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STRATEGY PRACTICE

Tapping the strategic potential of boards

Chinta Bhagat, Martin Hirt, and Conor Kehoe

Too many boards just review and approve strategy. Three questions can help them—and executives—begin to do better.

It's late afternoon in the boardroom, and the head of a major global infrastructure company's construction business is in the hot seat. A director with a background in the industry is questioning an assumption underlying the executive's return-on-invested-capital (ROIC) forecast: that the industry's ratio of leased (versus owned) equipment will remain relatively constant. The business leader appears confident about the assumption of stability, which has implications for both the competitive environment and for financial results. But the director isn't convinced: "In my experience, the ratio changes continuously with the economic cycle," he says, "and I'd feel a whole lot better about these estimates if you had some facts to prove that this has changed."

An uneasy silence settles over the room: the board member's point appears quite relevant but requires a familiarity with the industry's behavior and economics, and the rest of the board doesn't have it. Finally, the chairman intervenes: "The question John is raising is critical and not just for our construction business but for our entire strategy. We're not going to resolve this today, but let's make sure it's covered thoroughly during our strategy off-site. And Paul," says the chairman to the CEO, "let's have some good staff work in place to inform the discussion."

If the preceding exchange sounds familiar, it should: in the wake of the financial crisis, we find that uncomfortable conversations such as this one[1] are increasingly common in boardrooms around the world as corporate directors and executives come to grips with a changed environment. Ensuring that a company has a great strategy is among a board's most important functions and the ultimate measure of its stewardship. Yet even as new governance responsibilities and faster competitive shifts require much more—and much better—board engagement on strategy, a great number of boards remain hamstrung by familiar challenges.

The strategy challenge for boards

For starters, there's the problem of time: most boards have about six to eight meetings a year and are often hard pressed to get beyond compliance-related topics to secure the breathing space needed for developing strategy. When we recently surveyed board members to learn where they'd most like to spend additional time, two out of three picked strategy. A related finding was that 44 percent of directors said their boards simply reviewed and approved management's proposed strategies.

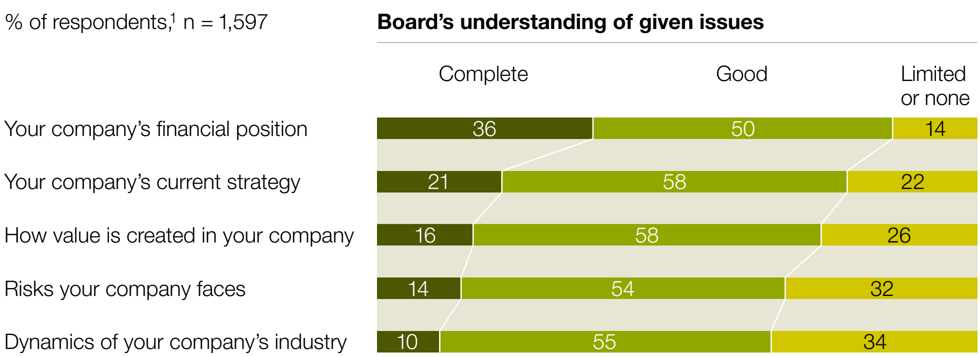
Why such limited engagement? One likely reason is an expertise gap: only 10 percent of the directors we surveyed felt that they fully understood the industry dynamics in which their companies operated. As a result, only 21 percent of them claimed to have a complete understanding of the current strategy (exhibit).

What's more, there's often a mismatch between the time horizons of board members (longer) and of top executives (shorter), and that lack of alignment can diminish a board's ability to engage in well-informed give-and-take about strategic trade-offs. "The chairman of my company has effectively been given a decade," says the CEO of a steelmaker in Asia, "and I have three years—tops—to make my mark. If I come up with a strategy that looks beyond the current cycle, I can never deliver the results expected from me. Yet I am supposed to work with him to create long-term shareholder value. How am I supposed to make this work?" It's a fair question, particularly since recent McKinsey research shows that major strategic moves

[1] This conversation is drawn from real events, though we have changed the names of those involved.

Exhibit

Board members said they understand their company's financial position significantly better than its risks or industry dynamics.



[1] Respondents who answered "don't know" are not shown; figures may not sum to 100%, because of rounding.
Source: June 2011 McKinsey survey of 1,597 corporate directors on governance

involving active capital reallocation deliver higher shareholder returns than more passive approaches over the long haul, but lower returns over time frames of less than three years.[2]

Compounding these challenges is the increased economic volatility prompting many companies to rethink their strategic rhythm, so that it becomes less calendar driven and formulaic and more a journey involving frequent and regular dialogue among a broader group of executives.[3] To remain relevant, boards must join management on this journey, and management in turn must bring the board along—all while ensuring that strategic cocreation doesn't become confusion or, worse, shadow management.

Three questions to spur high-quality engagement

While no one-size-fits-all solution can guide companies as they set out, we suggest that board members and senior managers ask themselves three simple questions as they approach the development

[2] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," mckinseyquarterly.com, March 2012.

[3] See Chris Bradley, Lowell Bryan, and Sven Smit, "Managing the strategy journey," mckinseyquarterly.com, July 2012.

of strategy. Using them should raise the quality of engagement and help determine the practical steps each group must take to get there.

To illustrate what this looks like, we return to the infrastructure company we mentioned at the beginning of this article. The company had three key business units—construction, cement manufacturing, and the ownership and operation of infrastructure projects (primarily power plants)—as well as a fledgling real-estate business. It had expanded aggressively in emerging markets in the mid-to-late 1990s, until the Asian currency crisis forced it to sell off some of its more adventurous purchases and precipitated an equity investment by a large institutional investor with long-term interests in infrastructure. The investor appointed a new chairman, who in turn brought in a new CEO. After a few years of strong success and continued volatility (punctuated by the global financial crisis), the company's growth hit a plateau, triggering a thorough review of the strategy by the board.

When the chairman discussed the matter with the CEO, they agreed that the company had to take a different approach. Some of the board members were new and grappling with the problems of stewarding a complex multinational and multibusiness corporation. What's more, several fundamental questions were on the table that could conceivably lead to a full-blown restructuring and transformation involving the spin-off of divisions and the reallocation of capital to new areas.

The usual annual strategic refresh was unlikely to provide the board with an appreciation of the context it would need to address these questions fully, let alone to generate fresh insights in response. Such dissatisfaction with mechanistic annual board-level strategy processes is widespread, in our experience. The answer for this board (and several others we know) was to throw out the annual process and replace it with a much more intense but less frequent form of engagement—roughly every three years in this case—while still devoting some time at *every board meeting* to pressure-testing the strategy in light of its progress and changes in critical variables.

Pushing to answer the questions below, as the infrastructure company did, can help organizations enhance the quality of board engagement on strategy, both when that engagement must be deep and during the regular course of business.

1. Does the board understand the industry's dynamics well enough?

Most boards spend most of their strategic time reviewing plans, yet as we've noted, relatively few directors feel they have a complete understanding of the dynamics of the industries their companies operate in or even of how those companies create value. To remedy this problem and to avoid the superficiality it can engender, boards need time—some without management present—so they can more fully understand the structure and economics of the business, as well as how it creates value. They should use this time to get ahead of issues rather than always feeling a step behind during conversations on strategy or accepting management biases or ingrained habits of thought.

Board members at the infrastructure company began by studying its performance, focusing solely on ROIC across economic cycles. The board then studied all value drivers that affected ROIC. Revenue growth and earnings before interest and taxes, on which management spent most of its time, were two important but only partial explanations of the company's overall performance. Through a combination of independent sessions and two formal discussions with the CEO, the board established a much stronger foundation for a subsequent dialogue with management about strategy.

It turned out, for example, that the board member who had expressed concerns about the construction business's assumptions for leased-versus-owned equipment was right—not just for that unit, but also for most of the company's operations. One implication was that the forward-looking returns from the construction business were higher and more stable than those from the cement business, which, on the face of it, had higher margins and was better known and larger overall. This observation led the board to a closer look at both of these units and to a fuller appreciation of the construction business's strong project-management talent bench, which was well positioned to help counteract its "lumpier" risk profile.

2. Has there been enough board–management debate before a specific strategy is discussed?

Armed with a foundational view based on a clearer understanding of industry and company economics, boards are in a better position to have the kinds of informed dialogue with senior managers that ultimately help them prepare smarter and more refined strategic options for consideration. Board members should approach these discussions with an owner's mind-set and with the goal of helping management to broaden its thinking by considering new, even unexpected, perspectives.

At the infrastructure company, such discussions were triggered by the chairman, who remarked, "I've found this process of assessing the industry and company economics very enlightening so far. It makes me wonder: if a private-equity firm were to take over this company right now, what would they do with it?" The question's disruptive nature changed the frame of the discussion from "What more can we do with this business?" to "Should we be in this business at all?" It led to the recognition that the cement unit required a level of scale and competitiveness the corporation didn't have and was unlikely to achieve organically. That realization ultimately led the infrastructure company to spin off the business.

During such debates, management's role is to introduce key pieces of content: a detailed review of competitors, key external trends likely to affect the business, and a view of the specific capabilities the company can use to differentiate itself. The goal of the dialogue is to develop a stronger, shared understanding of the skills and resources the company can use to produce strong returns, as opposed to merely moving with the tide.[4]

It's important, however, that this dialogue should stop short of deciding on a strategy, which comes next.

3. Have the board and management discussed all strategic options and wrestled them to the ground?

Very often, the energizing discussions between the board and management about the business, its economics, and the competition represent the end of the debate. Afterward, the CEO and top team go off to develop a plan that is then presented to the board for approval.

Instead, what's needed at this point is for management to take some time—mostly spent alone—to formulate a robust set of strategic options, each followed through to its logical end state, including the implications for the allocation of people, capital, and other resources.

[4] Determining whether a strategy will beat the market is one of ten crucial tests that boards can apply to determine the quality and strength of business-unit strategies. For more, see Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," mckinseyquarterly.com, January 2011.

These strategic options can then be brought back to the board for discussion and decision making.

At the infrastructure company, the actual off-site strategy meeting, held during two days to ensure adequate time, focused entirely on debating and deciding between strategic options and then working through the resource-allocation implications of the decisions. Among the various debates, two stood out. One was whether to double down on the company's highest-potential business—construction services—by allocating additional talent and capital for an M&A-led consolidation initiative in two high-potential markets. The other was whether to exit the company's real-estate business. Forcing an explicit conversation about it proved to be a relief for both the board and the management team, who agreed that these issues had been an unstated source of unease for quite some time.

An important caveat: forcing meaningful, high-quality conversations like these is challenging, particularly when boards aren't used to having them, and places a premium on the board chair's ability to facilitate discussion. Creating a participative, collaborative dynamic while maintaining a healthy tension is critical. Also, the chair must neither monopolize the discussion nor fail to intervene strongly to shut down unproductive tangents.

In this case, the infrastructure company used some time on the last day of its off-site meeting to discuss how the board and management would monitor execution. This led to a healthy negotiation between the two on "what would get done by when." The company also created time for a final debate, on the allocation of resources, ensuring that no one was left behind in the decision making. The director with a background in the industry spent some time with

With a clearer understanding of industry and company economics, boards can have the kinds of informed dialogue with senior managers that ultimately help them prepare smarter options.

the CEO providing input on path dependencies, allocations of capital and people, and high-level time lines.

Extending the discussion of strategic options all the way to monitoring execution was a powerful—and unusual—step. Normally, this isn't necessary. But boards sometimes overlook how difficult it is for executives to reconcile the sweeping changes they and the board have committed themselves to with day-to-day operational realities that consume the executives' time. Sometimes, this is an unintended consequence of the timing of off-site strategy meetings. When they are held near the end of the financial year, there isn't enough time to flesh out plans and create linkages to key performance indicators before the budget must be approved.

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Developing strategy has always been complex—and becomes more so with a board's increased involvement, which introduces new voices and expertise to the debate and puts pressure on management teams and board members alike to find the best answers. Yet this form of strategy development, when done well, is invaluable. It not only leads to clearer strategies but also creates the alignment necessary to make bolder moves with more confidence and to follow through by committing resources to key decisions. ○

Chinta Bhagat is a principal in McKinsey's Singapore office, **Martin Hirt** is a director in the Taipei office, and **Conor Kehoe** is a director in the London office.