers play a crucial role in executing the overarching vision on a day-to-day basis.

Organizational capital can be measured through widely varying approaches. By our estimates, organizational capital, measured as the capitalized value of expenditure on building a company's systems and processes, is roughly equal to the value of physical capital in the sample of companies we studied (See Box 3, "Measuring organizational capital").

Measuring organizational capital

Attempts to measure organizational capital have followed three main approaches. The first focuses on the cost of creating organizational capital. Some studies have used the overhead costs of establishing systems and processes that enable people to work together as the measure of organizational capital. These costs are estimated using proxies from the company's profit-and-loss statement, typically the selling, general, and administrative (SG&A) expenditure.¹ SG&A expenses include components that go into building organizational systems and talent development. Spending on training, onboarding, recruiting, and building digital and other tools that enable employees to collaborate are included, as are location and infrastructure expenditure.

The second approach attempts to identify the different components of organizational capital using nonmonetary and survey-based approaches. Studies have gathered information from companies about their managerial practices.² In this chapter, we apply this approach by using McKinsey's Organizational Health Index (OHI) diagnostic and other firm-level measures to identify the distinctive organizational signatures associated with each of our four company categories.

Another measurement approach attempts to capitalize the value of investment in building systems and putting in place management practices—that is, to capitalize SG&A expenses.³ This approach assumes that the effect of this

expenditure is not short-lived but instead has an enduring impact. Its value depreciates over time but at a slower pace than physical and other intangible capital, as organizational practices are more ingrained, firm-specific, and harder to imitate.⁴ The rate of depreciation depends upon the attrition of employees from the company as well as the obsolescence of skills possessed by employees over time. Studies have typically assumed a 10 to 15 percent depreciation rate over time, implying a useful life of seven to ten years.⁵

In this research, we create a rough approximation of organizational capital by capitalizing SG&A expenditure, excluding compensation as well as sales and marketing expenditure (where included). For companies in our sample, we find that organizational capital is estimated at 70 percent of revenue. For comparison, physical capital (measured as plant, property, and equipment assets from corporate balance sheets) is about 60 percent of revenue. These estimates vary by sector. In the energy, materials, and utilities sectors, for example, physical capital is 140 percent of revenue, while organizational capital is about 50 percent. In the healthcare sector, organizational capital is estimated at 75 percent of revenue, while physical capital is approximated at 32 percent of revenue. For any company, however, organizational capital accounts for a significant outflow of expenditure, making it vital to think about how to utilize it meaningfully.

¹ Baruch Lev and Suresh Radhakrishnan, "The valuation of organizational capital," in *Measuring capital in the new economy*, Carol Corrado, John Haltiwanger, and Daniel Sichel, eds., University of Chicago Press, 2005.

² Sandra E. Black and Lisa M. Lynch, "How to compete: The impact of workplace practices and information technology on productivity," *Review of Economics and Statistics*, volume 83, issue 3, 2001; and Nicholas Bloom and John Van Reenen, "Measuring and explaining management practices across firms and countries," *Quarterly Journal of Economics*, volume 122, issue 4, 2007.

³ Supriyo De and Dilip Dutta, "Impact of intangible capital on productivity and growth: Lessons from the Indian information technology software industry," *Economic Record*, volume 83, number 51, 2007.

⁴ Claudia Tronconi and Giuseppe Vittucci Marzetti, "Organizational capital and firm performance: Empirical evidence for European firms," *Economics Letters*, volume 112, number 2, 2011.

⁵ *Ibid.*; and Andrea Eisfeldt and Dimitris Papanikolaou, "Organizational capital and the cross-section of expected returns," *Journal of Finance*, volume 68, issue 4, 2013.

P+P Winners generate superior returns on their human and organizational capital investments

Applying one of the approaches described in Box 3, we estimated investment in organizational capital by using SG&A overhead expenditure as a proxy. We also estimated investment in human capital as the compensation paid out to employees.

We find that P+P Winners not only invest in human and organizational capital but also do a better job of translating those investments into top-line impact to benefit the company. Since companies in the sample spend an average of 33 percent of revenue on compensation and organizational overhead combined, it is vital to make these substantial investments as productive as possible.

P+P Winners generate roughly 30 percent higher revenue growth for every dollar invested in compensation and organizational overhead than Performance-Driven Companies (not controlling for other drivers of revenue growth). In other words, P+P Winners follow a strategy in which they channel their talent effectively, with systems, management practices, culture, and leadership that enable them to execute successfully against business priorities.

By contrast, Performance-Driven Companies, which roughly match the financial returns of P+P Winners, derive their advantage from other types of capital (Exhibit 6).¹⁹ They generate similar revenue growth for every additional dollar of physical capital and double the revenue growth for every dollar of other intangible capital (estimated as R&D and sales and marketing expenditures, which amount to 12.5 percent of revenue). At a time when the cost of top talent is rising, Performance-Driven Companies may stand to gain by making their investments in compensation and organizational overhead more productive. This is a clear avenue remaining open for them to achieve even higher financial performance.

¹⁹ In addition, we used a regression approach to quantify the sensitivity of revenue growth to the different investment drivers discussed above. We then identified "high-efficacy" companies with disproportionately high revenue growth compared to growth in human and organizational capital investment, controlling for all other drivers (see the technical appendix for more details). We found that 24 percent of P+P Winners were high-efficacy companies, compared to 17 percent of Performance-Driven Companies.

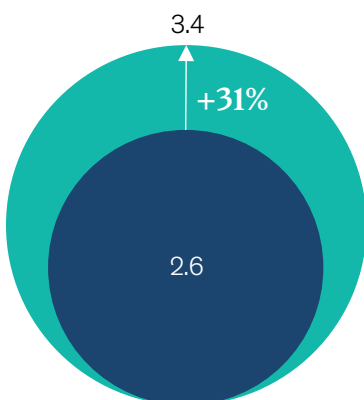
Exhibit 6

P+P Winners and Performance-Driven Companies focus on generating higher returns from different forms of capital.

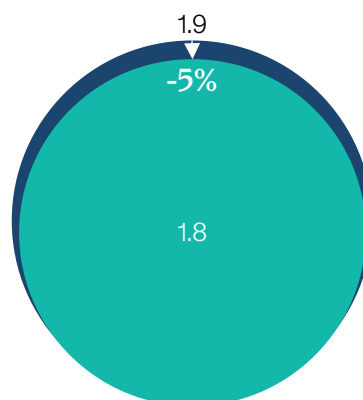
Revenue growth per \$ increase in ...

■ P+P Winners ■ Performance-Driven Companies²

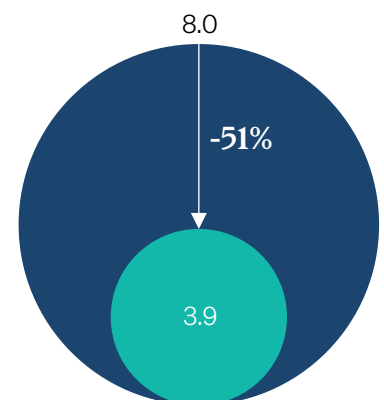
... human capital (compensation) and organizational overhead,¹ \$



... physical capital (PPE), \$



... other intangible capital (R&D and sales and marketing), \$



¹ Organizational overhead is estimated as selling, general, and administrative (SG&A) expenditure, excluding compensation, sales and marketing expenditure, R&D expenditure where included.

² Values represent statistically significant differences with respect to corresponding values of P+P Winners (at confidence interval of 95 percent, with p-value < 0.05). Note: Sample size for revenue growth per dollar increase in organizational expenditure and human capital: Performance-Driven Companies = 220 ; P+P Winners = 109. Sample size for revenue growth per dollar increase in physical capital: Performance-Driven Companies = 341 ; P+P Winners = 163. Sample size for revenue growth per dollar increase in other intangible capital: Performance-Driven Companies = 260 ; P+P Winners = 131. All values are sectorally reweighted. Source: McKinsey's Corporate Performance Analytics; S&P Global; McKinsey Global Institute analysis

Organizational capital is unique to each employer— and its effectiveness varies widely

A distinctive set of organizational practices can be a source of competitive advantage that boosts financial performance.²⁰ However, developing and executing it requires investment and energy. Neglected or poorly designed organizational capital can hinder productivity, waste resources, and harm a company's reputation. Toxic workplaces tolerate unnecessary stress within the system and drive people away; well-run workplaces tend to attract talented people and give them space to innovate. Organizational capital determines the employee experience, which also makes it important to job satisfaction, life satisfaction, and individual well-being.²¹

Employers can take highly divergent approaches in pursuit of productivity, with positive or negative implications for the employee experience. In the baseball example described at the beginning of this chapter, different organizational practices could be equally successful. One team may thrive because its manager is highly disciplined, while another may succeed because its manager keeps the clubhouse loose. Similarly, one company may insist on rigid hours; another may offer flexibility as long as goals are met. Some employers set tough quotas or install surveillance software to monitor every keystroke; others operate on a culture of trust. Sometimes even good intentions to create a collegial workplace can have ambiguous results. A startup that brings in a ping-pong table and beer tap may fail unless its performance management practices are as good as its perks. A company that opts for an open office plan to spur collaboration may find that employees cannot perform with the noise and distractions.

Each employer chooses its own combination of management practices and injects its own philosophy and personality into individual elements. Execution also matters. One study found that higher productivity does not stem from adopting a particular practice but from how that practice is implemented.²² To give just one example, teams in one company may waste time in meetings, while those in another stick to agendas and use meetings to make clear decisions.

In addition to business processes, institutional knowledge is an important element of organizational capital.²³ This includes knowing how things have been done in the past as well as the ongoing integration of new knowledge. Organizations that excel at accumulating, integrating, and sharing knowledge efficiently build a strong basis for innovation.²⁴ They also tend to provide employees with the kind of learning environments that in turn build human capital. Working in this type of setting is especially beneficial for individuals near the beginning of their careers, since they add knowledge and capabilities that they carry with them as they move to other organizations.²⁵

Developing and executing a distinctive set of organizational practices takes investment and energy.

²⁰ "Organizational health: A fast track to performance improvement," *McKinsey Quarterly*, September 2017. See also Mariagrazia Squicciarini and Marie Le Mouel, *Defining and measuring investment in organizational capital: Using US microdata to develop a task-based approach*, OECD Science, Technology and Industry working papers number 2012/05, September 2012.

²¹ *This time it's personal: Shaping the "new possible" through employee experience*, McKinsey & Company, September 2021.

²² Sandra E. Black and Lisa M. Lynch, "How to compete: The impact of workplace practices and information technology on productivity," *The Review of Economics and Statistics*, volume 83, issue 3, August 2001.

²³ Andrew Atkeson and Patrick J. Kehoe, "Modeling and measuring organization capital," *Journal of Political Economy*, volume 113, number 5, October 2005.

²⁴ Antonio Carmona-Lavado, Gloria Cuevas-Rodriguez, and Carmen Cabello-Medina, "Social and organizational capital: Building the context for innovation," *Industrial Marketing Management*, volume 39, issue 4, May 2010.

²⁵ Victoria Gregory, *Firms as learning environments: Implications for earnings dynamics and job search*, Federal Reserve Bank of St. Louis, January 2021.

P+P Winners share a distinctive organizational capital signature

McKinsey's Organizational Health Index (OHI) diagnostic has been applied to thousands of companies over the years. It is a survey-based tool that aggregates the views of employees and managers on a set of nine key organizational outcomes and 37 management practices.²⁶

While it is often used to take the temperature of organizations and diagnose problems, OHI data, when consolidated across companies, also offers a rare look at their inner workings. It should be noted, however, that the resulting picture shows where companies have spikes. It does not mean that companies completely reject or neglect the practices that do not show up in the set of top priorities; rather, it shows what they emphasize.

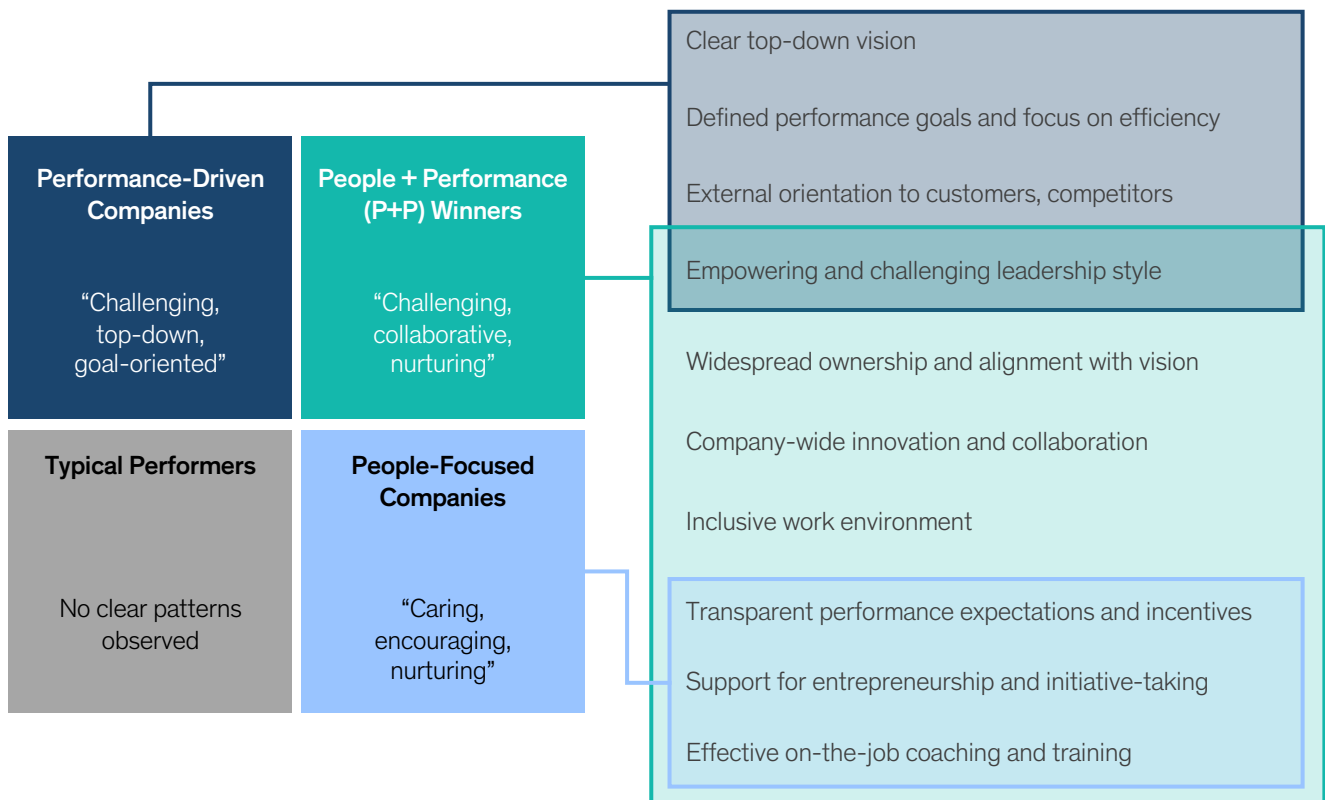
When we overlay OHI data onto our company categorizations, clear differences emerge (Exhibit 7). The mix of individual practices chosen by each type of company adds up to a distinct organizational fabric. While Performance-Driven Companies are challenging, goal-oriented environments that focus on optimizing resources, People-Focused Companies are more caring, encouraging, and nurturing. P+P Winners tend to balance these two aspects, emerging as both challenging and nurturing. They are also more collaborative than firms in the other categories. In addition to hiring and developing talented individuals, they build the kind of organizational capital that enables them to succeed. This dual focus creates its own virtuous cycle, since this kind of energizing environment becomes attractive to people in the future.

²⁶ How OHI works, McKinsey & Company, mckinsey.com/solutions/orgsolutions/overview/organizational-health-index/how-ohi-works.

Exhibit 7

P+P Winners possess a distinctive organizational signature.

Organizational elements prioritized by each category of company, based on Organizational Health Index surveys and other metrics



Source: Organizational Health Index by McKinsey; Refinitiv; McKinsey's proprietary Organizational Data Platform, which draws on licensed, de-identified public professional profile data; McKinsey Global Institute analysis

Looking in more detail at the overall set of 37 management practices examined in OHI surveys, we see that the leaders of P+P Winners give employees autonomy to make their own decisions and challenge them to achieve more. These companies motivate through financial and nonfinancial incentives and career opportunities. They also have cultures of innovation and collaboration as well as entrepreneurial, challenging, inclusive work environments. (See the technical appendix for more detail on specific practices.)

Survey respondents from P+P Winners often pointed to employee involvement in setting company direction and to consultative leadership, which gives employees some autonomy and weighs their opinions on important decisions. They also reported having room for creativity and entrepreneurship, with managers encouraging employees to experiment and protecting them from day-to-day pressures to allow them do so. Finally, P+P Winners emphasize knowledge sharing and bottom-up innovation, with clear processes and systems for employees to contribute ideas and work together. Notably, this type of employee empowerment is paired with challenging leadership and transparent performance standards and consequences. P+P Winners motivate employees who perform well with rewards and advancement opportunities. This combination seems to strike a balance between giving employees autonomy and providing structure, expectations, and guardrails to channel their efforts effectively in support of business goals.²⁷ P+P Winners are well run, and they spend wisely on human capital—in a way that yields returns for the company and for its people as well.

In addition, P+P Winners are standard setters when it comes to inclusivity (Exhibit 8). They have the lowest gender pay gaps—in contrast to Performance-Driven Companies, which have the profitability to rectify these disparities but instead have the largest pay gaps. P+P Winners are also more likely to host employee affinity groups, with the aim of supporting diverse talent and making their workplaces more inclusive; companies at any level of profitability should be able to do this. Perhaps most striking, P+P Winners are far more likely than companies in other categories to provide childcare support, which is a powerful mechanism for attracting and retaining working parents. Because this can be a costly benefit, the most profitable companies are best positioned to offer it—but Performance-Driven Companies are least likely to do so.

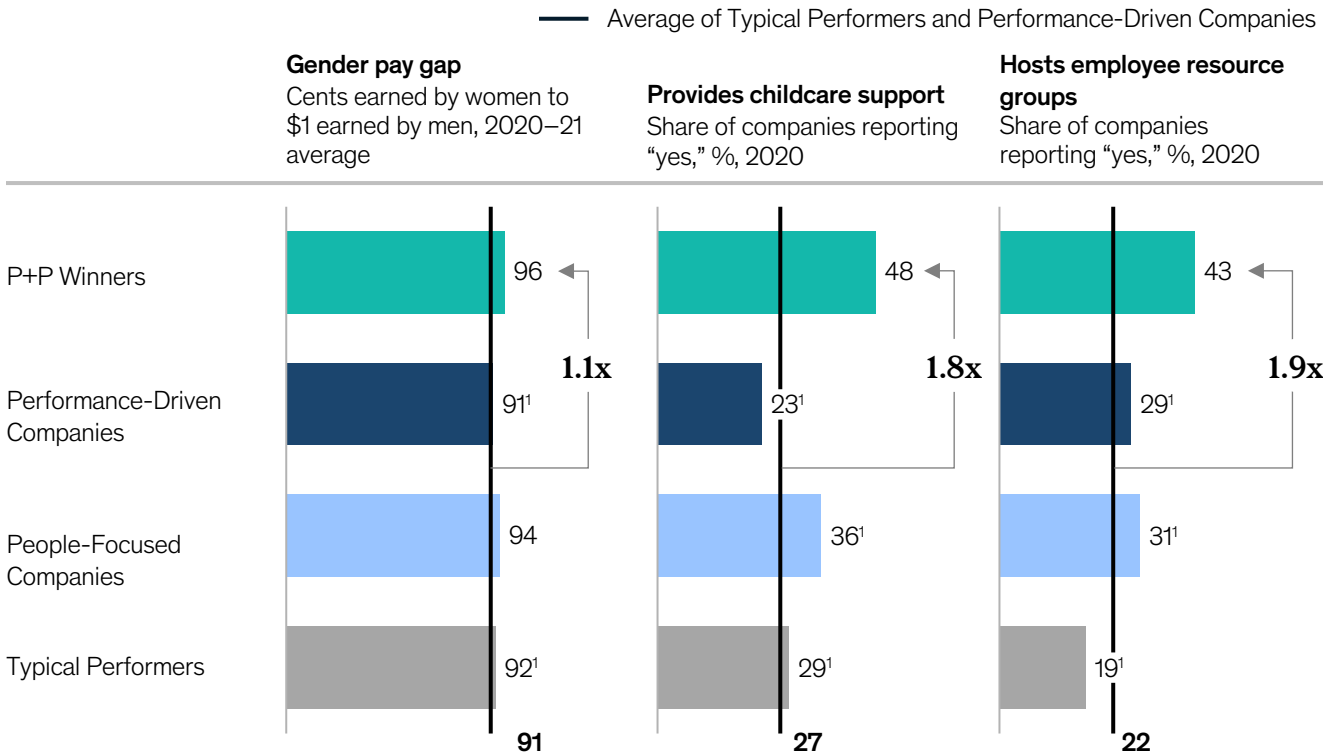
P+P Winners have some areas of overlap with the other categories of companies—and some key areas where they depart from the rest. Their challenging and consultative leadership style, interestingly, is shared by Performance-Driven Companies, which seems to indicate that it is crucial for top-tier financial results.

But Performance-Driven Companies diverge from P+P Winners in a number of crucial ways. They do create a unified vision throughout the organization, but the vision and decisions tend to flow from the top down. Motivating employees, creating a positive work environment, and encouraging new ideas tend to take a back seat to rigorous management of employee output and an external focus on customers, competitors, and the marketplace (see Exhibit 7).

The combined emphasis on performance contracts (written performance goals that clearly define what employees are expected to deliver), outsourcing expertise, and professional standards speaks to a somewhat transactional relationship with workers. This approach is based on a view of the company as an optimal allocator and manager of inputs that maximize output—and it is a valid one that obviously yields results, since Performance-Driven Companies are in the top quintile of financial performance. But this choice may come under pressure as industries, technologies, and labor market dynamics change, requiring more organic responses from within organizations.

²⁷ This lines up closely with the execution edge “recipe” (or mix of management practices) identified in previous McKinsey research based on Organizational Health Index results. See “The hidden value of organizational health—and how to capture it,” *McKinsey Quarterly*, April 2014.

P+P Winners focus on inclusivity.



¹ Values represent statistically significant differences with respect to corresponding values of P+P Winners (at confidence interval of 95 percent with p-value < 0.05). Note: Sample size for gender pay gap: P+P Winners = 42, Performance-Driven Companies = 71, People-Focused Companies = 28, Typical Performers = 96. Sample size for childcare support and employee resource groups: P+P Winners = 146, Performance-Driven Companies = 322, People-Focused Companies = 197, Typical Performers = 759. All values are sectorally reweighted. Source: Refinitiv; McKinsey Global Institute analysis

Performance-Driven Companies are more externally focused on customers and markets than P+P Winners. While “customer focus” does not appear as a priority practice for P+P Winners, it does not mean that they are not geared to addressing customer needs. However, they are more likely to use internal innovation to anticipate what customers need and create solutions for them, while Performance-Driven Companies focus externally on gathering customer feedback and addressing opportunities detected through market intelligence. This difference could possibly explain why Performance-Driven Companies are better at riding the upside of business cycles. Yet their lack of focus on enabling internal innovation and change means that they may be more exposed to volatility on the downside.

People-Focused Companies emphasize many of the same “feel-good” practices as P+P Winners. The areas of overlap include employee involvement, creating a positive work environment, and motivating employees through performance incentives and growth opportunities. People-Focused Companies also emphasize talent development through on-the-job coaching even more than P+P Winners. They have an added focus on risk management (encouraging employees to escalate issues at the right level), personal ownership (creating a sense of belonging), and inspirational leaders (who find ways to make work more meaningful for their employees and provide praise and recognition).

But P+P Winners go beyond nurturing their employees in their more challenging leadership style that pushes people out of their comfort zones and encourages them to experiment. People-Focused Companies appear to be less results-oriented. These companies are also missing an innovation engine, unlike P+P Winners, with their focus on enabling knowledge sharing and collaboration throughout their organizations.



3. A blueprint for leaders: How to transform organizational capital

Because it is not measured, organizational capital is not always actively managed. It is easy for firms to become complacent and stick to “the way we have always done things.” But letting this source of competitive advantage stagnate can be a real risk to performance. This is especially true at a time when disruptive technologies and demographic shifts are upending business dynamics, and labor markets are recalibrating after the profound shock of the pandemic. Even thriving companies need to establish new kinds of connective tissue, norms, and expectations for remote and hybrid work.

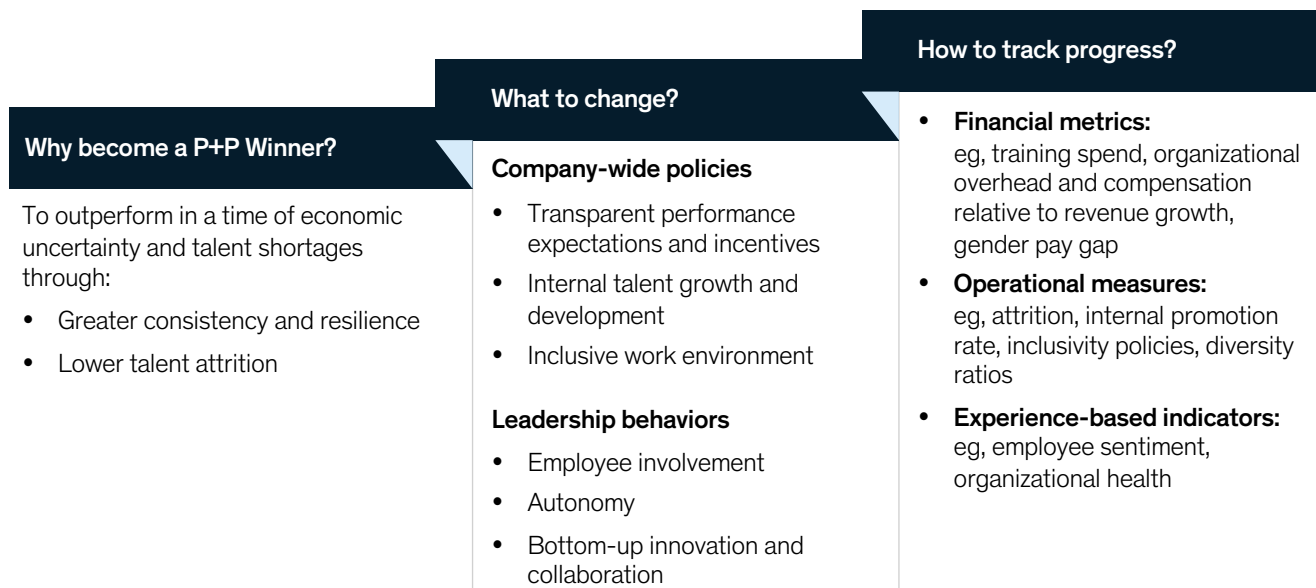
Guiding principles, working norms, frontline managers, and support systems have to be in place so that talent can execute. If these elements are ineffective, resources go to waste, resulting in lost potential. Management practices should add up to a recognizable corporate fabric that engages employees at all levels. Unsurprisingly, this has never been easy for companies spanning multiple units and geographies, and remote and hybrid work is now exacerbating the challenge. But it is possible for companies to implement more effective management practices—and unleash more of the potential within their people in the process. This chapter offers a brief overview of the key questions—the why, what, and how—involved in taking on this challenge (Exhibit 9).

Corporate leaders need a deeper focus on the nuances of organizational capital. Human capital is not merely a labor input; people are any company’s core asset. The workplace should work for people, with coaching to help them develop, structures for support, and workflows that remove frustrations. Employees know what works on the front lines, and their voices and viewpoints should inform any redesign.²⁸ Beyond improving the employee experience, these principles can enhance competitiveness and adaptability in a fast-moving world.

Companies can implement more effective management practices—and unleash more of the potential within their people in the process.

²⁸ Josh Bersin, *Irresistible: The seven secrets of the world’s most enduring, employee-focused organizations*, Ideapress Publishing, 2022.

Blueprint: How can you transform your organizational capital?



Source: McKinsey Global Institute analysis

Other types of companies can make real gains by emulating P+P Winners

Should all companies aspire to be P+P Winners? The answer is an unambiguous yes for the Typical Performers and People-Focused Companies in our data set (and it is worth noting that the majority of firms we analyzed fit into the Typical category). Both of these groups have ample scope to improve; their financial performance lags well behind that of the other two groups. People-Focused Companies in particular need to address the leadership, cultural, and strategy issues holding them back from converting their investment in human capital into productivity and innovation. The halo effect of investing in people development is not enough on its own to produce top results without the right organizational capital in place. Typical Performers have even further to go in developing employees to prepare them to execute.

Aspiring to be a P+P Winner has not historically been a clear-cut imperative for Performance-Driven Companies, however. While investing more resources into developing people is positive for employees and society, these companies are already top-tier financial performers. Their innate characteristics may also make it more challenging to implement a more people-centric model. Performance-Driven Companies may drive results through a more standards-based, top-down model, with an external focus on customers and market opportunities (as opposed to the bottom-up innovation and employee empowerment that P+P Winners enable).

P+P Winners and Performance-Driven Companies look very similar in average financial performance over a long cycle historically. Yet this is an incomplete picture. Performance-Driven Companies experience more bumps and pain getting to the same destination. In a scenario where market trends are in their favor, these companies seem to be able to capture the upside well, but in periods of uncertainty, they lack the stability of P+P Winners. Not prioritizing human capital development seems to increase the exposure of Performance-Driven Companies to volatility and risk in turbulent times. This susceptibility is especially aggravated when there is a shortage of talent.

In the past, a more transactional relationship with employees may have been shaped by a belief that it is easy to access the labor market. Performance-Driven Companies have historically filled and refilled certain types of jobs externally, and they are willing to outsource certain types of specialized functions. It may require a massive, difficult cultural change to focus more deeply on developing and nurturing people if that approach is not baked into their DNA.

But now, in the wake of the pandemic, building resilience is the need of the hour. Companies everywhere have struggled with attrition and hiring; in some cases, vacancies have hampered operations and customer service. This may be a moment for leaders of Performance-Driven Companies to reassess their organizational fabric. Even with inflation and the possibility of a slowdown clouding the picture, some tightness in the labor market may be structural rather than cyclical. In light of higher worker expectations and ongoing labor shortages, companies may need to prioritize employee retention and cultivate the skills they need—particularly if they are going to need more digital, interpersonal, and critical thinking skills to achieve business objectives in the future. Even high-performing companies can benefit from periodically examining whether their organizational practices give employees the balance of support and challenge that will empower them to work more productively. P+P Winners show that it is possible to support employees' aspirations without undercutting performance.

Other companies can change specific systems and behaviors to move toward the P+P Winner style of organizational capital

As described earlier in this research, P+P Winners are characterized by reward-based performance management, bottom-up innovation and collaboration, consultative and challenging leadership, and a creative, competitive, and inclusive work environment that tends to attract and retain talent even in challenging times. But how can other types of companies emulate this in practice?

In some cases, positive change in these areas could be spurred by changes to company-wide policies and systems. In others, it will take behavior change from leaders. While C-suite executives can articulate the vision and set the example, frontline and middle managers are key actors since they set the tone for individual teams, have greater visibility into what's working, and can be the biggest influence on the employee experience.

Company-wide systems and policies

Transparent performance expectations and incentives. Companies can benefit from periodically reassessing how expectations are outlined for employees and how their performance is evaluated. In companies where these areas are muddy, a solid first step could be better articulating the key performance indicators associated with various roles. For some types of sales or manufacturing jobs, for instance, targets can be carefully calibrated with financial goals and perhaps formalized in performance contracts. However, it is also important to consider whether a performance evaluation system is geared to all of the roles in the company or whether it forces an ill-fitting process onto staff in creative or support roles. Different types of jobs may need entirely different evaluation metrics.

Taking performance management from good to great, however, requires something more than establishing top-down targets and leaving employees to hit them on their own, with fear of failure as the prime motivator. P+P Winners clarify both expectations and incentives and take a more dynamic approach to achieving them. Ongoing coaching and continuous feedback are key to helping employees resolve challenges and adapt the way they work as needed. The best results come from managers staying engaged and giving feedback in the moment, always with an eye toward goals—and encouraging employees to achieve more than they thought possible.

While companies have to be able to address underperformance, they also need mechanisms for recognition. To promote healthy competition across teams or geographies, financial incentives could be powerful motivators; it may be worth reassessing whether bonus structures could be more effective or whether they should be expanded. In addition to financial rewards, a multitude of gestures can make people feel appreciated. Some involve public recognition, such as calling out a job well done in group meetings or internal newsletters or handing out company awards. Others can be more personal, such as a direct thank-you email or a one-on-one lunch. One leading global technology corporation introduced peer bonuses and outstanding management awards while rolling out a review process with specific, transparent metrics for performance. Another software company abolished annual performance reviews and ranking employees on a bell curve in favor of a continuous performance evaluation system with regular check-ins for employees and managers to discuss professional aspirations.

Internal talent growth and development. Companies that do not emphasize human capital development often hire people into the openings they have at any given moment—and once people are slotted into those roles, there is not often a clear way for them to stretch beyond them. When these companies need a different type of expertise or skill set, their impulse is to go outside to find it, whether through new hires or outsourcing. In a sense, they think of human capital as an asset that flows in and out of the company. But they are leaving some latent potential untapped by not recognizing that the value of each individual's human capital can be enhanced over time. Many people who are already within the company have the capabilities to do more and to master different things.

Developing people is not always easy, and it may not come naturally to companies that have not historically emphasized training and growth. But creating room for trusted employees who already know the company's practices to grow and add new skills can have an immense upside. Approaches can involve sending people to external classes or establishing formal training programs. One global consumer company offers its employees vocational courses, with some receiving more than 10,000 applicants annually. It is equally important to ensure that people stepping into new roles have engaged on-the-job coaching.

Each role within the organization should have clear—and clearly communicated—paths toward future roles, defined by the skills required to be qualified. Employees should be able to identify their next opportunities early in their tenure and co-create development plans with their leaders.²⁹ One way to do this in a large organization is to create an internal talent platform where employees can access learning modules, establish new proficiencies, and find their next internal role. Some top companies have mentorship programs for employees in different career stages, and some host talks and connectivity events to provide career development and networking opportunities.

Mobility is about experience, not only promotions. Lateral moves can also enable people to recharge, expand their skills, or find a position that is a better fit. Yet most organizations undervalue lateral movement or make it difficult. Rotational programs are often geared to recent graduates who are management trainees, but companies can design internal mobility options for a broader pool of employees. Stints in different departments or geographies can keep midcareer workers learning and feeling energized.

An inclusive work environment. It is well established that diverse teams produce better business results, in part by bringing in a broader range of ideas and helping organizations break out of groupthink.³⁰ For many companies that are lagging on measures of diversity, improvement starts with a more expansive approach to hiring, casting a wider net in recruitment and giving greater consideration to candidates who may not fit the mold of the past. As it becomes the norm for large companies to report on diversity metrics and pay gaps, the imperative to make hiring reflect the broader community is becoming more urgent.

²⁹ "A call to action: Provide employees with room to grow," McKinsey Organization Blog, February 14, 2022.

³⁰ See, for example, *Diversity wins: How inclusion matters*, McKinsey & Company, May 2020; Paul Gompers and Silpa Kovvali, "The other diversity dividend," *Harvard Business Review*, July–August 2018; and *Women matter: Gender diversity, a corporate performance driver*, McKinsey & Company, 2007.

But hiring is only a preliminary step. Many companies now have diversity targets for hiring in their general workforces and their leadership ranks. What sets the P+P Winners apart is not just their commitment to diversity but also their commitment to making their workplaces more inclusive. It is not enough to bring more diverse hires on board; it is important to deliver a positive workplace experience and put measures in place to retain and advance diverse talent over time. Affinity groups, for example, can help people connect with a supportive community. Offering targeted mentorship, ensuring that project teams are diverse, being thoughtful about workplace accommodations for disabilities, and recognizing a wider set of holidays are other ways to make the workplace inclusive. Companies can also reduce pay gaps across different groups of employees. A global tech firm began publishing regular gender pay gap reports measuring current status of the pay gap, historic progress, future targets, and initiatives for reaching these goals.

If retention is an issue for a certain demographic, the underlying causes should be explored and addressed. To ensure that women are not derailed as they move from the early to the middle stages of their careers, for example, companies can offer generous paid parental leave and childcare benefits. Some P+P Winners go even further, with daycare facilities on site and dependent-care assistance programs. During the pandemic, a global consumer company offered a range of virtual childcare services for all age groups of children, summer and skill camps, coaches for new parents, and one-on-one child minders.

Shifts in leadership behavior

P+P Winners focus on developing outstanding leaders. Bosses and supervisors play an outsized role in determining employees' job satisfaction, which in turn affects their well-being.³¹ Sadly, three-quarters of respondents in one recent survey said that the most stressful aspect of their job was their immediate boss.³² Frontline and mid-level managers are a particularly important level—and people often need training to step into these roles. One way to ensure effective leadership and stop a leader's bad tendencies from harming morale or effectiveness is creating a system of 360-degree feedback.

Employee involvement. Leadership matters for driving results. All leadership styles are not created equal, however. A top-down style can be effective, but employees should not feel that major directives are dropped on them from above, with a disconnect between the vision and the realities they face on the ground. P+P Winners ensure that employees feel involved in bringing the specifics of a company's vision to life—an approach that can give them more of a sense of ownership, increasing the likelihood of creating loyalty and value.

This does not necessarily imply an overreliance on crowdsourcing or the total absence of top-down decision making. But it is a more engaged style of leadership that makes room for employees to have a voice. The most effective leaders listen as much as they talk, recognizing that good ideas (and the next generation of leadership) often come from those on the front lines. They consciously follow an approach that enables employees to speak up, not only to involve them in establishing the companies' vision and offer ideas but also to state frankly when things are not working.

Autonomy. Operational discipline is important, and companies where it is lacking may be able to harvest low-hanging fruit by tightening up processes and accountability. But there is a balance to be struck. Focusing solely on how employees can become more efficient at what they did yesterday may close off avenues for growth and improvement. Some companies that have taken lean principles to extremes have found themselves less able to respond when market conditions change.

P+P Winners insist on efficiency, but they allow some room for trying new things. They take a more expansive approach, aiming to empower a workforce that is trained to think and capable of adapting.

³¹ "The boss factor: Making the world a better place through workplace relationship," *McKinsey Quarterly*, September 2020.

³² Mary Abbajay, "What to do when you have a bad boss," *Harvard Business Review*, September 2018.

Leaders in P+P Winners give team members the autonomy to make and execute decisions without excess bureaucracy or micromanaging. A consumer electronics giant, for example, undertook a massive transformation of its organizational structure, adopting a flat structure with only three management layers that gave its employees more leeway in decision making. Its focus on team targets and accountability, with tight and fast feedback loops through digital systems, enabled speedy execution, with product iterations often released in less than a week.

Bottom-up innovation and collaboration. Innovation is one of the key differentiators that sets P+P Winners apart. They promote a culture of “intrapreneurship” that makes it possible for people to collaborate and share expertise and ideas across functions. This is not a simple matter of putting out a suggestion box. Beyond creating forums for new ideas, leaders allocate resources to pilots and full-fledged execution. A dedicated innovation unit, for example, with a rotating group of cross-functional experts and an agile, test-and-learn launch model, could bring new products to test markets and commercialization. All of this should happen within the broader context of the company’s identity and vision for the future.

How can companies embark on a transformation and manage the process?

Changing entrenched systems and long-established ways of doing things is never easy. One way to think about approaching this task is to follow a five-step road map: aspire, assess, architect, act, and advance. Research has shown that the odds of managing change effectively are greatly increased if an organization starts by setting an aspiration—in this case, articulating how much more employees could achieve and how much more the organization could deliver to them in return.³³

With a larger vision in mind, companies then need to clarify their true starting points by diagnosing the current state of the organization’s health. This assessment can happen through surveys, interviews, and focus groups. Asking employees about issues that may have gone unquestioned for years, such as the mix of benefits or meeting and communication norms, could reveal areas that are ripe for change. Even if it’s painful, it is important to dig deeper on areas of employee discontent and to focus intently on whether frontline managers are actually equipped to lead and coach people.

With hard data and unvarnished opinions in hand, companies can then create a blueprint to build greater employee empowerment, a culture of innovation, and a more engaging workplace. It should feature sequenced milestones, with real thought about how to set up and drive priority initiatives, keeping in mind that traditional hierarchies may not be the best drivers of change. It’s important to be prepared for a long-term, continuous process, however. Cultures can be stubborn things, and they may improve in incremental and nonlinear ways. Consistency matters, and certain business units or geographies may need deeper changes than others.

Transformation is never easy—but it is possible. Many companies have taken on the challenge of reshaping their organizational cultures and have ultimately made themselves more resilient and consistent over time (see Box 4, “Organizational transformation in action”).

Meaningful organizational change is not about one-and-done pronouncements. It requires energy and commitment over the long term.

³³ Scott Keller and Bill Schaninger, *Beyond Performance 2.0: A proven approach to leading large-scale change*, John Wiley, 2019.

Organizational transformation in action

Our data set contains examples of companies that invested in strengthening their organizational fabric and went on to improve their resilience and consistency—and, in some cases, achieve better overall financial performance.

A large consumer goods company, for example, cleared away barriers to innovation by setting up formal, recurring, and adaptable processes. It moved away from departments working in silos to cross-functional teams, speeding the best ideas through to prototyping and launch. An unusually high rate of internal promotions and transfers gives employees the mobility they need to grow and advance. Similarly, a multinational electronics maker set out to make its slow-moving leadership style more entrepreneurial. Leaders were given both live and simulated projects with the specific goal of designing new approaches and enabling collaboration and innovation within teams. The company also emphasizes ongoing training so that employees are always learning. Both of these companies became more consistent after these efforts, remaining in the top two quintiles of economic profitability and ROIC in the consumer sector over the latter years of the 2010s (after not being in the top two quintiles in many of the previous seven to eight years). They also withstood the COVID-19 pandemic better than the global financial crisis, with higher revenue growth and increases in ROIC rather than drops.

A few companies in our sample saw significant increases in economic profitability and ROIC after their organizational transformations. A computer hardware manufacturer established a “fail fast” culture, empowering employees to challenge the status quo and be more creative. Similarly, a multinational automotive manufacturer began to encourage constructive criticism and challenge employees to solve problems with fresh ideas rather than compromises by committee. Both of

these companies showed continued and significant growth in economic profitability and ROIC over the last 12 to 15 years after implementing these cultural shifts.

New practices and cultural changes need to be continually reinforced over time. If leaders approach a transformation as a series of one-off interventions rather than new habits that have to be sustained, they can flounder. One vehicle manufacturer rolled out a clear and specific vision, consulting employees at every level. This laid the groundwork for an engaged and empowered workforce—and it did yield results for several years. But as the initial commitment faded, the company’s financial performance fell off over the last few years of the prepandemic decade.

Companies that stay the course over the long term and take a continuous improvement approach to their organizational practices performed consistently over longer periods of time—in some cases, more than two decades. One large pharmaceutical firm that viewed cultural change as an ongoing journey set up formal processes to frame issues candidly, enlisted employees to help create the company’s vision and culture, and challenged its leaders to model change rather than mandating it. The firm also offers almost three times more training hours than the average company. Similarly, a multinational technology giant discarded a ranking system for employee rewards. It began to encourage greater experimentation and create a work environment built on empathy while ensuring that employees have access to internal mobility opportunities.

In all of these cases, it is impossible to draw a straight causal line from new organizational practices to financial performance. Many external market and macroeconomic forces were also in play during the periods we examined. But the correlations are intriguing—and increasingly so as employers place greater value on attracting and retaining talent.

It may be tempting to throw multiple initiatives against the wall to see what sticks, but there is value in taking a more disciplined approach to organizational capital. Companies can give it the same rigorous, sustained attention as other balance sheet assets by measuring and monitoring hard financial, operational, and experience-based metrics (Exhibit 10). On the financial side, they can measure organizational overhead, spending efficacy, and gender pay gaps, for example. Training spend per employee can serve as a proxy for investment in human capital. Operationally, companies can monitor voluntary and involuntary attrition, diversity, rates of internal promotion, and PTO utilization rates. Training programs can be measured by looking at completion rates and post-course assessments. Additionally, periodically surveying employees can help management take the pulse of the workforce and monitor organizational health; predictive analytics can link indicators to potential future impact.

Companies can use financial, operational, and experience-based metrics to assess their organizational capital.

Illustrative

Publicly declared | Partly available/can be estimated from public sources | Not publicly declared



Financial metrics

- R&D expenditure
- Revenue per employee
- Training spend per employee, by program (eg, functional training, leadership training)
- Gender pay gap by level and business unit
- Financial rewards as percentage of salary
- Investment efficacy: compensation per employee, revenue growth per \$ increase in capital investment (spending on organizational systems and processes¹ and compensation)
- Human capital value added ((revenue – expenses + pay and benefits)/full-time employees)
- Human capital ROI ((revenue – expenses + pay and benefits)/pay and benefits)
- Organizational capital: capitalized value of expenditure on organizational systems and processes¹



Operational metrics

- Internal mobility rate (internal moves as % of total employees or total moves), share of internal promotions, share of lateral moves in total internal moves, share of positions filled internally
- Voluntary and involuntary turnover rate
- Share of diverse employees, retention and promotion rates of diverse employees, share of employees involved in affinity groups
- Number of patents (or patent applications)/year
- Training hours and spend per employee
- Learning engagement (course enrollment and completion rates, assessment scores)



Experience-based metrics

- Employee satisfaction with:
 - culture
 - work-life balance
 - compensation and benefits
 - job security and advancement
 - diversity levels and inclusion policies
 - CEO and management approval
- Training experience satisfaction
- Innovation quotient/culture

¹ A proxy of selling, general, and administrative (SG&A) expenditure, excluding compensation, sales and marketing expense, and R&D expense, where included, could be used.

Source: Jac Fitz-enz, The ROI of human capital, 2009; CIPD, Human capital metrics and analytics, 2017; McKinsey Global Institute analysis

Great organizations shape the lives of the people who work for them and lead the market by example. P+P Winners design their organizational systems in a manner that not only enhances productivity in the present but also establishes fundamental elements that enable future success. Companies may be inclined to stick with the way they have always done things, believing that consistency is key to riding the tide. However, the world is changing, employee expectations are shifting, and companies need to adapt. As the adage goes, “Culture isn’t just one aspect of the game. It is the game.”

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