Better strategy through **organizational** design

Redesigning an organization to take advantage of today's sources of wealth creation isn't easy, but there can be no better use of a CEO's time.

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Corporate strategy, according to the classic definition, consists of the actions a company takes to gain competitive advantage. Executives invest enormous energy in product designs and long-range strategic plans, though many of these initiatives become obsolete as markets and competitors adapt, social norms and regulations evolve, and technologies advance. Yet most corporate leaders overlook a golden opportunity to create a durable competitive advantage and generate high returns for less money and with less risk: making organizational design the heart of strategy. It's time for executives to recognize the strategic need to develop organizational capabilities that help companies thrive no matter what conditions they meet.

Modern corporations are massive, complex, dynamic ecosystems. In many of them, organizational inertia is considerable. Organizational-design work is hard and time consuming, and any meaningful change usually involves difficult personality issues and corporate politics. No surprise, then, that rather than tackle internal organizational issues to boost the performance of companies, many CEOs typically opt for the ad hoc structural change, the big acquisition, or a focus on where and how to compete.

Clement Mok

Article at a glance

Executives have a golden opportunity to orient strategy around organizational design and thus to make companies thrive no matter how market and competitive conditions change.

Organizational-design work is hard and time consuming, but its payback—in profits, costs, and risks—surpasses that of investments in product design and other traditional strategic initiatives.

Building strategy around organizational design represents an evolution away from the organizational structures of the 20th-century industrial age, when capital was the scarce resource and vertical, hierarchical structures were the key to efficient performance.

The key ingredients of progressive corporate strategy in the 21st century are "one-company" governance structures, knowledge and talent markets, and organizational designs intended to maximize collaboration among the talented workers who create today's wealth.

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They would be better off focusing on organizational design. Our research convinces us that in the digital age, there is no better use of a CEO's time and energy than making organizations work better. Most companies were designed for the industrial age of the past century, when capital was the scarce resource, interaction costs were high, and hierarchical authority and vertically integrated structures were the keys to efficient operation. Today superior performance flows from the ability to fit these structures into the present century's very different sources of wealth creation. By remaking the organization to mobilize the mind power of the workforce and tap into its underutilized talents, knowledge, relationships, and skills, companies can both help their people to undertake more rewarding, productive work and create sources of significant new wealth at relatively low risk.

Corporate leaders can consciously design and build organizational interventions to achieve these goals, but to do so they must think holistically about designs incorporating market mechanisms that nurture talent and knowledge, governance structures that undo unproductive complexity, and new performance metrics—notably profit per employee—that are suited to a business environment where talent, not capital, is the scarce resource. Companies that are large, complex, and talent driven are typically the best candidates, but our thinking on organizational design also applies to smaller companies and to poorly managed as well as well-run ones.

Modernizing organizational designs for a 21st-century business environment can trump the gains generated by other, more traditional strategic initiatives. The work often takes years of sustained effort to put in place but pays off by creating competitive advantages that rivals can't copy easily.

Strategic-minded executives may not be able to control the weather, but they can design a ship and equip it with a crew that can navigate the ocean under all weather conditions.

Creating wealth from talent

The opportunity to create wealth by reducing unproductive complexity and increasing productive interactions is great in today's corporations. (Of course, not all forms of complexity are unproductive; for a discussion of institutional versus individual complexity, see "Cracking the complexity code," in the current issue.) The numbers rapidly become large. If a company with 100,000 employees makes internal organizational-design changes that add $30,000 in profit per employee,[1] for instance, that would mean $3 billion in extra profits. Since they would be what economists call "rents"—additional earnings requiring no additional, marginal invest- ment of capital or labor—they would create $30 billion in new wealth (at a 10 percent capitalization rate).

We arrived at our convictions about strategic organizational design not just through qualitative judgments but also through a quantitative analysis of the forces that have driven the market capitalization of the leading companies since the start of the networked digital age, in the mid-1990s. From 1995 to 2005, the 30 companies with the largest market capitalization in 2007 saw their profit per employee soar, on average, to $83,000, from $35,000. The number of people these companies employ more than doubled, on average, to 198,000, from 92,000. Their return on invested capital (or book value, in the case of financial institutions) increased to 23 percent, from only 17 percent (that is, by about one-third). As a result, this group's median market capitalization rose nearly fivefold, to $168 billion, from $34 billion, with a total return to shareholders (TRS) of 17 percent a year. The driver of this increase in market caps was a fivefold increase in average profits. This increase in the profit per employee of the 30 com- panies with the largest market caps contrasts sharply with the relatively uniform relationship between profits and the number of employees of large companies before 1990 and the lack of such a dramatic improvement subsequently for the average large company.[2]

It is hardly news that the growth of profits and of market caps should be closely correlated and that a fivefold increase in the one should lead to a fivefold increase in the other. But this relationship does suggest that today

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[1] That sum represents the difference between the profit per employee of the top 30 companies in an industry and the next 30.

[2] The relationship between a company's profits and its number of employees remained relatively consistent from at least 1970 to 1990. The order-of-magnitude changes that occurred after 1990 are clearly outside any normal business cycle activity.

the creation of wealth calls for a new focus: maximizing returns on people, not capital. Total profits, after all, are the product of profit per employee and the total number of employees. Maximizing profit per employee and the number of employees therefore increases total profits, which in turn drive market capitalization.

Focusing on this formula (rather than returns on capital and on the amount of capital deployed) offers several advantages. For one, profit per employee, unlike returns on capital, is a good proxy for earnings on intangibles. The reason, in part, is that the total number of employees is easy to obtain, while a company's capital, surprisingly, is subject to the vagaries of accounting on issues such as goodwill and to corporate-finance decisions such as debt-to-equity ratios, dividend policies, and liquidity preferences. And these days, talent—not capital—is usually a company's scarcest resource.[3]

Talent is the scarce resource because it is the ultimate generator of the intangibles that drive the creation of wealth in the digital age. Winning companies are those that can increase their profit per employee by mobilizing labor, capital, and mind power into profitable institutional skills, intellectual property, networks, and brands. The returns to companies that can accomplish all this are extremely attractive because intangibles now confer enormous scale and scope advantages. Furthermore, intangibles represent unique assets for the individual companies in possession of them— that is, they are unique in supply—so they can create "natural monop- olies," which are difficult for other companies to replicate.

Unfortunately, however, almost all of today's companies, from the mediocre to the superlative, were built primarily to mobilize labor and capital, not the intangible assets that generate increases in profit per employee. Trying to run a 21st-century company with organizational models designed for the 20th limits how well it can perform and creates massive, unnecessary, and unproductive complexity, which frustrates workers and wastes money. The structural ailments that plague the modern corporation include hard- to-manage businesses, thick silo walls, confusing matrix structures, e-mail overload, and "undoable" jobs.[4]

Today's companies must redesign themselves to remove unproductive complexity while simultaneously stimulating the effective, efficient creation and exchange of valuable intangibles. They must be able to mobilize mind

[3] Lowell L. Bryan, "The new metrics of corporate performance: Profit per employee," *The McKinsey Quarterly*, 2007 Number 1, pp. 56–65.
[4] Lowell L. Bryan and Claudia Joyce, "The 21st-century organization," *The McKinsey Quarterly*, 2005 Number 3, pp. 24–33.

power as well as labor and capital. In other words, they can overcome the organizational challenges they face and thereby create extraordinary wealth.

Organization as strategy

Our approach to organizational design springs not from the work of organizational theorists but from our perspective as organizational strategists. Organizational design, we believe, should be about developing and implementing corporate strategy. Organizations can be designed to fit the economic conditions of the 21st century and use specific initiatives to put such designs in place. Companies that do so can create substantial new wealth for their shareholders.

Debates among academics, consultants, and HR professionals who work in the field of organization are notorious for their variety and intensity. Any student who ventures into the literature will quickly be caught up in these controversies. A central one concerns the trade-offs between organizational approaches to structuring work. Should companies emphasize collaboration, which puts a premium on their employees' mutual self-interest and the sharing of specialized skills and individual knowledge? Or should they rely instead on hierarchical authority, the most powerful tool they have for mobilizing large numbers of people efficiently? Other debates focus on the benefits of centralization versus decentralization, the roles of management and leadership, organizational design versus change management, and so on.

These debates were relevant in the past; after all, in the 20th-century world economy, the costs of interacting and transacting business were very high, and many different organizational models had advantages and disadvantages. But in today's digital and global economy, many of these historic trade-offs lack meaning: for example, interaction and transaction costs have tumbled and continue to fall, so the issue is no longer whether hierarchy or collaboration is better. Hierarchy and collaboration are, and will continue to be, essential elements of all large, successful enterprises. The critical issue for performance-minded executives is how to use both more effectively to liberate talented people from unproductive complexity.

Hierarchy, for instance, is efficient for setting aspirations, making decisions, assigning tasks, allocating resources, managing people who cannot direct themselves, and holding people accountable. Even in the 21st century, we need hierarchy to put boundaries around individuals and teams. Management must ensure that workers direct and organize their own work so that it furthers the interests of the shareholders, not just their personal interests. Hierarchy, then, is necessary.

But the new element that can help 21st-century corporations create more wealth is large-scale collaboration, across the entire enterprise, enabled by digital technology. In small organizations (such as teams), natural mutual self-interest often drives people to collaborate. But to make people collaborate in large organizations, you must create a sense of mutual self-interest by holding talented, ambitious employees accountable not just for their own work but also for their performance in helping others within the organization. (That's why basketball players are measured on their ability to get the ball to players who then score—assists, to use the technical term—as well as on the points they themselves score.) Digital technology provides the means not just to promote efficient, effective, and large-scale collaboration but also to measure each person's "assists" and thus motivate employees to collaborate in ways that were not possible in the past.

Mobilizing minds

If the common enemy in today's corporations is unproductive complexity, the trick will be to design companies so that both hierarchy and collaboration can do their work efficiently and effectively. Our answer to this challenge involves reworking the practical nuts and bolts of organizational design to free up the wealth-creating power of a company's talented, self-directed employees.

In essence, to overcome unproductive complexity, a company must undertake a management initiative specifically to make itself operate as a single profit center that can allocate decisions among the employees best able to make them. To do so, the company will have to streamline its hierarchy and learn how to expand its capabilities horizontally rather than adding vertical layers. It must also become more flexible by giving managers the freedom to add or shed talent as necessary and to pull whatever information and knowledge they need from the organization's best minds. The workers closest to the company's business opportunities must collaborate easily with one another, exchanging knowledge throughout the enterprise, and find jobs that match their skills and development needs. And the company will have to become much better at measuring its performance if it is to motivate these people and hold them accountable.

The starting point is streamlining the way hierarchy is used so that it can become efficient and effective. Such a design involves creating one simple backbone line structure to drive performance and place authority at the front line, where a company's most direct contact with its business opportunities occurs. This approach will require most companies to eliminate the matrix structures that have grown up in their intermediate levels and, at the same time, to replace these with formal network structures

that use mutual self-interest rather than authority to motivate collaboration. Another key to such a design is creating enterprise-wide shared utilities that serve as centers of excellence in functions such as branding or financial analysis and make it possible to capture scale effects without compromising on service to line operations.

To prevent these line and support structures from becoming silos that hinder effective enterprise-wide collaboration, other design changes are required. Chief among them is creating a "one-company" governance structure by establishing a partnership at the top to run the company and using enterprise-wide standards, protocols, and values to develop an effective one-company culture. This partnership should also lead the strategic initiatives that help the company adapt to a constantly changing external environment and that better balance short-term earnings pressures with the need for long-term investments.

With such a streamlined, one-company organization in place, market mechanisms can be introduced to improve the flow of intangible assets throughout the enterprise. These mechanisms include not just formal networks but also talent and knowledge marketplaces, which remove unproductive complexity while stimulating the efficient, effective mobilization of mind power. All of these approaches are designed to help self-directed people work more effectively with one another, outside the company's hierarchical structures, from a sense of mutual self-interest.

Formal networks provide the organizational structure to harness the power of a company's natural communities of mutual interest, which have emerged spontaneously in the digital age. These networks, sometimes called "communities of practice," boost the value of the informal networks that in many companies already exist among groups of professionals or managers with common interests rooted in similar jobs, skills, or needs for knowledge. Investing in and formalizing the roles of such networks can encourage people with common interests to collaborate with relatively little ambiguity about decision-making authority. In vertical or matrix structures, such ambiguity generates internal organizational complications and tension.[5]

A knowledge marketplace enables a company to motivate the people who create knowledge and seek to exchange it from a sense of mutual self-interest. A company's valuable knowledge resides largely in the heads of its

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[5] Robert L. Cross, Roger D. Martin, and Leigh M. Weiss, "Mapping the value of employee collaboration," *The McKinsey Quarterly*, 2006 Number 3, pp. 28–41.

most talented, thoughtful employees: professionals and managers. For the better part of two decades, companies have invested heavily in knowledge management—with limited results because real value comes less from managing knowledge than from creating and exchanging it. To promote the exchange of knowledge, companies must remove the structural barriers to the interactions of professionals and managers as they solve problems. The trick is to create, within a company, markets with "knowledge objects" to trade, buyers to acquire them, and exchange mechanisms to facilitate the transfer. Significant investments may be needed to establish and run such markets, but they can substantially improve the ability to create and exchange knowledge and dramatically cut the costs of searching for and disseminating it across an organization.

As for a talent marketplace, it can create efficiencies by helping employees in a talent pool to explore alternative assignments, of varying duration, within a single organizational unit or across a vast enterprise. Talent markets, now at an early stage of development in some large corporations, enable managers to "pull" the best people while simultaneously giving talented employees greater choice over their assignments so they can find the jobs that best fit their skills and development needs. Companies must define a talent marketplace by, among other steps, specifying standardized roles, validating the candidates' qualifications, and establishing the compensation standards for roles or assignments. The payback is the ability to connect gifted men and women more directly and efficiently with managers seeking talent.

Modified financial-performance metrics to change the behavior of professionals and managers are also essential. Almost all companies are far too focused on accounting earnings and returns on capital rather than on creating higher economic returns from intangibles. Furthermore, they rely too heavily on measures of individual rather than mutual accountability and thereby promote dysfunctional behavior. Some of the ideas discussed in this article are far reaching; they would require companies to redesign their internal financial-performance measurement and employee evaluation systems fundamentally to motivate and drive wealth-creating activity.

A worthy goal

Such comprehensive design work will certainly require a company's leaders to invest significant energy and focus. But we are convinced that there is no greater opportunity to create better organizations that are more closely aligned with the fundamentals of today's global business environment. For a large company, the value of increasing profit per employee and the

number of employees who can work together profitably is tens of billions of dollars in additional market value.

Such an investment will usually generate the highest possible returns, relative to the costs and risks, of almost any possible use of labor or capital. Companies routinely spend huge amounts of money designing better ways (such as call centers or factories) for employees to do labor-intensive work. They also invest heavily in activities such as designing new products. We believe that the time has come to apply these levels of investment to redesign the way organizations undertake thought-intensive work. The challenges may be great, but the payoffs in profitability and organizational excellence will be even greater.

In the 21st century, the real money will be in strategic organizational design. Only corporate leaders can address this issue as it should be addressed— throughout the enterprise. Q

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