



# Management matters

McKinsey&Company

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Government intervention to protect manufacturers against competition might not be the remedy for western economies losing industries and jobs to China, India and other low-cost countries. Corporate performance in manufacturing is strongly linked to the quality of management techniques – and competitive intensity is needed to stimulate the spread of best practice, according to new research from McKinsey and the Centre for Economic Performance at the London School of Economics.

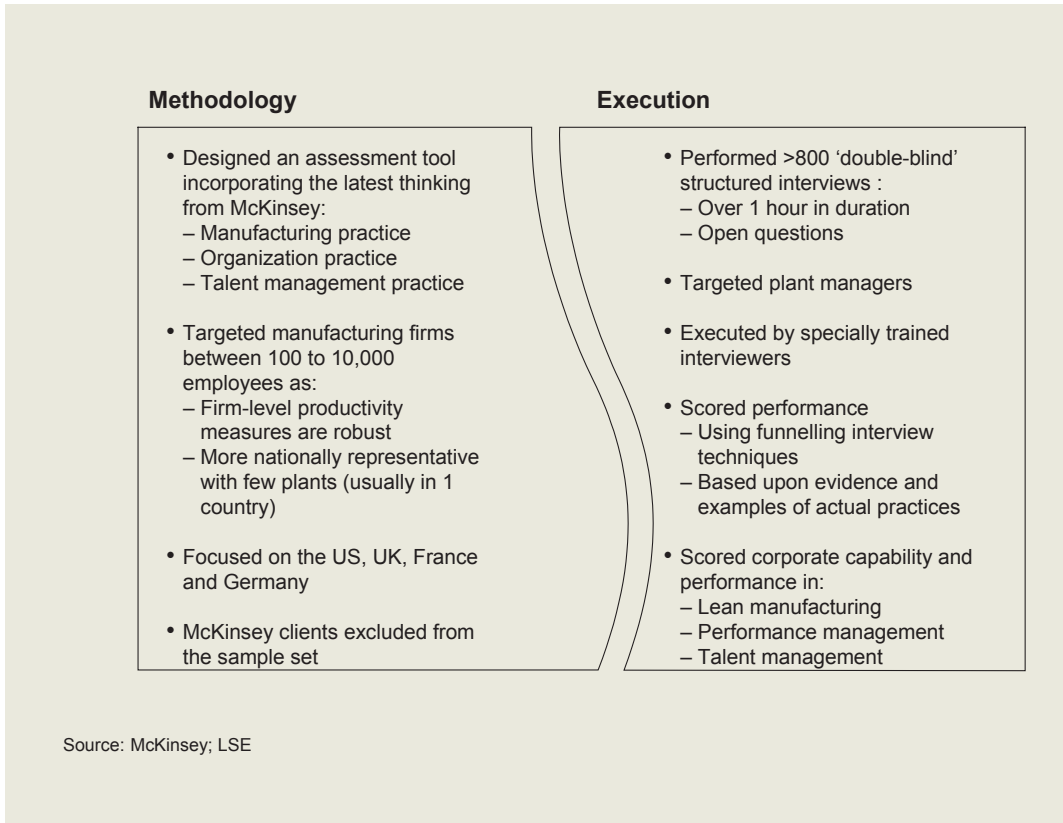
Data showing how important management practice is to company performance has emerged from the research, which is based on interviews with more than 700 medium-sized manufacturing companies in the United States, the United Kingdom, France and Germany. The results confirm the correlation, observed in an earlier, smaller study, between management practice and productivity, and management practice and return on capital employed (ROCE).<sup>1</sup> This latest study goes further and finds a positive, statistically significant correlation between a company's score on our management practice assessment scale and several measures of company success, including sales per employee, sales growth, market share growth and capital market evaluation.

The message for managers is clear: companies that adopt best-practice management perform better. There is news for employees too. The study shows that the better a company is managed, the more likely its workforce is to strike a beneficial work-life balance.

<sup>1</sup> Stephen J. Dorgan and John J. Dowdy, "When IT lifts productivity," *The McKinsey Quarterly*, 2004, Number 4, pp., 13-15.

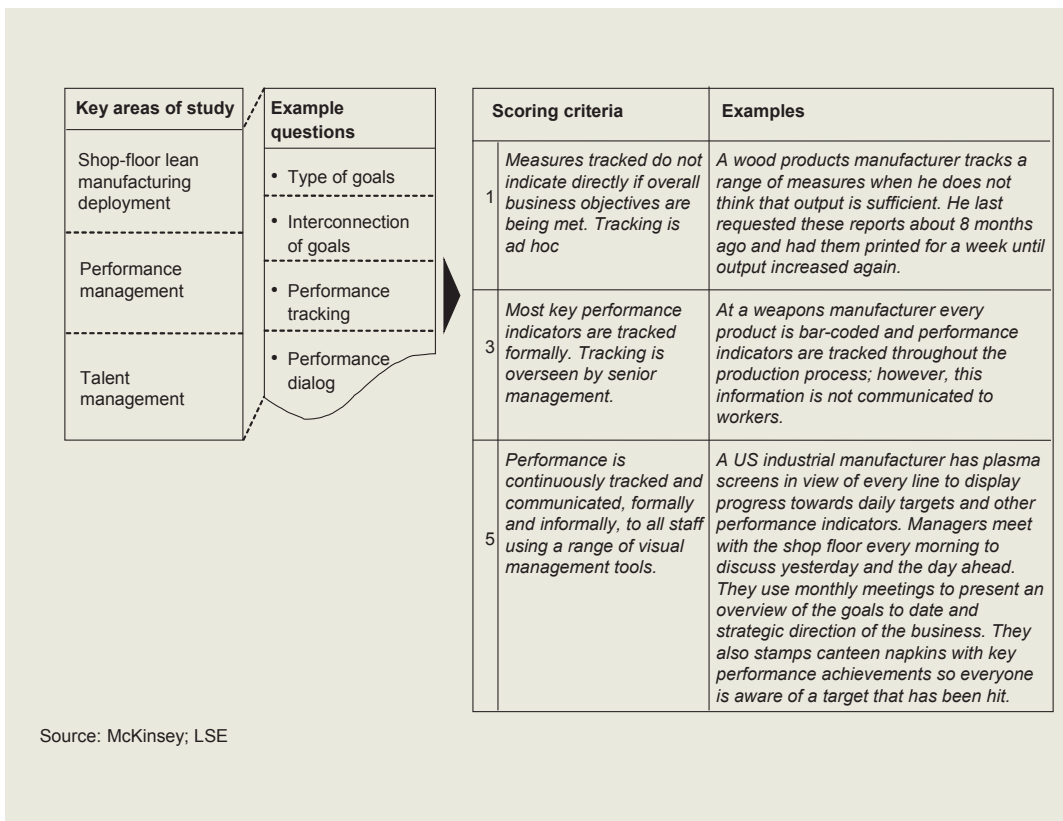
## EXHIBIT 1

### Primary data collection



## EXHIBIT 2

### Performance scoring



## Survey design

To measure management practices, researchers interviewed one or two senior plant-level managers from each of more than 700 companies (*Exhibit 1*). Plant managers were selected because they are senior enough to have a reasonable perspective on what happens in a company, but not so senior that they might be out of touch with the shop floor. The interviews covered 18 topics in three broad areas of management practice:

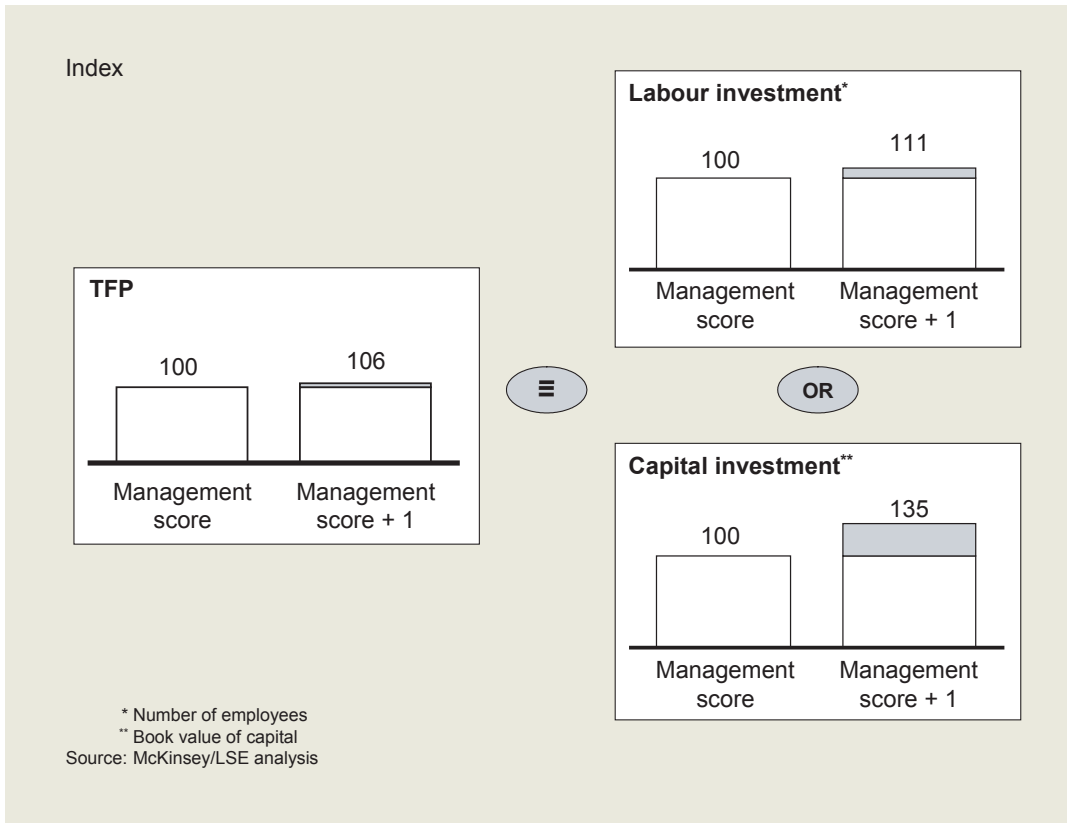
- **Shop floor operations.** Have companies adopted both the letter and the spirit of lean manufacturing?
- **Target setting and performance management.** Are they setting the right targets, tracking the right outcomes, and taking appropriate action if the two don't tally?
- **Talent management.** Are they hiring, developing and keeping the right people, rather than people they would do better without?

For each topic the companies were given scores from 1 to 5 (the highest). The average of the 18 separate scores was the overall management score. Some of the topics and examples of highly and poorly rated answers are shown in *Exhibit 2*. The research team drew on McKinsey's management consulting experience to define what constitutes poor, good and excellent practice on each topic. To ensure impartiality, only companies that had no relationship with McKinsey were included in the study.

Medium-sized firms, which tend to rely on local management, were selected in preference to large firms whose multinational operations might obscure country differences. The interviews relied on open questions and the interviewers were trained to probe for details of practices on the ground.

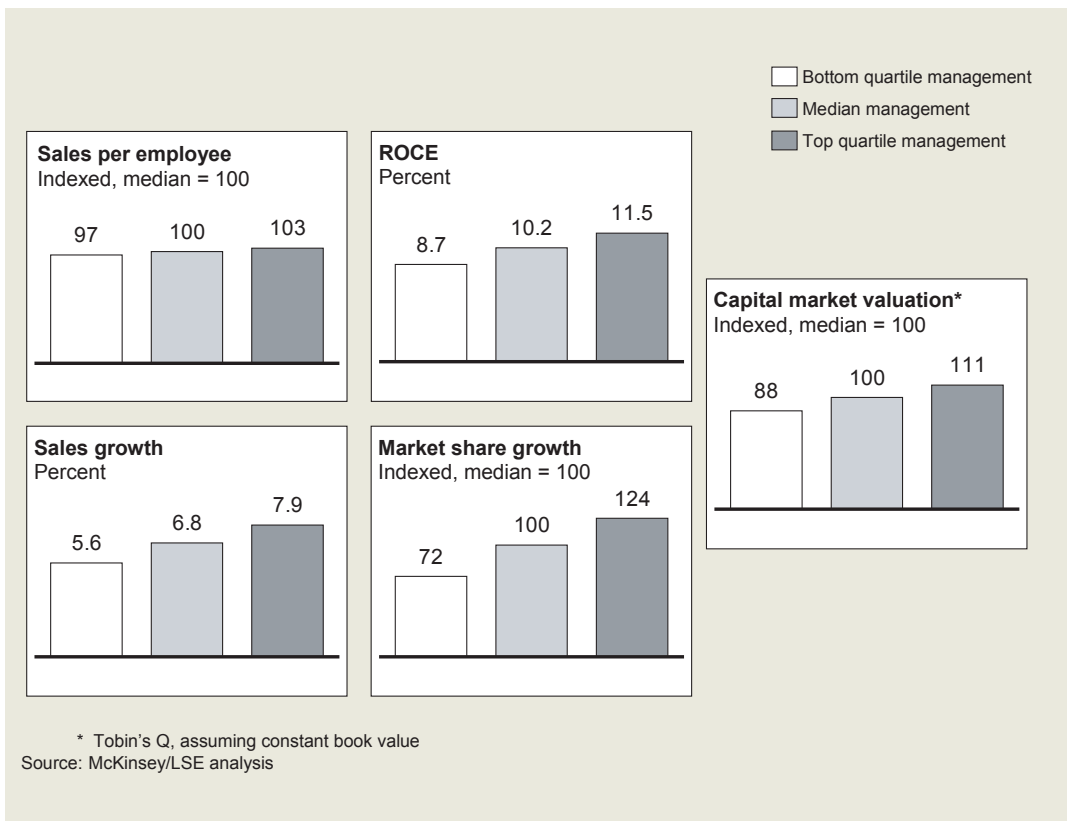
### EXHIBIT 3

#### Impact of improving management practice on output



### EXHIBIT 4

#### Correlations between management practice and company performance



## Management practice and company performance

In comparing each company's management score with its performance data, the ways in which the one influences the other become clear.

To start with, there is a correlation between a high standard of management practice and a high level of total factor productivity (TFP). This is important because TFP measures the productivity of firms after we have controlled for the quantity and quality of other inputs such as labour and capital. Put simply, producing the same output for less input results in significant benefits. A company making a profit on sales of 10 percent, for example, can almost double that profit if it increases TFP by 10 percent. Money so earned can be retained as profit, re-invested in the company or passed to customers in the form of better pricing.

We also found that a 1-point improvement in a company's management score, based on the 1-to-5 scale, correlates with a 6 percent increase in TFP. Although this might appear small, this increase is equivalent to the output of about 11 percent more people, or an increase in the capital stock of about 35 percent (*Exhibit 3*). Moreover, moving a

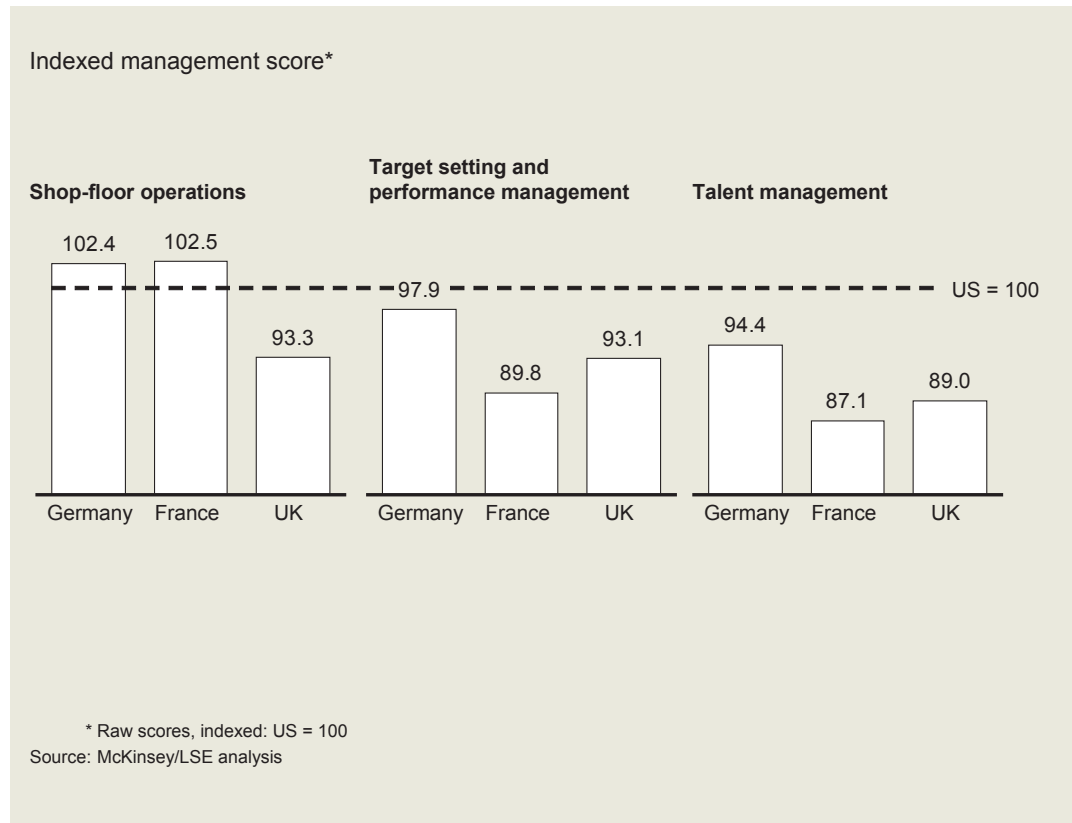
company from the bottom quartile of management scores to the top is linked with a increase in ROCE from less than 9 percent to more than 11 percent.

Next, the best-managed companies were found to have higher sales per employee, higher rates of growth in sales and market share, and higher stock market valuations, irrespective of their country of operation, size, sector or other similar characteristics (*Exhibit 4*). So while correlation analyses cannot prove that better management leads to better performance, all the robust correlations observed in our study are consistent with this idea.

A detailed analysis of the results highlights two important factors. First, companies need to attain a certain 'hygiene' level of good practice across the board. This accounts for about half of a well-managed company's score. Second, beyond the sound management baseline, the best companies often excel at either the shop-floor nuts and bolts of operations or at people management. This factor accounts for just under 10 percent of the variation in a company's score.

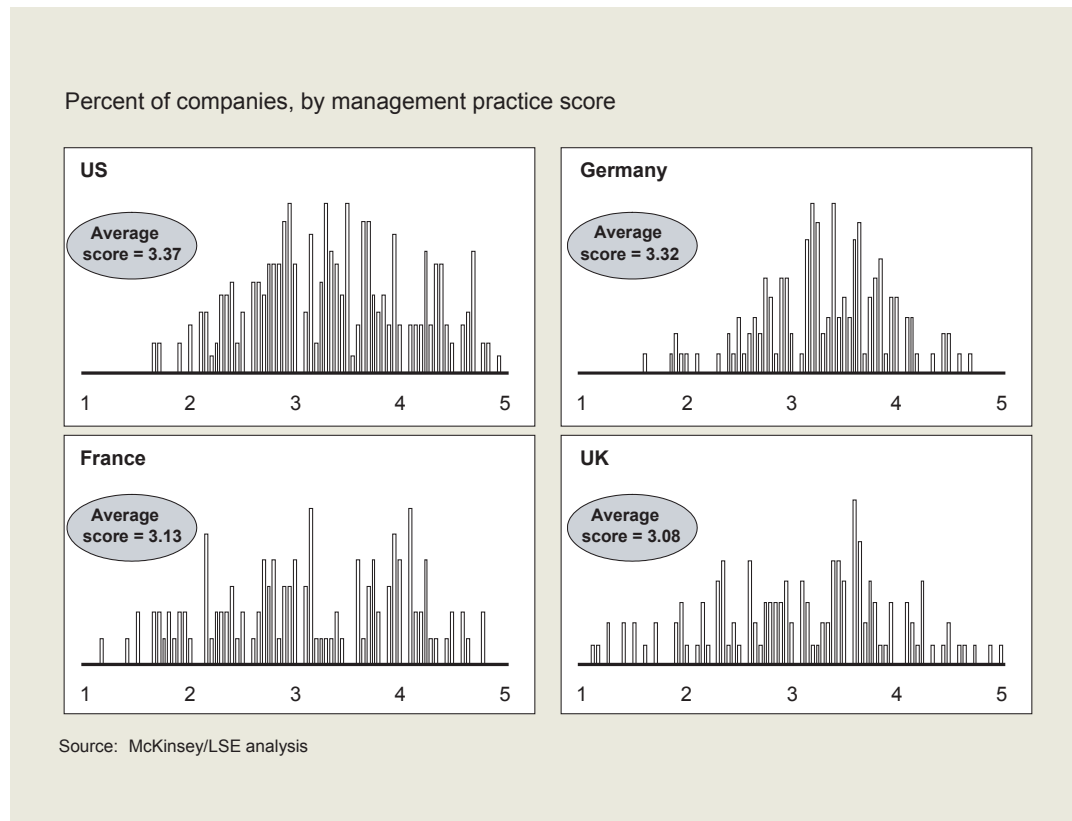
## EXHIBIT 5

### National differences in management practice



## EXHIBIT 6

### Inter- and intra-country variation in management scores



The scores by country mirror this factor analysis. The French and German companies interviewed are expert at shop floor operations, whereas US firms are particularly good at the people management aspects of target setting and talent management (*Exhibit 5*).

### Good news for managers

The relationship between management practice and performance holds for companies in all four countries surveyed. Although the management techniques measured by the survey come largely from the United States, some by way of Japan, the connection is as important in continental Europe as it is in the United Kingdom and the United States.

While US companies had the highest average score overall, and UK companies the lowest, it is important to recognize that the quality of management practice varies much more within a given country than it does between countries (*Exhibit 6*). The United Kingdom, for example, has a wide spread of scores from top to bottom, with the best companies matching the top US firms. There is apparently nothing intrinsic to the local environment

in each of the four countries to prevent companies from achieving top scores in management practice.

In fact, statistical analysis shows that which country a company operates in accounts for only 2 percent of its overall management score. Country and industry sub-sector combined explain 42 percent, leaving 58 percent to be determined entirely by what managers choose to do (*Exhibit 7*). At a more detailed level, researchers found that management practices are influenced more by industry sub-sector than by geography. This finding supports the theory that product market sector characteristics are more important than country characteristics in stimulating the diffusion of best practice.

### Factors explaining the wide distribution in management performance

An important question arising from the results is how badly managed companies can survive. The research team found evidence for two possible explanations: variations in the degree of competition within different industry sub-sectors, and labour regulations.<sup>2</sup>

#### EXHIBIT 7

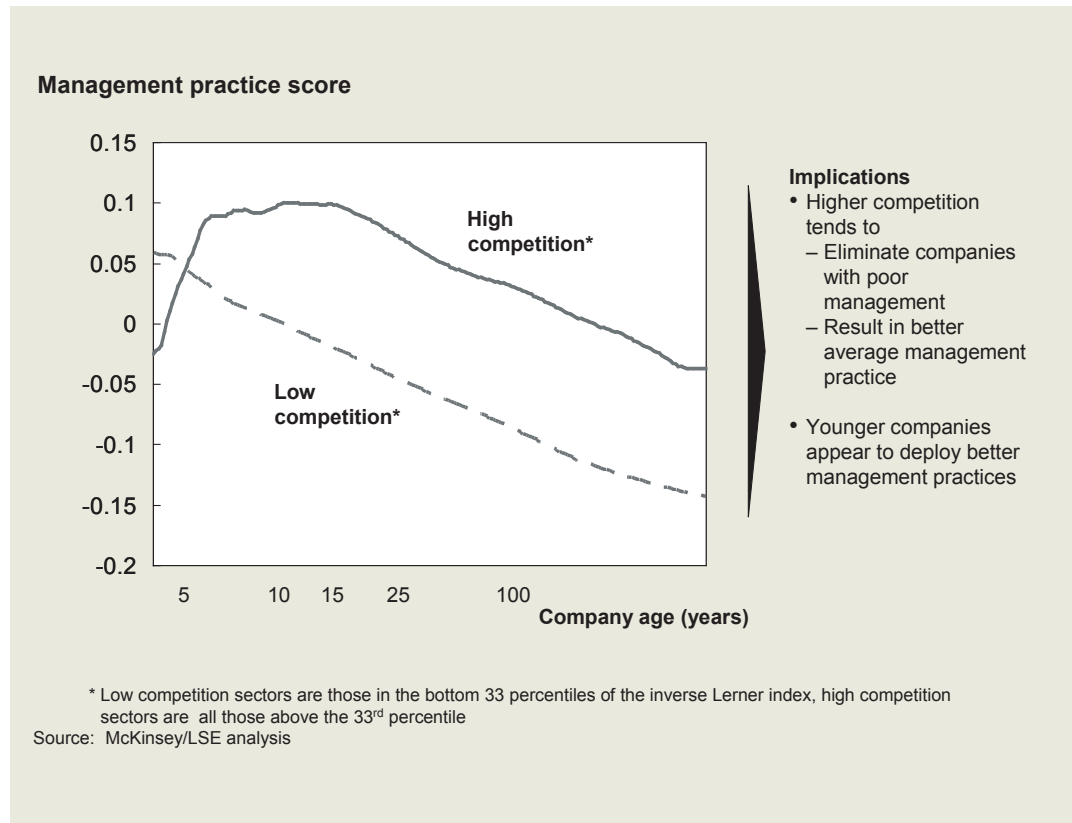
#### Factors influencing management practice score



<sup>2</sup>Researchers at the McKinsey Global Institute are among those that have extensively studied the determinants of a country's productivity. They examine productivity at the industry level, and the roles that competition, innovation, and regulatory policy play. See Diana Farrell, Heino Fassbender, Thomas Kneip, Stephan Kriesel and Eric Labaye, "Reviving French and German productivity," *The McKinsey Quarterly*, 2003, Number 1, pp. 40-55."

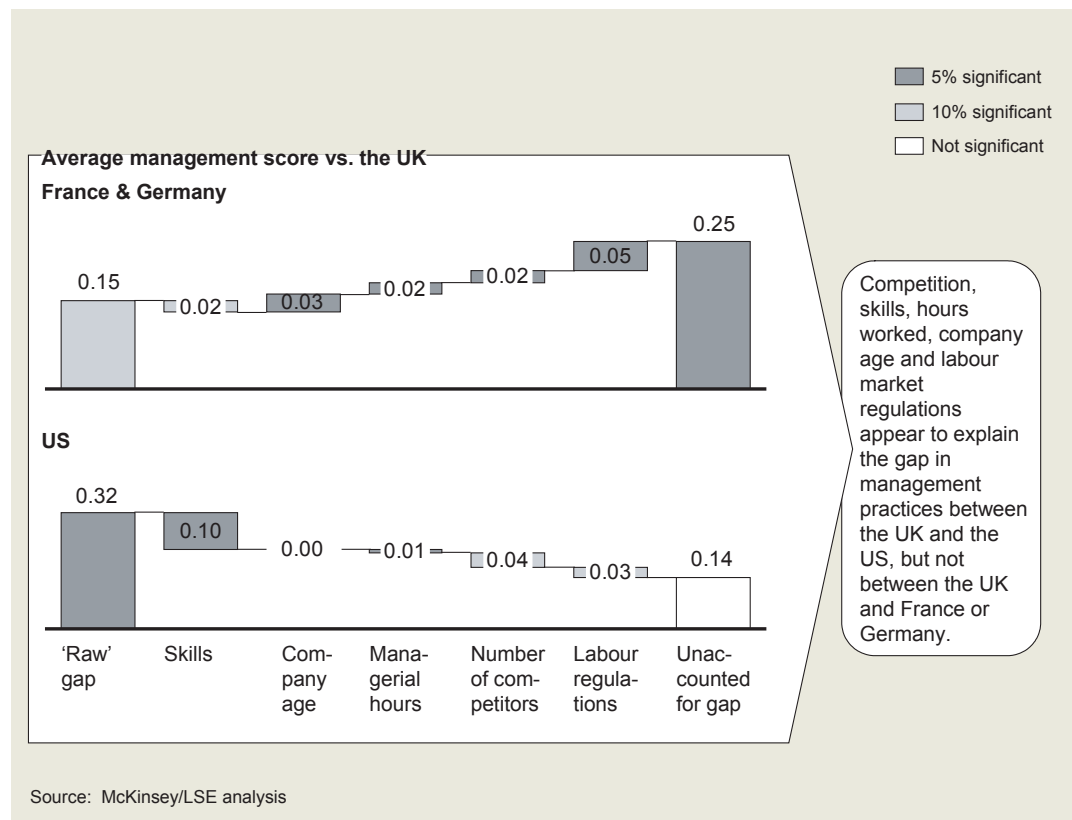
## EXHIBIT 8

### Effects of competition and firm age



## EXHIBIT 9

### The management gap between countries



The team assessed competition in any given sub-sector using three widely accepted measures: the Lerner index, which bases its calculations on the average 'excess' profits earned by competitors;<sup>3</sup> the degree of import penetration; and the number of rivals that companies said they faced. The study found that companies in the more competitive sectors tended to display significantly better management practices.

According to economic theory, competition affects companies in two main ways. First, it acts as a selection mechanism in the Darwinian sense that only the best-managed firms flourish, while the weak are forced to exit. Second, competition might prompt managers to work harder to survive. Interestingly, the team found more evidence for selection than for greater effort. The study also found that firms operating in particularly competitive sectors use more advanced management practices than those facing less rigorous competition (*Exhibit 8*). In addition, younger companies generally exhibit better management practices than older ones, perhaps showing their ability to innovate, learn and deploy best practice.

However, the study found no correlation between the degree of competition in a sector and proxies for managerial effort, such as hours worked. When the researchers compared hours worked by managers and workers on the shop floor between companies in sectors of high and low competition, they found no significant differences. Simply put, those in well-managed firms appear to work smarter rather than harder.

Not surprisingly perhaps, the team also found a link between poor management practice and regulatory frameworks that restrict companies' hiring practices and talent management.

What does all this add up to in explaining cross-country differences? The research identifies the drivers of good management practice that separate the United States from the United Kingdom (*Exhibit 9*). It also suggests that the gap between France and Germany on the one hand and the United Kingdom on the other is even larger and more significant than might first appear because companies in France and Germany really are doing things differently from their UK counterparts. Continental Europe could thus surge yet further ahead of the United Kingdom if it adopted the even more successful US-style best management practice and labour market regulations.

<sup>3</sup>The Lerner Index =  $1 - \text{profit} / \text{sales for all other competitors in the sector}$

## EXHIBIT 10

### US subsidiaries vs European domestic and multinational companies



## Policy implications

The survey found connections between management practice and a number of company characteristics that government policy can influence directly. These correlations too hold across all four countries.

First, the better-managed companies are likely to be bigger and more multinational than the underperformers. Subsidiaries of US multinationals in Europe in particular had a higher average management score than the subsidiaries of non-US companies in Europe, or domestic European firms (Exhibit 10). This suggests that barriers to foreign ownership and cross-border deals are likely to be damaging to the spread of good management, unless those deals stifle competition.

Second, well-managed companies have more highly skilled workers and managers. The researchers

used several proxies for skills: managerial and non-managerial training days, average employee wages and the percentage of the workforce holding degrees and MBA qualifications. Government policies fostering the acquisition of skills within companies should help to raise standards of management practice nationally.

Third, policies to boost competition within sectors, especially measures to ease the entry of newcomers and the exit of failures, should also boost standards of management practice.

But, as the results here show, while government can play a role in fostering better management practice, and presumably the improved corporate performance with which it is associated, it is ultimately the management practice choices made by individual managers that will make the difference.

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<http://cep.lse.ac.uk/management>**