

QUICK LOOK

- ⇒ Employees working beyond the executive suite often are less aware of total return to shareholders and how they can contribute to it in their daily jobs.
- ⇒ Companies need to identify and isolate those drivers that have the greatest impact on total return to shareholders and successful strategy execution, and communicate them to employees.
- ⇒ Incentive pay is the trump card in reinforcing organizational accountability for the key drivers.

mobilizing and engaging an organization to build enduring value

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What does it take for strategy to succeed? Corporations spend significant time on research, analysis and negotiation to create a winning strategy. Yet many strategies fail not because they are poorly conceived, but because they are poorly executed. Even the best-devised strategies risk failure if managers and lower-level employees don't understand what makes strategy happen and how they, as individuals and teams, fit into the plans.

The whole organization should be aligned with the business imperatives, and alignment is best achieved when employees know what they can do in their own jobs to make a difference. This occurs when the key drivers of value and strategic success are “unbundled” and communicated.

Unbundling refers to the means to:

- Achieve horizontal and vertical alignment across the organization
- Help people understand how they can contribute to overall business success
- Build accountability at all levels
- Create joint accountability through shared goals
- Link goals to rewards.

The unbundling process itself can be an important tool to clarify strategy, as it brings clarity to what truly is required to be successful.

Determine Value Drivers

Most public companies share the objective of increasing long-term total

return to shareholders (TRS). However, employees working beyond the executive suite often are less aware of TRS and how they can contribute to it in their daily jobs. Therefore, employees further down in the organization are best measured on those key drivers of company strategy and TRS that hold meaning for them and that they can influence most directly.

As such, companies need to identify and isolate those drivers that have the greatest impact on TRS. Clarifying company strategy, then coupling that with financial modeling, assessing historical correlations between the drivers and TRS, and/or carefully reviewing the metrics that analysts follow can identify drivers with the greatest impact.

A value tree, illustrated in Figure 1 on page 42, is a helpful tool for establishing a clear line of sight from individuals' efforts to the drivers of company value and strategic success. Value trees can be extended through successive levels to identify the key measures for specific departments and functions.

Value drivers may be financial, strategic or operational in nature. Strategic and operational drivers usually encompass determinants of customer value, measures of the effectiveness of internal operations and processes, the strength of organizational capabilities and the ability to sustain performance. Most companies do not need to start

from scratch in identifying strategic and operational drivers. Instead, they often are revealed in strategic planning efforts, customer satisfaction surveys, quality improvement efforts, etc. The value tree exercise is an opportunity to integrate the key learnings from different and often disconnected efforts into a common structure focused on companywide value creation. To that end, companies benefit from involving a broad range of individuals in identifying and prioritizing value drivers.

Isolate Leverage Points

A value tree exercise can illuminate numerous measures; prioritizing measures is an important next step. Pinpoint the drivers that will have true impact by answering the following:

- **Is this a high priority for customers?** Focus on drivers that have the most impact on the customer value/cost equation.
- **How does current performance measure up to the competition?** Significant improvement opportunities are good measures.
- **Is it worth the investment to improve?** A driver represents a good leverage point if performance lags the competition, if the driver is highly valued by customers and if catch-up costs are reasonable.

After evaluating its value drivers, a high-tech company found that its products were technologically superior

to its competitors' products. However, that superiority came at a price: Cycle time for new product development was far longer than the competitions' cycle times, and the company was losing key sales by being late to market. To solve the problem, the company lessened its focus on increasing its technological advantage and instead concentrated on reducing time to market. The strategy paid off. By reducing the cycle time by six months, the company increased margins by 3 percent and new product revenues by 20 percent, with an ultimate impact of \$5 million per year.

Mobilize the Company

Once the principal value drivers are determined and prioritized, individuals and teams should be made accountable for the drivers they influence. This requires mapping accountabilities across the organization, setting value

improvement targets and reinforcing accountability through rewards.

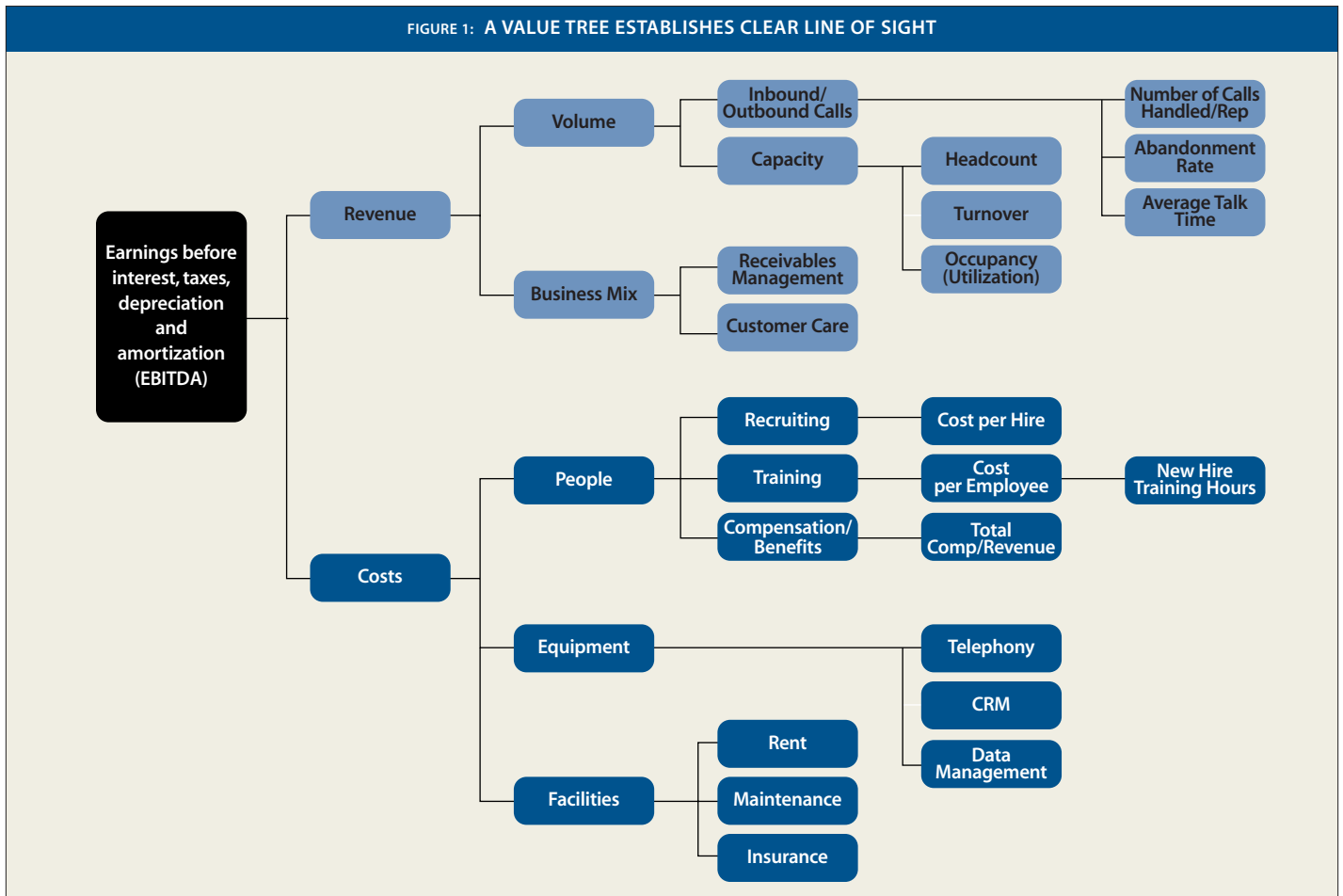
Map Accountabilities

Mapping involves assigning specific accountabilities for the value drivers to different parts of the company, thus building ownership for these drivers among groups within the company. It is important to strike a balance between those value drivers that provide clear line of sight and those that are divided so finely that they encourage or reward actions that would diminish performance. Individuals, groups or teams may classify measures, with shared accountability assigned to any interdependent parts of the value chain. Such classifications send clear messages about the need for cooperation and the expectation that multiple units will share responsibility across functions.

The mapping process is far superior

to traditional approaches to linking individual employees' performance and corporate performance. A major Northeastern company discovered the hard way that cascading goal setting doesn't automatically produce anticipated results. Like many organizations, this company tried to encourage cooperation by basing a portion of employee incentives on overall corporate performance and the building of individual accountability through individual goals that managers developed for their direct reports. In the end, the goal-setting process produced three anticipated results. First, employees received fragmented, misaligned and, at times, contradictory signals because individual objectives were based on the different managers' interpretations of corporate priorities, which were sometimes accurate but sometimes not. Second, because the

FIGURE 1: A VALUE TREE ESTABLISHES CLEAR LINE OF SIGHT



process was being conducted on a functional basis, it failed to recognize the number of areas in which cooperation and joint responsibility were required. Third, because employees did not understand the corporate objectives and how they affected goals, they found themselves focusing on daily tasks rather than overall company performance improvement.

Set Value Improvement Targets

Short-, intermediate- and long-term performance targets should be established, taking both a top-down and bottom-up perspective. The top-down perspective reflects the company's obligations to shareholders and involves consideration of historical performance, future expectations and continuous year-over-year performance improvement. (See Figure 2.) From a bottom-up perspective, consideration should be given to:

- **Internal Comparison.** This is appropriate if the company has multiple locations or similar units and can determine how much improvement would result if lower-performing units matched the benchmark (e.g., a residential services provider with hundreds of locations focused on bringing all units that are below median up to median, and all median performers to the 75th percentile). Comparisons also can be made over time by benchmarking against best month's or year's performance.
- **Technical Limits.** To establish technical limits, it is helpful to take an engineering approach by identifying the optimal performance level. Companies can examine key processes to see how close results can get to optimal performance (e.g., reducing downtime).
- **External Comparison.** External comparison to a peer group enables a company to assess competitor performance (e.g., a call center

FIGURE 2: BENCHMARKS FOR SETTING TOP-DOWN GOALS

Benchmarks	Issues to Address
Historical performance of peers (e.g., top-line growth, bottom-line growth, returns)	<p>If performance is below peers, determine:</p> <ul style="list-style-type: none"> • The gap between actual results and competitive performance • The reasons for underperforming and whether these reasons can be acted upon • How long it takes to achieve results on par with the industry. <p>If performance is above peers, determine what is required to sustain and/or further improve performance.</p>
Future market expectations (e.g., analyst expectations for the company and industry)	<p>Consider:</p> <ul style="list-style-type: none"> • Whether the company is positioned to meet or exceed market expectations for its own performance • If analysts' expectations for the industry vs. the company differ and if so, why • The amount of stretch required to meet industry expectations • Time required to achieve industry expectations and a reasonable ramp-up plan.
Continuous year-over-year company performance improvement	<p>Consider:</p> <ul style="list-style-type: none"> • Internal factors that will affect future performance (e.g., new product launches, technological breakthroughs, etc.) • Market factors that will affect future performance (e.g., potential market growth, mortgage rates) that could impact performance, and whether market share will be captured or lost.

benchmarked each of its work processes against peer data to identify improvement opportunities).

In the end, the art and science of goal setting consists of determining which approach or combination of approaches is most appropriate in a given organization at a given time.

Reinforce Organizational Accountability

With improvement targets set, the next step is to establish ways to monitor and reinforce performance on key value drivers. Existing management processes can aid in accomplishing those tasks — from generating awareness of the company's values and goals to performance management, career development, organization and job design and rewards, both financial and nonfinancial. Companies should prioritize the different processes and align them to support value creation.

Link Value Creation to Rewards

Incentive pay is the trump card in reinforcing organizational accountability because it sends such a strong message to employees about the most important drivers of the company's value creation. Incentives also enable the company to

hold employees accountable for those drivers that they affect.

Designed with well-chosen measures and well-set goals, incentives can produce dramatic improvements in value and, ultimately, in TRS. Designed poorly, incentives can seriously undermine value creation by:

- Centering individuals and teams on the wrong measures
- Focusing divisions or work groups on cross-purpose, conflicting activities
- Distracting and demotivating employees.

To create a real community of interests, it is critical to focus all incentive programs on driving value. At the executive level, where portfolio decisions are made about businesses and investments, focus incentives on the results those decisions produce for shareholders. At the business-unit level, where value is created through operations, measure incentive performance on key financial results and the strategic and operational value drivers influencing those results.

Also, use incentives to reinforce only the three to five most important drivers for each function or area. More drivers fragment the incentive plan. Use other rewards (e.g., spot awards, noncash

CASE STUDY: A FINANCIAL SERVICES COMPANY

A regional bank set a strategy to transform itself into a premier regional financial services institution with a strong focus on customer relationships. The company established three key business imperatives:

- Achieve superior top-line growth
- Maintain a cost structure in line with revenue
- Achieve superior returns on capital and earnings-per-share growth.

Achieving the strategy hinged on leveraging the bank's strong customer relationships and distribution channels to sell a broad range of financial services and products. The bank needed to retool its infrastructure to manage costs and support the strategy. It also needed to expand geographically to provide the engine for growth and convince stock analysts that it was more than a local bank with limited growth prospects.

The new strategy required major changes in all roles to attain its vision. Starting at the top, the bank's leaders needed to break out of their silos, abandon the comfort of hierarchy and evolve into true change agents, with strong market and customer orientations and long-term strategic focus. They had to begin collaborating on interdependent teams.

Given the strategy, the bank identified three broad categories of metrics, all aimed at driving TRS. The corporate financial objectives, specifically growth in earnings per share and return on equity, were clear drivers of TRS. They also identified key elements of the vision and strategy at a business-unit level, including business-unit earnings and metrics that addressed the strength and breadth of customer relationships. The final measures were corporate strategic and operational financial drivers that were key to managing costs and supporting strategy. Included in this group were efficiency ratio, revenue growth and credit quality. Measures were assigned and weighted according to each plan participant's accountabilities and ability to influence the measure. As an example, the figure below shows assignment and weightings of the measures for the top executive team. Note that goals were shared among team members to reinforce the need for collaboration.

WEIGHTING OF OPERATIONAL MEASURES FOR BANK'S LEADERSHIP TEAM

Metrics	EVP & COO General Banking Group	President and COO Financial Services Group	EVP and Chief Banking Officer	EVP and Chief Financial Officer	EVP and Chief Risk Officer	EVP and Chief Information Officer
Efficiency Ratio	20%	20%	20%	50%	20%	50%
Revenues— fee-based and interest-based	40%	50%	40%	35%	35%	35%
Credit Quality	40%	30%	40%	15%	45%	15%

As shown in the figure below, goals were tied to the achievement of absolute targets that reflected both historical and prospective analysis of peer-group performance and analyst forecasts, with targets set above the peer-group medians.

EARNINGS-PER-SHARE GROWTH

	Historical Five-Year Average	Prospective Forecast
Bank's Percent Change	15%	16%
Peer Group — Median Percent Change	11%	12%
Peer Group — 75 th Percentile Percent Change	21%	17%
Analyst Forecast for Regional Banks	—	10% - 12%

Even before plan performance results were known, the process of unbundling TRS, identifying the drivers and making the measures "personal" made a difference in the organization. The process alone helped employees grasp what it would take to execute strategy, heighten customer service and manage costs more effectively. The clarity of focus sparked collaboration and teamwork and a common sense of purpose to move the organization toward its goal of becoming a player of consequence in a much broader market.

FIGURE 3: VALUE CREATION INCENTIVE MEASURES FOR EMPLOYEE GROUPS

Type of Plan	Top Corporate Executives	Business Unit Executives	Other Employees (e.g., production, distribution, sales, etc.)
Long-Term Incentives	Focus on TRS via equity vehicles (e.g., stock options).	Focus on corporate TRS performance to reinforce membership on the corporate management team or the need for the significant sharing of resources across business units.	
Intermediate Term (Three to Five Years)	Corporate drivers of value creation.	Base on business unit value creation if the unit operates fairly autonomously and requires minimal sharing of resources.	
Annual Incentives	Link to corporate value creation or primary and/or secondary drivers of value (e.g., invested capital and earnings growth). May also include key organizational strategic/operational drivers (e.g., customer satisfaction or customer retention).	Base on the business unit's value creation performance during the year and/or performance versus strategic and operational value drivers.	Link to economic and/or strategic/operational value drivers.
Salary	Link to capability improvement in place of or in conjunction with annual incentives.	Link to capability improvement in place of or in conjunction with annual incentives.	Link to capability improvement in place of or in conjunction with annual incentives.

recognition) and management processes (e.g., performance management, regular management reporting) to reinforce other drivers. Figure 3 explains how to approach incentive measurement for various employee groups.

The incentive designs described in Figure 3 primarily focus on team or work-group performance. Other ways to incorporate individual performance measurement include:

- Using individual performance to create rises or drops to the earned team reward
- In areas in which individual performance is more critical than team results, base performance measures either primarily or entirely on individual performance (provided that the measures align with broader value creation efforts).


For a publishing giant launching a new magazine, a critical concern was motivating company executives to act like owners and ensure a successful start. The key

was creating a performance-unit incentive based on value creation. A value tree helped isolate the key performance measures that drove the business's value: operating margins, revenue growth and asset utilization. The incentives focused executives' actions on the results that would contribute to value creation. The company also identified the amount of value created under various performance scenarios, leading to a payout schedule that linked to the amount of value created. The company also identified how much of the value created at different performance levels would be shared with plan participants as a group. This step validated the reasonableness of overall funding levels.

In the end, a fairly complex model was translated into three measures and a payout matrix, tracking with the value created at different performance levels. Participants could clearly see what was required and how trade-offs between performance on different measures

affected incentives. The result: The venture attracted and retained key executives who were highly motivated to grow value during and after the magazine's launch. The new magazine went on to become one of the most successful launches in the publishing industry.

Moving Ahead

Clearly there are challenges involved in adopting the process outlined in this article. However, as discussed in "Case Study: A Financial Services Company," companies that take the challenge find it is well worth the effort. Mobilizing for value creation can enable companies to take a more holistic approach to organizational performance and rewards. In turn, this approach can foster cross-functional teamwork and accountability for those things that really do make a difference — and ultimately create value and strategic success — in the company. As with any program, desired results will not occur without continued focus and effort, but evidence shows that behavior will change if it is measured and rewarded. 

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