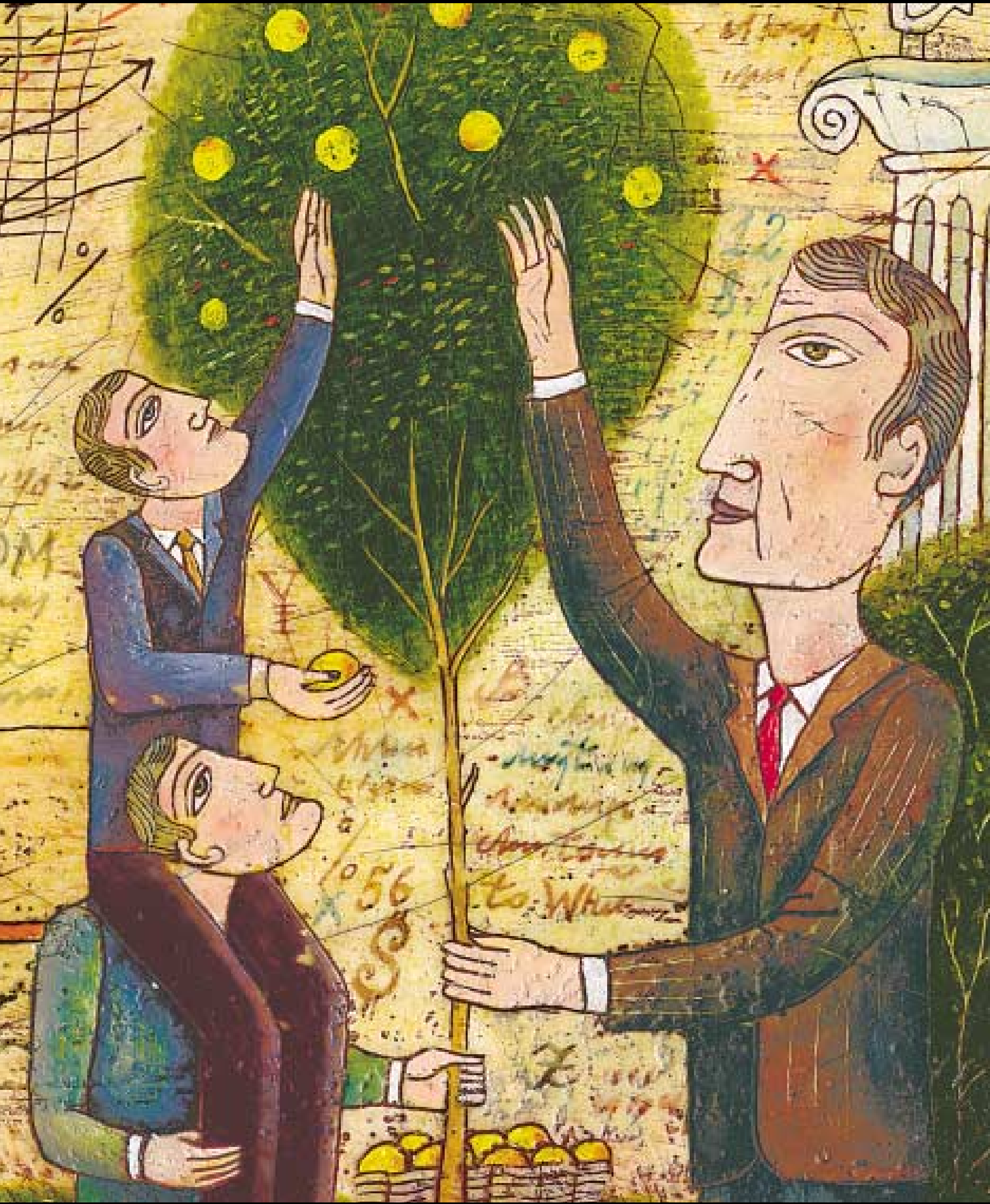
THE McKinsey Quarterly

Strategy = structure



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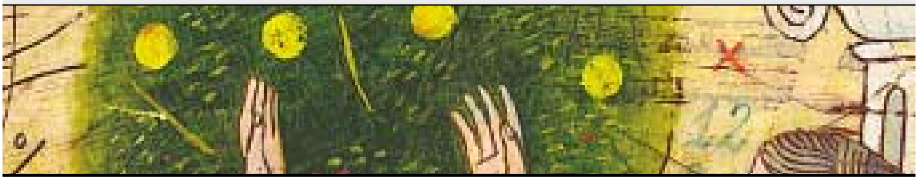

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Introduction

Big companies used to follow a simple rule of organizational design: "structure follows strategy." With this approach, executives would first set their strategy and then define the organizational model that best supported it. These days, however, big companies rarely have the luxury of following stable, long-lived strategies—and those companies' organizational structures must now be as supple and adaptable as the strategies they reflect.

As Sir John Browne, of British Petroleum, puts it, "Our strategy *is* our organization." In this model, organizational design, the quality of interactions within teams, and the distribution of energy in a company may be far more important determinants of success than the soundness of a given strategy.

The new belief in the importance of organization is closely linked to changing attitudes toward markets. As "The alchemy of LBOs," one of the articles in this Reader, reminds us, substantial value can be unlocked when businesses are taken out of large companies and given market-oriented performance incentives.

But a balance is necessary. Our second piece, "The innovative organization," argues that winning companies incorporate features of both large and small ones: they give entrepreneurial activities plenty of space as well as access to the parent companies' resources and knowledge.

Yet another piece of the puzzle is sustaining change and innovation without losing performance discipline. "Teamwork at the top" offers practical advice on how managers can work together most effectively—a considerable challenge as the scope of business changes.

Managers will always need great strategies. But strategic thought increasingly shares pride of place with organizational design and with the quality of leadership at every level of the corporation.

The **alchemy** of LBOs

Paul A. Butler

How can investment bankers achieve better results at chemicals companies than engineers and chemists do? No, it isn't black magic.

Over the past two years, big chemicals corporations seeking to improve shareholder returns by running more focused businesses have sold assets worth almost $20 billion to leveraged-buyout (LBO) firms and similar private companies.[1] Indeed, in 1999 and 2000 the value of public-to-private chemicals deals ran at about twice the total for the previous ten years.

Many people in the industry are bemused by this trend. How, they wonder, can investment bankers with no knowledge of engineering or chemicals, and

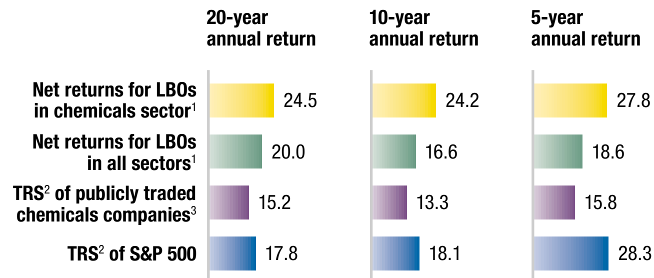
[1] For example, two private-equity firms, Cinven and Investcorp, paid a total of $2.1 billion for Zeneca's specialty-chemicals business in 1999, while the investment bank Morgan Grenfell Private Equity spent $1.1 billion on Ciba's epoxy resins business in the same year. Also, in 2000, the US LBO firm Apollo Management paid a similar sum for Shell's epoxy resins operations.


ADAM NIKLEWICZ

EXHIBIT **1**

Returns to investors: A comparison

Compound average annual rate of return, percent



[1]Includes leveraged-buyout-fund investments in later stages (for example, management buyouts, leveraged buyouts, and mezzanine financing); does not include venture capital. Returns are total returns to external investors, net of all fees, as of December 31, 1999.
[2]Total returns to shareholders.
[3]Composite of total returns to shareholders (capital appreciation plus dividends) for publicly traded chemicals companies in the United States.

with plans that seem to ignore industrial logic and strategic synergies, succeed as owners of these operations? But succeed they do. For 20 years, the total shareholder returns of publicly traded US chemicals companies have been lower than those of the S&P 500 (Exhibit 1). Meanwhile, chemicals companies owned by LBO firms delivered substantially higher returns than did their traditional counterparts—even when those returns are corrected for the LBO firms' higher leverage.

This fact poses real threats to chemicals corporations. First, institutional investors are questioning the ability of traditional managers—the engineers and chemists who built those huge tangles of pipes and vessels in the 1960s and 1970s—to run a maturing industry. The collapse of share prices over the past two years signals this loss of faith, which has created another problem: depressed prices make chemicals companies vulnerable to hostile bids from LBO firms or stronger competitors.

In addition, the ability of chemicals companies to grow through strategic acquisitions has been hampered by the ability of LBO players to pay higher prices for them. And chemicals companies are losing the war for talent: the best managers would rather work hard to turn around underperforming businesses in return for the potentially high rewards that LBO firms offer than cruise along in sluggish traditional chemicals companies.

How should those companies respond to the threat? They must start by understanding what an LBO firm does with a business it buys.

The truth about LBO firms

Some managers in the chemicals industry are consoled by any combination of false beliefs: that the new owners are looking to transfer their companies to a greater fool in the shortest possible time, that they are financial magicians who turn solid balance sheets into smoke and mirrors, and, worst of all, that they recklessly slash and burn sound businesses in their selfish quest for quick returns.

The truth is quite different. Detailed financial analyses of many deals, as well as interviews with dozens of people experienced in buying, selling, and operating leveraged chemicals buyouts, highlight some fundamental truths about LBO firms.

They create the most value by improving operations

Unlike property sharks, LBO firms hold businesses for a considerable time and improve their value before selling them. Although financial data for LBO firms are not reported, McKinsey analyzed nine chemicals LBOs, subsequently floated publicly, for which financial histories were available. About two-thirds of the value these LBOs captured was created during the holding period, and only one-third derived from the actual transaction. Other studies had similar findings.[2] It is, after all, in the interest of LBO firms to improve their chances of selling the businesses they hold.

They are tough but committed

LBO firms have been accused of ripping companies apart for a quick buck. But research shows that the need to generate higher cash flows from operations in order to service and repay high levels of debt compels LBO firms to improve the performance of their companies.

Freed from the constraints of the corporate center, LBO firms can more easily make difficult decisions about cutting jobs and disposing of businesses; removing unnecessary costs and improving capital productivity are well-tried levers. Moreover, R&D spending comes under close scrutiny after an LBO; resources are refocused on projects that offer a reasonable chance of return in the short and medium terms, not on undertakings with poor projected returns or a low probability of success. Similarly, highly motivated managers cut capital expenditures by getting more output from current assets instead of following the traditional route of cadging money from the corporate center every few years.

They want growth

LBO firms want more than value from their existing assets; they also seek growth: after all, an initial public offering is possible today only if the business to be floated has a history of strong growth. Research shows that

[2] *See*, for example, Patricia L. Anslinger and Thomas E. Copeland, “Growth through acquisitions: A fresh look,” *The McKinsey Quarterly*, 1996 Number 2, pp. 96–109.

LBO owners of businesses are willing to make acquisitions previously rejected by their former owners, which usually regarded them as noncore elements of the portfolio and therefore didn't want to invest much time and effort in running them.

Some financial players concentrate on just a few sectors. Huntsman is one of the best examples; in the 1980s and 1990s, it created a polystyrene business (later sold to Nova) from a variety of US and European acquisitions.[3] D. George Harris & Associates, another case in point, created a global salt and soda ash business from a number of acquisitions and then sold it as a package to IMC Global. Harris also undertook a similar project in construction chemicals, while Geo Specialty Chemicals did so in aluminum chemicals and Sovereign Specialty Chemicals did so in adhesives.

They hold on to their businesses

The conventional view is that LBO firms dress up and resell businesses as quickly as possible, usually within five years of purchase. But research into the 200 public-to-private chemicals deals undertaken since 1980 shows that less than one-third of the purchasers exited within five years. The holding times for deals that purchasers do exit have been falling sharply, however—from around eight years in the early 1980s to less than two in the late 1990s (Exhibit 2).

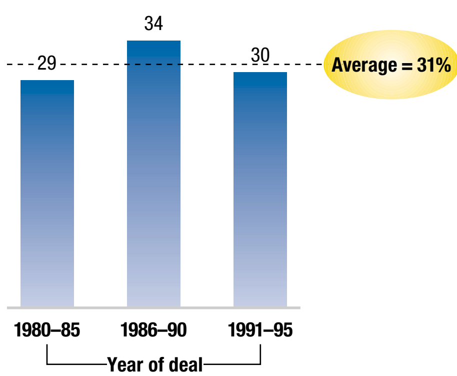
This change, however, may reflect the near impossibility of exiting

EXHIBIT 2

Unconventional wisdom: LBO firms hold on

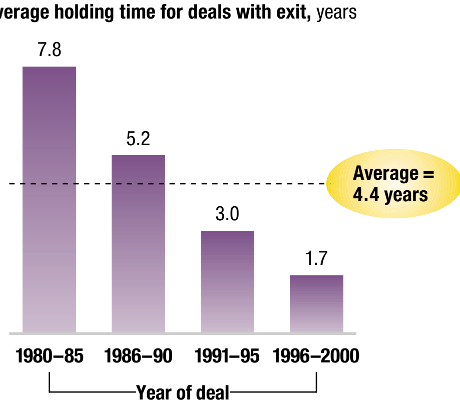
Only about one-third of LBO firms exit within 5 years of purchase . . .

Percent of deals exited by Year 5



. . . but for those who do, the holding times have fallen sharply

Average holding time for deals with exit, years



[3]Jon Huntsman, an early initiator of LBO activity in chemicals, had little experience in the industry; before setting out on his financial career, he had been a special assistant to US President Richard M. Nixon. In the years since Huntsman bought his first chemicals plant, from Shell, in 1982, he has built up the world's largest privately held chemicals company through a series of shrewd deals, such as the acquisition of many Texaco chemicals operations (from 1994 to 1997) and a huge chunk of the commodity businesses owned by Imperial Chemical Industries (in 1999).

through the LBO firms' favorite route: an IPO. As the quintessence of the old economy, the chemicals industry has been out of favor with investors, and since 1996 there has been no IPO of a chemicals business that had previously been taken private; the last were ChiRex and Brunner Mond. Selling to trade buyers is now the preferred exit route, though it isn't uncommon to make use of private-to-private sales and even of secondary LBOs—for example, a second injection of debt financing, often from another LBO house, after the first debt package has been repaid.

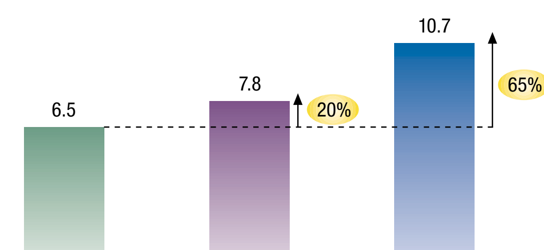
They are excellent negotiators

Financial buyers consistently paid less for their acquisitions during the 1990s than did trade buyers (Exhibit 3), probably because of their dispassionate approach: they screen dozens of deals for every one they execute. By contrast, traditional chemicals companies often overestimate the synergies to be gained by acquiring similar businesses and then get carried away in the auction of the prize asset, on which managers have set their hearts and possibly their careers.

EXHIBIT **3**

Financial buyers pay less

Entity value/EBITDA multiples[1] for chemicals industry deals, 1990–2000



	Average trading multiple (49 US and European companies)	Average transaction multiple for financial buyers (16 US and European deals)	Average transaction multiple for trade buyers (35 US and European deals)
US multiple	7.0	8.1	11.0
European multiple	6.0	7.4	10.5

[1]Ratio of entity value (market value of equity + market value of debt – excess cash) to earnings before interest, taxes, depreciation, and amortization (EBITDA).

The tax shield on debt interest makes many people think that the value in LBOs comes from using lots of debt rather than equity. LBOs are considered risky, however, so this tax advantage is almost entirely offset by the higher cost of the debt. What really drives the high performance of the LBO firms is the need to repay so much debt, as well as the fact that senior managers have put forward their own funds—often raised by borrowing from banks or by remortgaging family homes—as equity in the company. Combined with hopes of a big earn-out, these pressures promote concentrated efforts to generate cash and deliver results.

Differences between the financial-incentive packages for executives in the traditional part of the industry and their counterparts in businesses run by

LBO firms are startling. The major disparity is the link between effort and reward. Managers with experience in both environments invariably point to the weakness of the connection between what managers actually do in the large chemicals corporations they work for and their nonsalary compensation. Effort is unrelated to payback, since the value of stock options, bonuses, phantom shares, and similar devices is subject to many forces—including creative accounting—outside the managers' control.

Traditional chemicals companies measure performance through return on net assets or on capital employed. LBO firms, by contrast, focus single-mindedly either on earnings before interest, taxes, depreciation, and amortization (EBITDA) or on cash flow. The achievement of targets typically intended to double a business's EBITDA within five years triggers bonus payments to senior managers and, often, to other employees.

They often make companies safer and more environmentally responsible

One manager spoke of a revolution in the way health, safety, and the environment were handled after an LBO firm purchased a chemicals business: a company whose record was so poor that insurance had been almost impossible to get metamorphosed into one whose "reception area is plastered with safety awards." Victrex, another company purchased in an LBO, won awards from the United Kingdom's Royal Society for the Prevention of Accidents in each of the first two years following a buyout from Imperial Chemical Industries. No doubt, the motivation for these improvements wasn't entirely altruistic, since it is far easier to build up and exit from a business with a good safety record, but improved safety is a point in the LBO firms' favor.

The LBO approach

All these considerations show that traditional chemicals companies must now compete against new players that focus relentlessly on performance and growth. And this is no short-term trend. The amount of new funds seeking investment[4] and the huge restructuring opportunities created by the disintegration of European chemicals conglomerates (especially in France and Germany) point to more, not less, LBO activity.

Chemicals companies must therefore take action, since every one of them includes businesses that sit uncomfortably in the portfolio, dragging down share prices and putting them within reach of predators (*see* sidebar, "Who benefits from the LBO approach?").

[4]Lehman Brothers reports that US private-equity firms raised $84 billion in the first ten months of the year 2000, compared with $76 billion in 1999 and $34 billion in 1998.

Such companies have four options.

1. Get the best deal from financial buyers

Traditional chemicals corporations don't always get the best possible deal when they sell their businesses to LBO firms. In 1998, for example, Hoechst sold its Vianova Resins business to Morgan Grenfell Private Equity for $542 million. Only 12 months later, Morgan Grenfell resold Vianova to Solutia in a trade sale worth $640 million—an almost instant profit of nearly 20 percent.

Financial buyers pay less on average not only because of their dispassionate approach to acquisitions but also because they tend to negotiate downward during the due-diligence phase from a price that had earlier been accepted in principle. Once LBO firms find themselves the sole bidder, they are skilled at discovering problems (for instance, environmental liabilities or outdated equipment) in the seller's business offer.

Chemicals companies can respond in a number of ways. They should maintain a competitive auction right up to the last minute, because so many LBO firms, not to mention trade buyers, are interested in chemicals acquisitions. To boost the buyer's confidence in the senior managers of the business to be sold, the seller should also involve them in the negotiations. And if the selling company maintains a small equity stake in the business—say, 10 or

Who benefits from the LBO approach?

Traditional chemicals corporations should seriously consider a leveraged buyout if they satisfy some or all of the following criteria:

- Chronic underperformance as well as an unwillingness by owners to make difficult decisions—for instance, to close plants and cut costs
- Static or negative growth in demand in businesses whose focus has shifted to improving capital productivity; in this case, relentless attention to cutting costs and rationalizing production is needed
- Product, process, and market maturity that have collectively tilted the balance away from innovation and toward greater operational effectiveness
- Cash flows sufficiently strong and stable to support high leverage
- A lack of portfolio synergies

20 percent, possibly with a seat on the board—it will have a chance to learn how LBO firms achieve their high levels of return.

Selling noncore businesses to financial buyers is a low-risk approach and, in many cases, one that is preferable to hanging on to underperforming assets indefinitely. Fortunately, the LBO market is now sufficiently competitive that any business, except for one with massive environmental liabilities, should be able to fetch a fair price.

2. Execute an internal LBO

The second option, an internal LBO, aims to create as much value as LBO houses might but to capture the gain for a company's own shareholders. This course sounds simple, but its rarity in the chemicals industry, and indeed in most others, should bear witness to its difficulty. An internal LBO has a better chance of succeeding if a corporation has nothing to lose—that is, if the business unit is small and noncore or can't be sold for a reasonable price.

Unfortunately, corporate centers find it hard to resist the temptation to interfere in the operation of anything they own. When business managers whose companies have made the transition from ownership by corporations to ownership by LBO firms give interviews, they always emphasize that independence from the corporate center is the most important factor for success.

Exhibit 4 shows four financial structures, ranging from an internal carve-out to a joint venture with a private investment firm, that could be applied to an internal LBO. Their common features include high leverage, equity purchased with personal funds by the senior-management team, and complete operational and strategic freedom for those managers. The other important feature is the possibility of exit routes similar to those that might be expected in a real LBO. There can be no guarantee for the equity stakes of managers, but they must be able to have a reasonable expectation that, in the absence of an IPO, the parent might reacquire the business or that it could be sold to a trade buyer or recapitalized.

Financing options for an internal LBO are so numerous that an experienced practitioner must help the corporate parent choose the one that best suits the objectives of all parties: the seller, the debt providers, the senior business managers, and, in one variant, an LBO house as a joint-venture partner. The hard part is assessing the stock market's reaction. Both Allied Corporation's internal LBO of Union Texas Petroleum in 1985 and IMC's internal LBO of its fertilizer business in 1987 are said to have given the corporate parents

EXHIBIT 4

Four options for an internal LBO

Do-it-yourself ←→ Collaboration

	Internal carve-out	Leveraged partial public offering	Management buyout	Joint-venture LBO
Equity ownership				
• Chemicals company	100	70	80	40
• Public	0	20	0	0
• Management	0	10	20	10
• LBO firm	0	0	0	50
Quoted stock price?	No	Yes	No	No
Debt	Nonrecourse	Nonrecourse	Nonrecourse	Nonrecourse
Management incentives	Phantom stock linked to EBITDA[1]	Easy cash-out when options expire	Cash-out on exit	Cash-out on exit
Exit strategy	• Possibly none • Trade sale	• Secondary public offering • Trade sale • Repurchase by chemicals company	• Initial public offering • Trade sale • Repurchase by chemicals company	• Initial public offering • Trade sale • Repurchase by chemicals company
Advantages	• All value retained by chemicals company	• Independent market valuation • Equity liquidity	• Chemicals company retains majority of value • Managers are highly motivated	• Separation from chemicals company • Exploits LBO firm's skills
Disadvantages	• Difficulty of achieving truly nonrecourse debt • Temptation for chemicals company to interfere	• Complex, expensive • Stock price may not reflect business unit's true value	• Exit may be difficult • Equity valuation at exit may be difficult	• Considerable value goes to LBO firm • Exit and equity valuation may be difficult

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

(and, indirectly, their shareholders) the kind of returns typically associated with conventional LBOs.[5]

At present, the benefit for a chemicals corporation may be measured more by psychological effects than by share prices. An active search to find a solution for a troublesome business is almost certainly more satisfying than meeting a set of core-business performance targets that will get a company no credit from stock analysts. And if the internal LBO is successful or even looks as though it might be, it provides a huge incentive to expand the experiment to other, bigger problems. By comparison, the risks are modest for everyone involved.

3. Undertake a leveraged recapitalization

The third alternative, a leveraged recapitalization of an entire company, is riskier than an internal LBO because the former makes the entire company

[5]*See* G. Bennett Stewart III, *The Quest for Value: The EVA Management Guide*, New York: Harper, 1991.

more highly leveraged. Unlike a company that goes private, a recapitalized company retains its public shareholders, has stock quoted on a public exchange, and publishes the usual financial data. The difference is that more of the equity is placed in the hands of senior management, and possibly other employees, thus strengthening the incentive to maximize the company's performance.

Taking whole companies private in leveraged management buyouts goes as far as possible on the spectrum of **risk and reward**

Union Carbide conducted a leveraged recapitalization in 1985. Saddled with the consequences of a disastrous diversification and a serious accident at an Indian pesticide plant, the company faced a hostile bid from GAF, a much smaller player. Carbide saved itself from GAF's attentions by going into debt to repurchase 55 percent of its shares at a price GAF couldn't match. It then sold off its battery unit—which included Eveready Batteries, one of Carbide's best-performing businesses—and used the proceeds to pay off the debt. This defensive recapitalization forced Carbide to focus on just a few sectors of the petrochemicals industry, a strategy that was successful for nearly 15 years.[6]

4. Take the whole company private

The approach that goes about as far as possible on the risk-and-reward spectrum is to take the whole company private in a leveraged management buyout (MBO). Although the returns might prove spectacular, much personal wealth would have to be ventured, so it isn't surprising that the chemicals industry provides few examples. One of them was the buyout of most of the equity in GAF by Sam Heyman in 1989 and its flotation two years later.

That deal took place more than ten years ago. Today's executives must avoid accusations that a management buyout would permit a few insiders to make huge gains at the expense of thousands of public shareholders. To put the problem another way, no deal that shareholders would find acceptable is likely to give MBO participants the returns they desire.

Yet in some parts of the economy, management buyouts of whole companies have become quite fashionable. In UK commercial property, for example, a rash of participants—including MEPC, the sector's fourth-largest player—went private last year. More and more people think that market quotations

[6]Carbide ran out of steam in the late 1990s and will almost certainly end up being acquired by its rival Dow Chemical.

for property companies have outlived their usefulness, since buying a group of assets and collecting rents can never deliver equity-like rates of return on investment.

The chemicals industry as a whole hasn't reached that stage in its evolution yet, though some of its sectors, such as European fibers and fertilizers, are perilously close.

Chemicals companies should take advantage of the LBO firms' current appetite for their businesses and sell more unwanted assets. The present state of affairs probably won't last indefinitely, since LBO firms are likely to find it increasingly hard to exit from chemicals deals. The IPO route is closed for the foreseeable future, and trade sales are becoming more difficult because regulators fear that acquirers may raise their market concentration to unacceptable levels. As an alternative, companies could try the LBO approach to creating value; they might find that as much as 50 percent of their businesses could benefit, which would imply a huge overall improvement in their performance. Q

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OLEG KOULIKOV

The innovative organization:

Why new ventures need more than a room of their own

Jonathan D. Day, Paul Y. Mang, Ansgar Richter, and John Roberts

Companies *can* grow quickly without sacrificing performance discipline. The trick is to balance partitioning and integration.

The idea that new businesses prosper best when separated from their corporate parents has become a commonplace. Separation is no doubt the model of choice when the new and the old differ greatly—for example, an Internet start-up launched by an industrial company. But the simple injunction to cordon off new businesses is too narrow. Although ventures do need space to develop, strict separation can prevent them from obtaining invaluable resources and rob their parents of the vitality they can generate. Two-way relationships are needed, though only a few companies have developed organizations in which such relationships thrive.

Yet a delicate blend of separation and cooperation is a prerequisite for satisfying the twin demands of today's investors: focused performance and faster growth. The 1980s were mostly concerned with performance.[1] Underperforming assets were to be fixed—or sold. Diversification was viewed at best with suspicion and, when it took companies outside their areas of "core competence," regarded as a managerial crime.[2] Accordingly, the decade witnessed a wave of "bust-up" takeovers as acquirers split conglomerates into focused components and sold them to buyers in related industries.

Although investors still expect top performance and high returns from a company's core business units, they now also **demand growth**

The past few years have told a different story. Investors still expect top performance from a company's core business and high returns on existing assets. But they also demand growth: new assets and entry into new business arenas. Mergers increasingly aim to generate horizontal synergies, creating corporate behemoths of unprecedented size and strategic diversity.

How can companies deliver this combination of focus and flexibility, performance and growth? The conventional advice has been to plant the seeds of "foreign" businesses, acquired or developed internally, in walled gardens so that established businesses can't trample them. Citing the experiences of companies that have failed to take advantage of opportunities to innovate, a number of authors[3] have argued that greenfield units should be kept far away from operating businesses, even to the extent of physically separating their headquarters.

We believe that partitioning is desirable but can easily go too far. A company that seeks both performance and growth should give entrepreneurial activities plenty of space but also connect them, from the outset, to its parent's resources, knowledge, and goals. Achieving this balance of separation and integration calls for the full range of organizational and leadership interventions: structure as well as management processes, human-resources policies, and corporate culture.

[1] The dates in this article apply to the United States, where a wave of takeovers started in the early 1980s after the Reagan administration decided that it would do little to deter takeover bids. The takeover phenomenon took off in the United Kingdom during the late 1980s and in Continental Europe during the mid-1990s. *See* Ansgar Richter, *Restructuring or Restrukturierung? Corporate Restructuring in Britain and Germany*, London: London School of Economics: Centre for Economic Performance, 1997.

[2] *See* Michael C. Jensen, "Agency costs of free cash flow, corporate finance, and takeovers," *American Economic Review*, 1986, Volume 76, Number 2, pp. 323–9; and Michael C. Jensen, "Eclipse of the public corporation," *Harvard Business Review*, September–October 1989, pp. 61–75.

[3] *See* Clayton M. Christensen, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*, Boston, Massachusetts: Harvard Business School Press, 1997; and Mehrdad Baghai, Stephen Coley, and David White, *The Alchemy of Growth: Practical Insights for Building the Enduring Enterprise*, Reading, Massachusetts: Perseus Press, 1999.

Separate and integrate

Planning and resource allocation processes designed for established businesses can wither the prospects of a new one. Established businesses have customers, organizational structures, and prejudices that dispose them to stick with the familiar when they decide where to make their investments. Spending on core businesses, where risks are relatively easy to identify and control, can be defended without great difficulty. Investments in the discontinuous innovations that transform industries but pose greater risks are harder to justify, and the business case for these investments is harder to make without ambiguity.[4]

In the fight for corporate capital, talent, and commitment, new ideas often fail to attract managerial attention, particularly in their early stages: compared with an existing business, an idea of unproven worth can seem insubstantial. But by planting new ideas in separate organizational structures, managers can change the scale of comparison and create roles focused on nurturing new ideas rather than minimizing or squelching them.

Of course, leaders of existing businesses know that new initiatives may eventually replace them. Adding insult to injury, cash from core operations finances the challenges. Managers may thus resort to destructive tactics such as acquiring illiquid assets to make their units harder to sell or distorting news about the newcomers' success. For this reason, too, it often makes sense to place new and old businesses in separate entities and to limit the interaction between them, not only to shelter new businesses, but also to let the managers of core ones concentrate on meeting performance targets. Each kind of enterprise can operate under its own resource allocation criteria, performance measurement systems, and reward structures.

One way of increasing the distance between legacy businesses and new opportunities is to spin off or carve out distinct, legally separate units, as American Airlines did with Sabre (a reservations and information system) and Siemens with Infineon (a semiconductor manufacturer).[5] By contrast,

[4]*See* Joseph L. Bower and Clayton M. Christensen, "Disruptive technologies: Catching the wave," *Harvard Business Review,* January–February 1995, pp. 43–53; and Constantinos C. Markides, *All the Right Moves: A Guide to Crafting Breakthrough Strategy*, Boston, Massachusetts: Harvard Business School Press, 1999.

[5]*See* Jonathan D. Day and James C. Wendler, "The new economics of organization," *The McKinsey Quarterly*, 1998 Number 1, pp. 4–18; Patricia L. Anslinger, Steven J. Klepper, and Somu Subramaniam, "Breaking up is good to do," *The McKinsey Quarterly*, 1999 Number 1, pp. 16–27; and Patricia L. Anslinger, Sheila Bonini, and Michael Patsalos-Fox, "Doing the spin-out," *The McKinsey Quarterly*, 2000 Number 1, pp. 98–105.

Donaldson, Lufkin & Jenrette kept its e-brokerage subsidiary, DLJ*direct*, in-house but gave the unit separate responsibilities and authority within a rigorously decentralized structure.[6] Two-thirds of all established companies setting up Internet-based operations are said to have followed this model.

Top managers, already struggling with existing customers, markets, and employees, are faced with a growing **information overload**

Although partitioning on either model can take a company a long way toward achieving the goals of growth and performance, it presents a number of problems, primarily because it pushes the recognition and selection tasks involved in innovation and business building up to higher levels of management. In strictly partitioned organizations, very senior executives are responsible for detecting new possibilities and patterns and for bringing new ideas into focus. The chief executive must recognize embryonic ideas wherever they appear, combine them with other ideas and resources, and give them an appropriate organizational form—all without special allegiance to either the old or the new businesses.

Top managers, already struggling to maintain contact with existing customers, markets, and employees, are faced with a growing information overload. In some cases, new ideas are suppressed too quickly; in others, top managers champion projects whose true potential hasn't been assessed accurately. Many observers have attributed Apple Computer's wasteful investment in the failed Newton personal digital assistant to then-CEO John Sculley's early and enthusiastic promotion of the project. Moreover, since partitioning creates new organizational boundaries, it also limits the flow of information and ideas and thereby makes it more likely that they might be lost. Growth opportunities identified in the course of operating a core business can be a rich source of incremental and transforming innovations. Sony's Walkman and Corning's fiber-optic businesses emerged in just this way. In contrast, new businesses segregated from legacy businesses usually lack close contact with key customers, technology providers, and competitors—contacts that often generate promising new opportunities.

Isolated new businesses also have difficulty rejoining the mainstream, especially when they have developed new business models that are supposed to reinvigorate the operations they had left behind. Meanwhile, mature operating units, sealed off from the organization's pockets of innovation,

[6] DLJ has since been acquired by Credit Suisse First Boston. DLJ*direct* is now known as CSFB*direct.*

can acquire self-fulfilling labels such as "low growth" or "old economy," particularly when the new units are Internet related. The harder management tries to keep the old apart from the new, the more vociferously will employees of the core business complain that they are being denied their fair share of the new unit's success or fame; few people want to be stuck in a low-growth business when more glamorous opportunities exist under the same corporate roof.

Striking a balance: Nokia

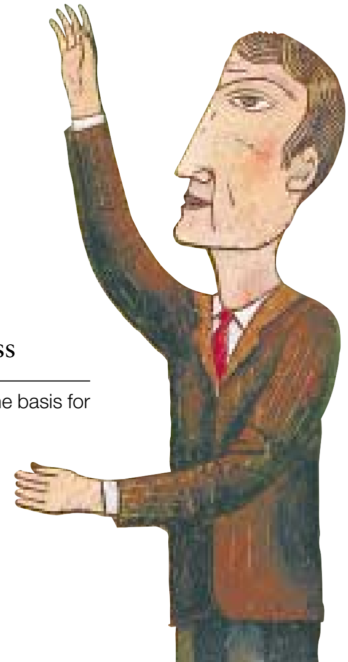
Separation and integration both serve the cause of profitable growth, so companies should drive both simultaneously. Consider the case of Nokia,[7] the Finnish telecommunications giant. The company is interesting not only because it has apparently succeeded in achieving the seemingly incompatible objectives of performance and growth but also because it uses a wide variety of organizational mechanisms to do so.

Nokia has two major business groups: Nokia Mobile Phones (NMP), the world's largest producer, and Nokia Networks (Net), a leading producer of mobile and fixed-line network equipment. The Nokia Research Center undertakes basic research for the business groups.

New ventures

In 1998, Nokia established the Nokia Ventures Organization (NVO) to test and develop nascent ideas that had the potential to generate revenues of $500 million to $1 billion within four to five years. Pekka Ala-Pietilä, the president of Nokia and of NVO, explains that the company "needed this kind of unit at the corporate level" because some initiatives "didn't fall easily into Nokia's existing organizational structure; they fell somehow in between the existing units, or they took place across these entities. So nobody was the natural owner of these initiatives. Therefore, the purpose of NVO is to look at growth opportunities that are *beyond* the remit of the existing businesses but *within* Nokia's overall vision."

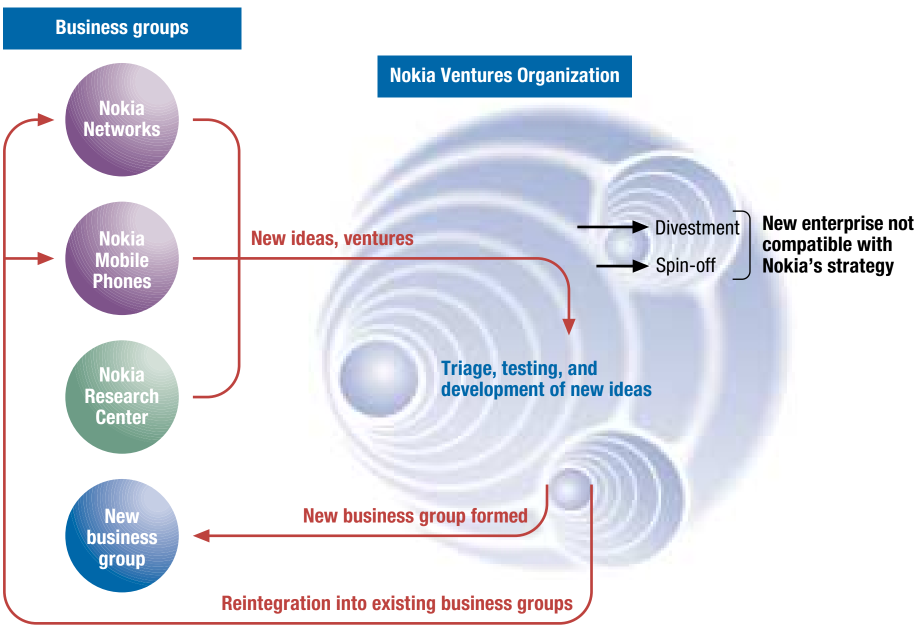
At first glance, Nokia's organizational chart tells a partitioning story: truly innovative activities have apparently been separated from the operating business



[7]This analysis draws on interviews conducted with Nokia executives as the basis for a Stanford Business School teaching case.

EXHIBIT

Nokia keeps ideas mobile



units and moved to NVO. However, a closer look reveals a range of mechanisms that closely link the two (exhibit).

Although NVO includes a venture capital fund that has been chartered to look for ideas originating outside Nokia, NVO's primary purpose is to develop internally generated projects. Some 80 percent of the 17,000 Nokia employees who have innovation-related jobs work for NMP or for Net. Every Nokia unit is expected to search for new ideas, and most new ideas are actually developed within the business groups. NVO deals only with proposals that go beyond Nokia's current technologies and seem likely to create new markets. The internal venture capital fund works in the same way; investments and acquisitions within the scope of the company's current strategy are made by the business groups, not by NVO.

Nascent ideas or young businesses moved into NVO don't stay there indefinitely: the viable ones are eventually integrated into the operating businesses, established as new divisions, or sold. As Markus Lindqvist, NVO's director of business development, says, "NVO does not exist for itself; it exists for Nokia, and that means, in particular, that if we start to do things, we don't regard them as being our own. What we do is up [to] somebody else to take further. Our customer is Nokia." In short, NVO functions as an accelerator: it speeds up the development of ideas. Businesses that can run on their own leave NVO.

Over the past 15 years, Nokia has exited from many businesses that didn't fit into its overall plans, and it exercises the same discipline in reviewing ideas being explored in NVO. One of NVO's undertakings, a health-services unit that developed telecom-based technologies for treating diabetes and other illnesses, was moved from its original home in NMP into NVO in 1998 and then sold a year later because Nokia felt that new owners could add more value.

So that people don't get overly drawn to **pet projects**, NVO and the business groups share financial incentives and salary schemes

Decisions about moving businesses between NVO and the business groups are made jointly by managers on both sides. New ideas emerging from day-to-day operations are normally passed on to the business groups and their development managers, who decide which unit has the best position for advancing these projects. If they look particularly promising, they go to the Nokia Ventures Board, which involves people from NVO, the Nokia Research Center, and the mainline businesses. The board decides how to combine ideas from a variety of sources, whether to embody those ideas as new businesses, and where such businesses should fit into the corporate organization. All ventures, whether they are developed in NVO or stay in the business groups, go through the same process.

Incentives

To ensure that people don't get overly attached to pet projects, NVO and the business groups also have the same financial incentives and salary schemes. Performance-related bonuses tend to reward the achievements of teams and of the whole company, not of individuals, and contingent pay forms a relatively small part of overall remuneration. The intention is to encourage Nokia managers, from the start, to concern themselves with the good of the company as a whole.

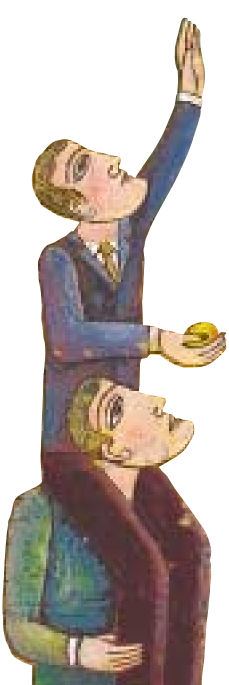
In the conventional view, managers who have no strong financial incentives won't take risks or make the extra effort needed to develop and promote emerging businesses. Yet these things happen at Nokia. Although some features of its incentive system undoubtedly reflect its unique identity or the egalitarianism of Finnish culture, other companies in other parts of the world should ponder Nokia's ability to move ideas across units and into its underlying fabric.

Keeping ideas mobile

Mechanisms other than incentives also help diffuse ideas throughout Nokia. NVO, for example, is overseen by the Nokia Ventures Board, most of whose 15 members—including the president of NMP (Matti Alahuhta) and of Net (Sari Baldauf)—come from the business groups. The board reviews NVO initiatives as they go through successive funding gates, thereby ensuring that they are accountable to the core business and don't drift from the shared agenda.

The opportunity to develop ideas into businesses inspires engineers and other employees to cross organizational boundaries, and this movement of employees throughout the company also helps diffuse the knowledge that NVO was created to promote. When openings occur, they are posted on a Nokia intranet. Managers are not allowed to prevent their people from transferring to other units, and hiring managers can't go headhunting or give people special inducements to move within the company. Nonetheless, in most cases teams move into NVO along with the ideas they conceive. Once an NVO venture has been developed, the people who worked on it are expected to return to the mainstream. Except for a few managers, NVO has no permanent staff.

Nokia relies heavily on personal networks. One of the main qualifications for membership on an NVO team is credibility in the eyes of the larger company. People build support for ideas by circulating them, since widely known ideas have the best chance of encountering a favorable milieu for development. The result is a system that encourages innovation throughout the company; as Net's Sari Baldauf says, "If you've got a good idea at Nokia, it will be hard to find someone who will stop you from acting on it."



The process at work

The history of Nokia Internet Communications (NIC), NVO's largest initiative by far, illustrates the process at work. NIC began with a group of engineers who moved to NVO to commercialize the Wireless Application Protocol (WAP) technology they had developed at the Nokia Research

Center. They were soon joined by staff from Net, and to gain outside expertise, NIC also made several acquisitions. As Markku Rauhamaa, vice president of its Wireless Software Solutions group, explains, NIC cooperates with the main business groups: "We don't have any problem [doing] things for NMP. There is such a high demand for our expertise there. . . . Typically, the challenges come from resource limitations."

The operating conditions created for new businesses shouldn't differ substantially from those they would encounter in the **open market**

Meanwhile, NIC generates several hundred million dollars a year in revenue. Nokia intends to move NIC out of NVO soon, either by integrating NIC with one of the company's existing businesses or by making it a business entity in its own right. The movement of ideas comes full circle.

Lessons

We present the Nokia story as an example neither of a company immune to failure nor of "best practice." In fact, Nokia faces formidable challenges: maturing demand for mobile handsets and increasing competition from Asian groups such as Samsung, as well as uncertainty about competing standards for third-generation (3G) telecom systems and about which data-based services will be the mobile Internet's "killer apps." Explosive growth, particularly beyond Finland, will make it difficult to maintain the egalitarian, nonhierarchical, and informal style that helps keep ideas mobile within the company.

Nonetheless, we believe that general lessons can be drawn from Nokia's search for an organization that integrates new ideas and at the same time separates them from the main business:

1. Nokia's story suggests that new ventures do need their own space to develop. Without their own resources, their own performance metrics, and a distinctive organizational design, they fail to develop the necessary entrepreneurial spirit.

   Even so, the operating conditions that companies create for new businesses shouldn't differ substantially from those they would encounter in the open market. New businesses should be free of undue encroachments by established ones but not of oversight or accountability; there is, for example, no reason to exempt entrepreneurs in established companies from the rigorous scrutiny that venture capitalists apply to their investments. Accordingly, NVO imposes tough controls on venture fund investments, on "venturing units" (small teams exploring ideas that are not ready to inspire NVO business units), and on business units such as NIC.

2. Nokia exemplifies the benefits of integration. Substantial business opportunities can arise when people exchange ideas, information, and experiences across organizational boundaries. Existing operations can be a powerful source of ideas for new businesses, but top management can't serve as the conduit, because well-honed administrative processes filter out ideas that are still in a fuzzy, premature state. Companies therefore need a number of overlapping channels that effectively transmit "soft" information. Nokia relies heavily on these messy, redundant systems. The mobility of its managers and a culture that encourages openness and the sharing of information create marketlike information flows within the company.

3. The experience of Nokia demonstrates the importance of a flexible and adaptable organizational structure. The organizational designs appropriate for business development change as quickly as the business itself. Once a venture can stand on its own, it should be quickly moved to an operational setting similar to those of established lines of business. The decision about whether to keep a new unit separate or to integrate it into an established organization should be based on the synergies or incompatibilities between these entities.[8] If the company concludes during the development process that the scope of a new unit's activity goes beyond that of the company as a whole, divestiture is the correct course of action.

   Employees sometimes pursue their own narrow interests or those of their departments or divisions, even at the expense of corporate goals. But such conflicts of interest are less likely to occur if trainees are exposed to different parts of the company, employees are rotated through it, and reward systems emphasize the greater good. Policies ensuring that both good and bad news must be made public also discourage selfish behavior.

Nokia managers emphasize that NVO is not in itself responsible for Nokia's remarkable balance of performance and growth. NVO is small compared with the rest of the company, and the structural and process innovations that

[8] *See* Robert A. Burgelman, "A process model of internal corporate venturing in the diversified major firm," *Administrative Science Quarterly*, June 1983, Volume 28, pp. 223–44.

Nokia has created are only part of the story. Human-resources policy and, especially, culture work with Nokia's structure and processes to keep ideas flowing through the company.

Companies that have mastered the balancing act between partitioning and integration will create many paths where ideas, talent, and capital can unite to create thriving new businesses. They will discover unexpected flows of new ideas among different parts of their companies, and when that happens, they will have met the challenge of the coming decade: fast growth without the sacrifice of performance discipline. Q

The authors wish to thank Andreas Credé of McKinsey's London office and Professor Bengt Holmstrom of the Sloan School of Management (Massachusetts Institute of Technology) for their comments on earlier versions of this article.

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Teamwork at the top

Erika Herb, Keith Leslie, and Colin Price

When the top team isn't working well, the whole company suffers. How can top teams fix themselves?

The popular business press on both sides of the Atlantic is infatuated with chief executive officers who have drunk from the Holy Grail of heroic leadership. To be sure, a single person can make a difference at times, but even such heroic CEOs as General Electric's Jack Welch emphasize the power of team leadership in action. As Welch himself said, "We've developed an incredibly talented team of people running our major businesses, and, perhaps more important, there's a healthy sense of collegiality, mutual trust, and respect for performance that pervades this organization."

Increasingly, the top team is essential to the success of the enterprise. Indeed, Welch is celebrated not only for increasing GE's revenues nearly sevenfold in his 20-year tenure but also for building one of the world's strongest executive talent portfolios, which has provided new leadership for many Fortune 500 companies besides GE.

So despite the obsessions of the business press, senior executives, shareholders, and boards of directors question the myth of heroic leadership.

RICCARDO STAMPATORI

Merely bringing in a new CEO to reshape an organization will tend to show mixed results; in the consumer goods companies analyzed in Exhibit 1, for example, they were always worse after the arrival of a new CEO. In reality, long-term success depends on the whole leadership team, for it has a broader and deeper reach into the organization than the CEO does, and its performance has a multiplier effect: a poorly performing team breeds competing agendas and turf politics; a high-performing one, organizational coherence and focus.

EXHIBIT **1**

Heroic leadership is not enough

Effect of hiring new CEO on total returns to shareholders (TRS), percent

	TRS under former CEO	Transition date	TRS under new CEO[1]
Procter & Gamble	34	January 1999	–19
Gillette	28	February 1999	–14
ConAgra Foods	27	September 1997	–33
Unilever	24	November 1997	–21
Nestlé	23	October 1997	18
Quaker Oats	21	September 1997	17
Nabisco	17	November 1997	12
Campbell Soup	15	July 1997	–16
Kellogg	13	January 1999	–23
Allied Domecq	7	August 1999	–8

[1]As of August 2000.

Often, however, the leadership team is at best a collection of strong individuals who sometimes work at cross-purposes. What does it take for senior managers to gel as a team? Our work with more than a score of top teams, involving upward of 500 executives in diverse private- and public-sector organizations, suggests a straightforward process for enhancing their performance.

The most effective teams, focusing initially on working together, get early results in their efforts to deal with important business issues and then reflect together on the manner in which they did so, thus discovering how to function as a team. Formal team-building retreats are rare; behavioral interventions and facilitated workshops, though sometimes helpful, are not central to the effort of team building. Top teams address business performance issues directly but behavioral issues only indirectly and after the event.

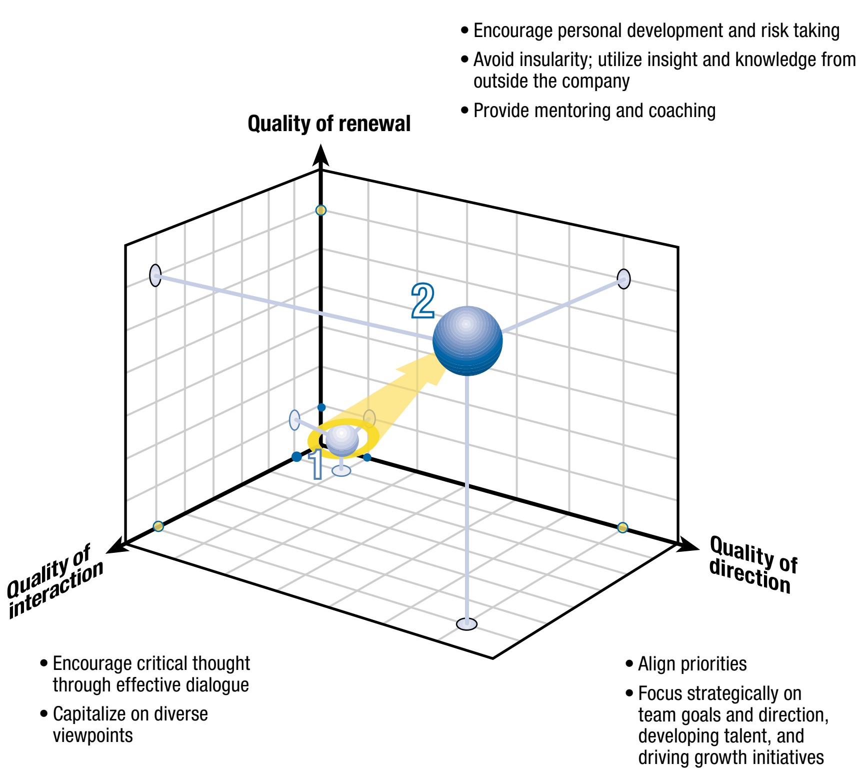
A second myth of leadership, as pervasive as the myth of the heroic CEO, is the idea that seasoned managers slotted into an organizational chart can easily function as a team. In reality, top teams face many problems: finding the right people, matching the available skills to the job, and learning to work together without taking the time to craft roles. Teams don't magically coalesce overnight. Their members have to be close in the professional rather than personal sense; they can thrive in an atmosphere of conflict if it is managed to increase creative output and to catalyze change. Becoming a top-performing top team must be one of the team's goals.

To meet that goal, teams have to master three dimensions of performance. First, they require a common direction: a shared understanding of goals and values. Second, skills of interaction are crucial if the team is to go beyond individual expertise to solve complex problems and, equally, if it is to withstand the scrutiny of the rest of the organization, for people usually take their cues from the top. Finally, top teams must always be able to renew themselves—to expand their capabilities in response to change.

One reason for the difficulty of improving a team's performance is that interaction, direction, and renewal are interdependent—teams need to go forward simultaneously on all three fronts to make real progress (Exhibit 2). It isn't surprising, for instance, that top teams interact poorly when they don't have a common direction. By contrast, enhanced performance in one dimension not only reinforces the improvement in others but also provides for the genuine personal development that builds success.

EXHIBIT **2**

Three dimensions of performance



Suppose, for example, the team believes that it must build trust among its members. It rarely helps to have self-conscious discussions or "sharing" exercises about keeping or breaching trust, an approach that may actually be quite destructive. But by working together to sharpen the sense of strategic direction—and in this way experiencing successful interactions—the team can indirectly, but often dramatically, improve its effectiveness and thus the feeling of trust among its members. In effect, the team exploits its strong reasoning abilities to build trust.

Identifying real problems

Tolstoy wrote, "Happy families are all alike; every unhappy family is unhappy in its own way." The same can be said of underperforming teams. Nonetheless, there are typical warning signs in each of the three dimensions of team performance.

Confused direction

Many CEOs assume that they and their top teams share a common understanding of corporate goals and values. Formal descriptions of roles, expected conduct, and corporate strategies and plans all reinforce this assumption, but several realities undermine it.

Lack of alignment. Executives may nod their heads when the CEO propounds a vision, but the team often lacks a shared view of how to implement it. At one well-known energy company, the five executives of a top team were asked to list the company's 10 highest priorities. Alarmingly, they listed a total of 23 priorities; only 2 appeared on every executive's list and only 7 on the lists of more than three members; indeed 13 of the 23 priorities appeared on only one list. In other cases, the team doesn't agree about how performance should be assessed, who the company's top performers are, or how to motivate the organization to achieve its stated objectives.

Lack of deep understanding. In some cases, the top team agrees on plans, but subsequent actions are inconsistent with its decisions. This problem reflects the tendency of top teams to focus on making decisions without examining the assumptions, the criteria, and the rationales behind them.

Lack of strategic focus. Top teams without a common direction spend more time on business as usual and on "fire fighting" than on seeking out and doing the work only they can do—work that is important to the organization and gives the team as a whole an opportunity to add value. A focused team concentrates on developing talent within the organization and on driving major growth initiatives; an unfocused team second-guesses line-management decisions, reruns analyses, and immerses itself in detail. Half of the executives we interviewed believed that they failed to add value in much of their work.

Ineffective interaction

Many management teams pay lip service to the importance of interaction but foster a working style that inhibits candid communication and collaboration.

Poor dialogue. Although the members of a team may spend much time talking to one another, they can often fail to communicate, by withholding vital information, suppressing critical opinions, or accepting questionable strategies out of fear of retaliation. These games lead not only to frustration but also to hidden agendas—problems that may stem from mistrust if individual team members don't know one another or organizational units have a history of conflict. According to 65 percent of the respondents in our top-team database, trust was a real issue for their teams.

Since the behavior of the top team is mimicked lower down in the organization, **dysfunctional** behavior can come to pervade it

Dysfunctional behavior. Often the most serious result of poor dialogue is an inability to capitalize on diverse viewpoints and backgrounds, thus reducing the team's ability to work creatively and adapt to changes in the market. And like any group of people, top teams can fall into destructive practices—for instance, the public humiliation of team members. Such behavior understandably creates fear and defensiveness and can intensify problems by isolating and scapegoating individual team members. Because the top team's conduct is mimicked lower down in the organization, this kind of behavior can come to pervade it.

An inability to renew

Although many top teams recognize the importance of organizational renewal, few of them institute processes that revitalize effort and commitment. Three problems can make it hard for members of a team to step back and honestly assess their own performance. These problems often have their origin in the team members' experience as middle managers. Most executives have climbed functional silos and are accustomed to defending their organizational turf. It is often difficult for such people to make the leap to broad strategic issues that have a bottom-line impact. Frequently, executives also can't adapt their leadership style to life at the top, where interactions tend to be shorter, more frequent, less prepared, and aimed at a wider and more diverse audience.

Personal dissatisfaction. Many team members, despite their apparently successful careers and enviable positions, have become frustrated or insufficiently challenged by their work. A quarter of our respondents said that their jobs didn't stretch them. Collectively and individually, team members ignore new sources of insight, information, and experience that could push them out of their comfort zone. The teams we have observed engaging in destructive politics usually discourage their members from assuming new roles or taking risks. As a result, these executives ultimately become bored, and their performance declines; hence, the typical CEO complaint that once-solid team members no longer energize others or adapt to changing needs.

Many team members, despite their successful and enviable careers, have **become frustrated** or insufficiently challenged by work

Insularity. Top teams rarely pay enough attention to information from outside their companies or industries—information that, digested quickly, could influence key strategic and organizational decisions. In addition, top teams seldom make the time to reflect on the information they do receive and to assess its future impact. Lacking structured processes to receive and reflect upon information from external sources, most teams don't find the time to generate a real strategic focus.

Deficient individual skills. Most companies give the members of their top teams little mentoring or coaching about how to effect change. Unlike middle managers, who frequently get broad training and coaching, senior managers usually work without a safety net and, frequently, without a second chance. Among the executives we surveyed, 80 percent believed that they had the necessary skills to fulfill their role, but only 30 percent believed that all of their colleagues did.

Becoming a top team

How can a company set about improving the performance of its top team? Our research points to some useful strategies for promoting effective action, reflection, and cohesion.

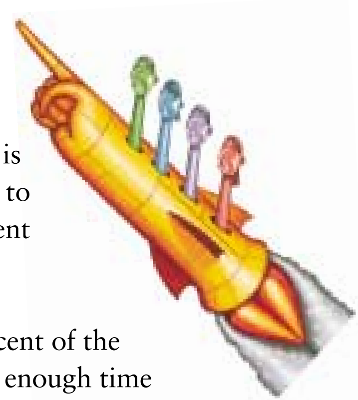
How it works

Many behavioral team-improvement efforts fail because they don't speak to the needs of top managers: programmed exercises, for instance, seem artificial. Our work with top teams suggests four ways to build their performance by replicating the way senior executives actually work together (*see* sidebar, "A case study," on the next page).

1. Address a number of initiatives concurrently. The top team must focus on the most pressing issues—work that only it can do. Achieving tangible outcomes in a variety of management challenges is essential. The activities most likely to foster team action and reflection include framing strategy, managing performance, managing stakeholders, and reviewing top talent. The team really needs to do these things whether or not its members are attempting to improve their own performance as a team. The action element of the cycle improves the direction of the organization and its ability to renew itself, while reflection makes it possible for teams to discover ways of improving their interaction.

2. Channel the team's discontent. Only 20 percent of the executives we surveyed thought their team was a high-performing one. Successful teams invite external challenges, focus on competitive threats, and judge themselves by best practice, since comparisons with industry leaders or key competitors raise the quality of debate by putting facts on the table.

3. Minimize outside intrusions. It is hard for a team to execute an improvement process by itself; some form of facilitation is usually required. Consultants or coaches should observe top teams at work rather than lead meetings or presentations. They should never try to direct the team's work. Finally, they should ensure that real work dominates the improvement process. Teams must discover what is effective for them. Merely telling a team the solution to its problems reinforces the poor quality of its alignment and interaction.



4. Encourage inquiry and reflection. More than 80 percent of the executives we surveyed said that they didn't set aside enough time for analyzing the root causes of problems. These executives believe that instead of developing rules of thumb slowly and subconsciously, they should use their business experience to draw lessons. Most senior business executives took a decade or more to develop their business judgment, but with the

tenure of CEOs becoming shorter as investors' expectations rise, most top teams just cannot wait years to improve their performance. Facilitating team cycles of action and reflection—accelerating the pace of change and making the process of discovery explicit—can have a significant effect in as quickly as three months.

What it looks like

On the face of it, a top team going through the performance improvement process resembles any other top team at work. As usual, CEOs and senior executives address a number of strands of business, but they focus on major

A case study

Creating a new organizational structure does little to improve a company's performance if the top team can't work together effectively. One dysfunctional top team ran a fast-growing UK industrial company trying to launch a new growth strategy. The company replaced its centralized functional silos with semi-autonomous business units led by a smaller top team. At first, the new organization seemed to be taking shape, but months after its formation the CEO saw that the senior team was struggling to manage the performance of the company's business units, to respond to crises, and to develop a corporate strategy. He feared that the team's lackluster performance would hold back the rest of the organization. A quick survey of managers a level below the top team confirmed his fears: the top team, it appeared, was "running behind," "stuck in old behavior," and "generally not very helpful."

How could the performance of the senior team be improved quickly without reverting to the command-and-control system? The CEO felt that the team was missing important opportunities to expand the business while focusing on trivial issues. Further, he wondered why only half of the team participated in debate and whether the others had no opinion or were simply afraid to argue their own points of view.

After reviewing the feedback from the leaders of business units, the top team began the process of improvement by acknowledging that it needed to change its approach, and quickly. As a next step, the members of the team identified their top ten priorities—and discovered a range of conflicting views. The team tried to sort these priorities and to define a common strategy. Meanwhile, a facilitator observed the team at work and later interviewed its members at length. Thus, their poor interaction was added to the range of issues under consideration.

The team committed itself to monthly one-day sessions focusing on major strategic issues, and the facilitator tracked its progress on interaction. These sessions addressed a series of topics—talent, strategy, performance, growth—that strategic issues and work together as colleagues rather than delegate tasks to staffers, consultants, or individual team members. At a minimum, the entire top team should spend one day each month together, without staffers, doing real work as a team. Subgroups of two or three members should work together a couple of times a week on every issue the team is addressing and should probably spend some time with a facilitator as well.

Teams rarely manage to improve their performance wholly outside their active working environment, so short-term workshops, no matter how attractive the setting or how heart-felt and candid the members' exchanges may be, aren't likely to change their mode of working. Structured self-discovery

stretched the team's thinking and opened new opportunities for the company. Between sessions, subgroups of two or three members worked on issues for the full team to debate and resolve.

Over a three-month period, there was an improvement in all three dimensions of team performance:

1. A common direction

The team members were much more explicit about their individual and collective roles, including responsibilities and behavior. They also reached consensus on a number of business fundamentals: strategy, performance, people, and organization. As a result, the top team now plays a much more active role in leading the corporate strategy.

2. More effective interaction

The quality of the team's debate and decision making rose dramatically. Individual members of the team could take risks with one another, exposing their previously hidden agendas and making their dialogue more honest, because the level of trust had risen substantially. The result was wider participation, more constructive debate, greater excitement, and more creative output.

3. Active renewal processes

To inject new ideas and fresh perspectives, the top team looked for outside sources of information and developed a variety of scenarios about its industry. It also increased its effectiveness through individual coaching of members as well as by recruiting a new member from outside the company.

"I can't imagine going back to the way we were before," the CEO said. "Not just the old structure but the old way of working. Our modus operandi is just fundamentally different. Almost everyone participates; the atmosphere is more relaxed yet at the same time more openly challenging. I especially appreciate the value of our reflective working sessions, which give us a chance to step back and make sure we are not missing the big picture."

and reflection must be combined with decision making and action in the real world; the constant interplay among these elements over time is what creates lasting change.

Why it works

Teamwork is a pragmatic enterprise that grows from tangible achievements. The action-reflection cycle—supported by improved direction, interaction, and renewal—complements the work style of most senior teams. First, this approach pushes them to address their own performance just as directly and forcefully as they would address other business performance issues. By doing real work on important problems and applying business judgment to reflect on that work, top teams jump-start their performance and satisfy their need for visible progress.

> By doing real work on important problems, top teams jump-start their performance as well as satisfy their need for **visible progress**

Second, taking an oblique approach to sensitive performance issues allows top teams to address their behavior after the event, without personal confrontations. Team members discover that alternative points of view are valid, that the CEO doesn't have all the ideas the company needs for success, and that the team can be both challenging and supportive at the same time. This paradoxical combination—the indirect assessment of team behavior through direct work on critical issues—allows top teams to manage their own performance. Before investing time and resources in programs to build the top team, leaders should ensure that such efforts deal with its real work.

Teams must assess their own performance regularly and honestly. Every senior team should also dedicate several working sessions a year to issues—such as technology, changing demographics, political and environmental pressures, and emerging themes from management literature—that have little bearing on the next quarter but could reshape the enterprise and the team itself during the next five years. Teams should also explore unexpected successes and interesting failures inside and outside their organizations. They ought to travel, both physically and intellectually, outside their own regions and industries to companies that have tackled challenges similar to their own.

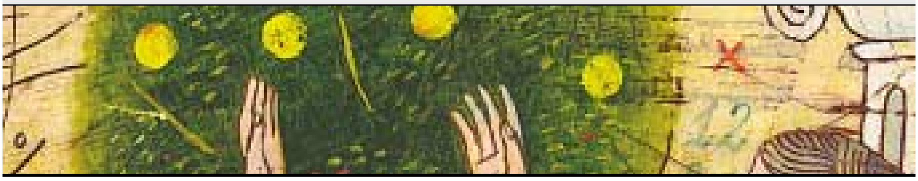
In doing all this, teams should pay attention to the consistency of their leadership, the quality of their interaction, and their opportunities for renewal.

They must also build into their work processes ample time to reflect on the deeper causes of problems, on the areas where they can add the most value as a team, and on the quality of their past decisions. It is the process of discovering the best way for the members of the team to work together that ensures the absorption of basic behavioral lessons.

The prize for building effective top teams is clear: they develop better strategies, perform more consistently, and increase the confidence of stakeholders. They get positive results—and make the work itself a more positive experience both for the team's members and for the people they lead. Q

In working with top teams, the authors have applied the direction-interaction-renewal framework originally developed in the trailblazing work of Michael Jung and other McKinsey colleagues in the leadership and organization practice. The authors gratefully acknowledge their contributions.

Erika Herb is a consultant in McKinsey's London office, where **Keith Leslie** and **Colin Price** are principals.



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The McKinsey Quarterly, 1994 Number 2

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