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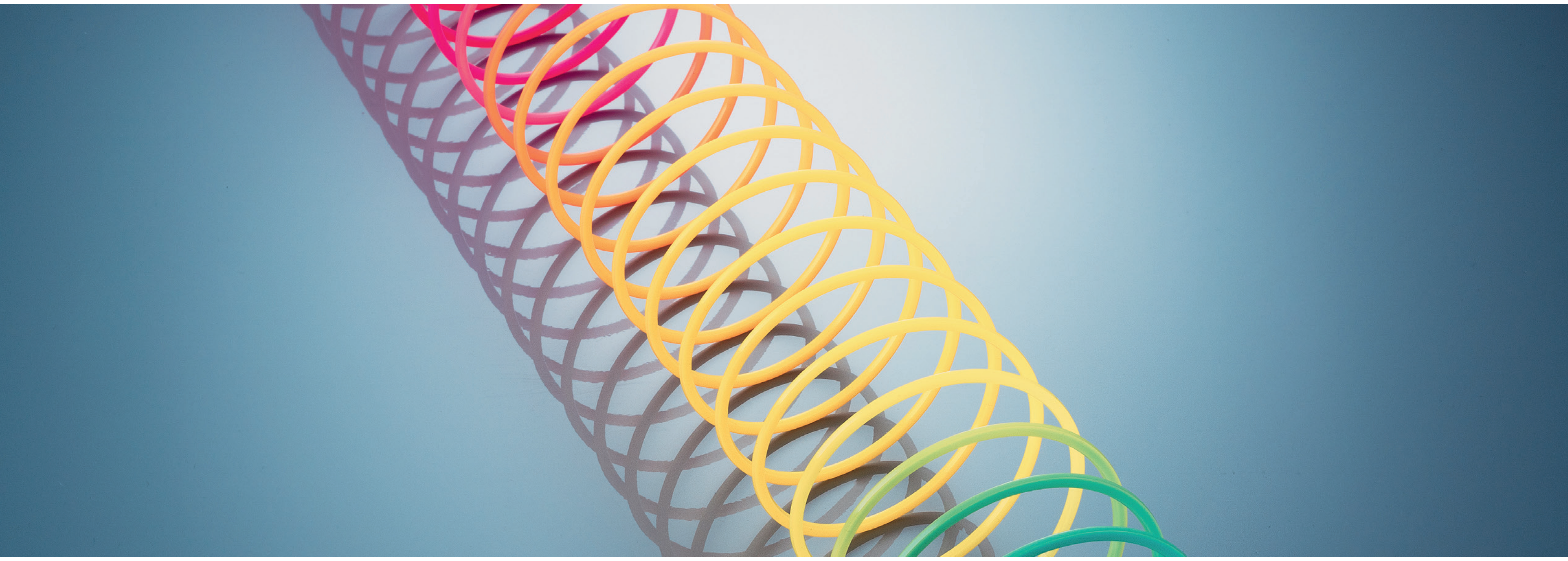

Corporate Finance

In search of a better stretch target

Aggressive goals can dramatically improve a company's performance. But unachievable goals can do more harm than good. Here's how to stretch without breaking.

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The urge to improve is innate in most companies, where better service, stronger performance, and faster operations are inextricably tied to earnings, bonuses, and shareholder returns. The impetus is so strong, in fact, that the practice of setting stretch targets for a company's performance has become emblematic for the grit and aggressiveness expected of a modern executive. Managers take pride in seeking to achieve the unthinkable.

Sometimes they succeed, surprising even themselves with how much stretch targets can improve performance. But there are limits to how far they can push. The wrong metrics can sap motivation and undermine performance.[1] Targets set along one metric without regard for the effect on performance elsewhere can destroy value. And broad-based aggregate measures of profit margin, operating profit, and earnings per share are only loosely linked to valuation. One CFO recently admitted to us that his multibillion-dollar global company would hit its quarterly goals for earnings before interest, taxes, depreciation, and amortization (EBITDA), but only at the cost of reducing its operating cash flow. Signs of unhealthy stretch targets can be quite clear—and any of them can lead to poor behaviors, distracting senior managers and having no impact on value.

Healthy stretch targets start with using the right kinds of metrics: achievable, focused, transparent, and grounded in objective data tied to value creation. But even the right kinds of metrics can destroy value when managers neglect best practices. In our experience, a healthier stretch requires companies to calibrate targets against cross-functional trade-offs. It demands that executives build trust with employees, rewarding success rather than always moving the goal up, but also that they confirm that employees succeed fairly. And it requires that there be no stigma attached to bringing out bad news, so that employees are encouraged to be transparent about their progress.

Calibrate cross-functional trade-offs between targets

The larger and more complex a company is, the more likely one unit or function's stretch targets will affect the performance of others. For example, reducing inventory levels to meet a working-capital target can make it hard to fill orders if a company's production system, its demand, and its suppliers are not stable enough—and that can lead to lost sales. Conversely, if a sales team pushes for 7 percent growth in a market that is growing at 4 percent, for example, it's likely to chase as many deals as possible. Since the team can't sell what the company doesn't have, they'll have to initiate production even for deals that are more likely to fall through. That, in turn, affects performance up and down the supply chain—with negative consequences for the company's cash-conversion rate, depending on how much unsold inventory piles up.

CFOs—or other C-suite managers—can set targets from a cross-functional perspective across the entire business, but they often lack a functional or business-unit perspective on the details. The business-unit leaders they rely on for those details often promote different metrics depending on their own siloed vantage points. In the end, managers often resort to targets anchored in past performance, catchy slogans, or just lazy application. We often see them simply adding a flat percentage-point increase to last year's results, averaging performance levels across an entire group, or setting sales targets based on growth assumptions oblivious to the pace of the market (exhibit). Managers at one Asian company arbitrarily targeted 25 percent growth per year for 25 years—apparently unencumbered by the mathematical implications. And managers at a global manufacturer decided that tripling inventory turns would be an inspirational target, even though the company was already better than most of its peers and the target was physically impossible.

Managers that set the best stretch targets do so with a clear understanding of the trade-offs between interconnected objectives—between earnings goals and cash needs, for example, or between growth objectives and R&D costs. The experience at one manufacturing company is illustrative. Managers of the various units each sought to optimize their own particular target. Manufacturing wanted to maintain a constant level of production to keep utilization up. Sales wanted shorter lead times and more product variants. Sourcing wanted lower unit costs. And finance wanted to improve cash performance. This led to uncertainty among functions and made it difficult for any of them to plan. For example, sourcing could cut costs if there were more certainty on volumes from sales, and sales could sell more and hit its target margins if it was clear that sourcing could lower costs.

To make the various functions work better together, the company undertook an exercise to align the key assumptions that they should all use for planning purposes. That way, everyone would be using consistent assumptions on costs, price, and the performance baseline. These included, for example, that sales should assume a certain cost per unit if managers committed to selling a certain number of units. Through several iterations, the

Exhibit

Unhealthy stretch targets lead to unhealthy behaviors.

Types of unhealthy stretch targets

Formulaic	Set by adding a flat percentage on top of whatever was proposed by the business unit
Excessive	Unclear, even at a relatively high level, how these targets will be met
Opaque	Rolled up from different functions, without clarity on shared assumptions
Overly broad	Broad-based aggregate measures of profit margin, operating profit, and earnings per share

Signs of unhealthy behavior

Manipulation	Signs of gaming to meet the targets, such as sales spiking unexpectedly at the end of the quarter or inventory increasing dramatically right after it's measured
Surprises	Actual performance levels are regularly well off targets and forecasts
Hedging	Signs that any layer of the organization is underestimating or not revealing some opportunity, as a reserve for when it's inevitably asked for more
Misplaced priorities	Meeting goals even at the cost of lowering performance on measures that affect valuation

company was able to set a matrix of targets to which each function could commit, knowing that other functions had committed to delivering the prerequisites for success. Based on this, each function was able to create a comprehensive plan to achieve the targets.

Build trust with employees—but verify they succeed fairly

Stretch targets succeed only when employees believe they can meet their goals if they try hard enough and that they will be rewarded if they do. There has to be a chance of failure in order to motivate employees to work harder. But if they expect failure and see targets as unrealistic, they will conclude that they won't receive a bonus anyway and just stop trying. When their good work earns them little more than endless rounds of ever-harder-to-meet stretch targets, they're more likely to hold opportunities in reserve—allowing themselves to fall short for one goal in order to improve their chances of meeting the next one. That leads to lower performance, poor morale, and declining trust in management. Expecting this kind of sandbagging, managers set ever more aggressive targets, and a vicious cycle of eroding trust develops.

Moreover, when the path to improvement looks like it will take too long, managers also need to be on the lookout for shortcuts. Function or unit managers can use a variety of cheats that improve some metrics in the short term. But such cheats can also create a kind of expectations treadmill that demands ever greater improvements over time and ultimately undermines the company's overall performance. For instance, when sales repeatedly offers customers big discounts to take delivery at the end of the quarter—so-called pull-ins—customers learn to time their purchases in expectation of those benefits. When sourcing pushes out orders to the day after quarter's end, plant inventory levels skyrocket immediately after the end of the quarter. When business managers change inventory-reserve policies, they may improve earnings temporarily, but not cash flow.

Some companies address this gaming with a combination of executive jawboning and visible consequences. The CEO and CFO repeatedly emphasize the importance of doing things the right way and celebrate successes. But they also deal harshly, even publicly, with any instances of egregious gaming. Others have employed more structural guardrails, strengthening their underlying systems to make sure that targets aren't gamed. For example, when managers at one company discovered that the sales staff was systematically creating fake orders in the system to ensure that supply would be available for last-minute orders, they introduced a more robust process to scrutinize orders. To prevent last-minute sales pull-ins, managers set a firm deadline for when orders could be placed and required new documentation from customers before approving an order and initiating production. And they reviewed their sales- and operations-planning processes to identify and remove unlikely commitments.

Setting targets collaboratively can also help. Executives at one global materials company, for example, spent six weeks analyzing and benchmarking performance targets that they could realistically achieve. They then spent another six weeks identifying specific initiatives and developing detailed implementation plans—including a weekly dialogue to fine-tune their stretch targets and confirm the targets worked together. In the end, the full senior-executive team committed to the plan, and the numbers were memorialized in a progressive series of targets that were reviewed weekly to prevent backtracking. The outcome exceeded senior management's expectations—with the additional benefit of strongly felt ownership throughout the organization of the actions taken to deliver the target.

Make it safe to share bad news

It's human nature to discount, ignore, or deny bad news. And when everyone is striving for a stretch target, it's hard to admit that you're the one falling behind. As a result, we often see managers taken by surprise when everyone finally admits where they are in the last few days of the quarter. Performance forecasts at one company, for example, were consistent with the expectations of meeting the stretch targets for many months. So managers were taken aback at the end of the quarter when actual performance numbers were much worse. In the aftermath, they were chagrined to learn that business and functional group leaders had known the stretch targets were unreachable for several months but were reluctant to break the news.

Such surprises can leave companies in an unexpectedly bad position. For instance, if manufacturing waits until a week before deliveries are expected to lower its production commitments, the sales force would be in an extremely poor position with customers. Such behavior could lead to lower sales, or it may lead sales managers to overforecast demand or artificially accelerate delivery deadlines.

We have seen companies address this in several ways. If managers set interim milestones for major deliverables and a regular operating mechanism to review them, they can create an early warning signal that something might be at risk. For instance, one milestone for commercial deals might be obtaining essential permits and qualifications by a certain date. If managers learn that the permits are running behind schedule, they would see that as an early sign that the deals might not land as expected.

Managers can also reward people for coming forward with potential issues and working proactively to solve them—even if this involves reporting bad news. At one global chemical company, for example, junior-level managers alerted senior executives that negotiations with customers and suppliers hadn't led to expected supply-chain improvements and that some value continued to be lost with regard to service. Fortunately, they elevated the bad news early enough in the cycle to address it, even presenting an action plan to fill the gap with the stretch targets, and were recognized for their resilience. Facing similar shortfalls in meeting demand-management targets, another unit was ultimately praised for collaborating across functions to create a solution that was in the interest of the business overall and not just their own work stream.

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Managers can improve a company's performance by setting the right stretch targets that motivate employees. But pushing too hard can have the opposite effect. ■

[1] See, for example, John W. Atkinson, *An Introduction to Motivation*, first edition, Princeton, NJ: Van Nostrand, 1964; John W. Atkinson, "Motivational determinants of risk-taking behavior," *Psychological Review*, Volume 64, Part 1, Number 6, pp. 359–72.

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