Capitalizing on Capabilities

By Dave Ulrich and Norm Smallwood

Assets like leadership, talent, and speed are what produce superior market value. A capabilities audit can show you how you measure up—and how to build on your intangible strengths.

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When asked which companies they admire, people quickly point to organizations like General Electric, Starbucks, Nordstrom, or Microsoft. Ask how many layers of management these companies have, though, or how they set strategy, and you'll discover that few know or care. What people respect about these companies is not how they are structured or their specific approaches to management, but their capabilities—an ability to innovate, for example, or to respond to changing customer needs. Such "organizational capabilities," as we call them, are key intangible assets. You can't see or touch them, yet they can make all the difference in the world when it comes to market value.

The collective skills, abilities, and expertise of an organization, these capabilities are the outcome of investments in human resources—staffing, training, compensation, communication, and other practices. They represent the ways that people and resources are brought together to accomplish work. They form the identity and personality of the organization by defining what it is good at doing and, in the end, what it *is.* They are stable over time and more difficult for competitors to copy than access to capital markets, product strategy, or technology. They aren't easy to measure, so managers often pay far less attention to them than to tangible investments like plant and equipment, but these capabilities give investors confidence in future earnings. Differences in intangible assets explain why, for example, upstart airline JetBlue's market valuation is twice as high as Delta's, despite JetBlue's having significantly lower revenues and earnings.

In this article, we look at organizational capabilities and how leaders can evaluate and build the ones they need to create intangible value. Through case studies, we explain how to do a capabilities audit, which provides a high-level picture of an organization's strengths and areas for improvement. We've conducted and observed dozens of such audits, and we've found them a useful and powerful way to turn intangible assets into something concrete and measurable.

Organization Capabilities Explained

While people often use the words "competence" and "capability" interchangeably, we make a distinction between the two: We refer to an individual's competence in an area but to an organization’s capabilities. With this difference in mind, let’s compare individual and organizational levels of analysis as well as technical and social skill sets:

	Individual	Organizational
Technical	1 An individual’s functional competence	3 An organization’s core competencies
Social	2 An individual’s leadership ability	4 An organization's capabilities

In the table above, the individual-technical cell (1) represents a person’s functional competence, such as technical expertise in marketing, finance, or manufacturing. The individual-social cell (2) is about a person’s leadership ability—for instance, to set direction, communicate a vision, and motivate people. The organizational-technical cell (3) comprises a company’s core technical competencies. For example, a financial services firm must know how to manage risk. The organizational-social cell (4) represents an organization’s underlying DNA, culture, and personality. These might include such capabilities as innovation and speed.

Organizational capabilities emerge when a company combines (and delivers on) individuals’ competencies and abilities. An employee may be technically literate or demonstrate leadership skill, but the company as a whole may or may not embody the same strengths. (If it does, employees who excel in these areas will likely be engaged; if not, they may be frustrated.) Additionally, a company’s organizational capabilities enable it to turn its technical know-how into results. It may possess a core capability in marketing, but if the organization does not have what it takes to make change happen, that capability does not add value.

There is no magic list of capabilities appropriate to every organization. However, we’ve identified 11 capabilities—listed below—that well-managed companies tend to have. (Such companies typically excel in as many as three of these areas while maintaining industry parity in the others.) When an organization falls below the norm in any of the 11 capabilities, dysfunction and competitive disadvantage will likely ensue.

Talent: We are good at attracting, motivating, and retaining competent and committed people. Competent employees have the skills for today’s and tomorrow’s business requirements; committed employees deploy those skills regularly and predictably. Competence comes as leaders *buy* (acquire new talent), *build* (develop existing talent), *borrow* (access thought leaders through alliances or partnerships), *bounce* (remove poor talent), and *bind* (keep the best talent). Leaders can earn commitment from employees by ensuring that the ones who contribute more will in turn receive more of what matters to them. Means of assessing talent include productivity measures, retention statistics (though it's a good sign when employees are targeted by search firms), employee surveys, and direct observation.

Speed: We are good at making important changes happen fast. Speed means that the organization can recognize opportunities and act quickly when it comes to new markets, new products, new employee contracts, and new business processes. Speed may be tracked in a variety of ways: how long it takes to go from concept to commercialization, for example, or from the collection of customer data to changes in customer relations. Just as increases in inventory turns show that physical assets are well used, savings in time demonstrate labor productivity as well as increased enthusiasm and responsiveness to opportunities. Leaders may create a return-on-time-invested (ROTI) index where they monitor how long it took to do something and the value created by the activity.

Shared mindset /brand identity: We are good at ensuring that customers and employees have positive and consistent images of and experiences with our organization. To gauge shared mindset, ask each member of your team to answer the following question: What are the top three things we want to be known for in the future by our best customers? Collect the answers to this query and measure the degree of consensus by calculating the percent of responses that fall into the most common three categories. We have done this exercise hundreds of times, often to find a shared mindset of 50%–60%. Leading companies score in the 80%–90% range. The next step is to invite key customers to answer the same question. The greater the degree of alignment between internal and external mindsets, the greater the value of this capability.

Accountability: We are good at obtaining high performance from employees. Performance accountability becomes an organization capability when employees realize that it's unacceptable not to meet their goals. The way to track it is to examine the tools you use to manage performance. By looking at a performance appraisal form, can you derive the strategy of the business? What percent of employees receive an appraisal each year? How much does compensation vary based on employee performance? Some firms claim a pay-for-performance philosophy but give annual compensation increases that range from 3.5% to 4.5%: These companies aren't paying for performance. We would suggest that with an average increase of 4%, an ideal range for acknowledging both low and high performance would be 0%–12%.

Collaboration: We are good at working across boundaries to ensure both efficiency and leverage. Collaboration occurs when an organization as a whole gains efficiencies of operation through the pooling of services, technologies, or economies of scale or through the sharing of ideas and talent across boundaries. Shared services, for example, have been found to produce 15% to 25% savings in administrative costs while maintaining an acceptable level of quality. Knowing that the average large company spends about $1,600 per employee per year in administration, you can calculate the probable cost savings of shared services: $1,600 * 0.20 (cost savings) * number of employees. Collaboration may be tracked both throughout the organization and among teams. You can determine whether your organization is truly collaborative by calculating your break-up value. Estimate what each division of your company might be worth to a potential buyer, then add up these numbers and compare the total with your current market value. If the break-up value is 25% more than the current market value of the assets (rule of thumb), collaboration is not a strength.

Learning: We are good at generating and generalizing ideas with impact. Organizations generate new ideas through benchmarking, experimentation, competence acquisition (hiring or developing people with new skills and ideas), and continuous improvement. Such ideas are generalized when they move across a boundary of time (from one leader to the next), space (from one geography to another), or division (from one structural entity to another) [Au: want to clarify parenthetically, as you did with the other boundaries? ... *OK, good idea*]. For individuals, learning means letting go of old practices and adapting new ones. You can track this competence by determining the half-life of knowledge (when 50% of what you know how to do is out of date). Several years ago, we talked with a senior scientist at Intel who was a world expert in VLSI (very-large-scale integration). He explained his learning transitions by describing how he had spent his career keeping up with fast-changing generations of vacuum tube technology. While others in his field trained to become managers, he chose to become a technology expert. His half-life of knowledge was about two years, which meant that every two years, he had to learn 50% new things to do his job well. Of course, this measurement is easier to calculate in a technical setting than in some others, but the crucial notion is that knowledge can and should be continually updated.

Leadership: We are good at embedding leaders throughout the organization. Companies that consistently produce leaders generally have a clear leadership brand—a common understanding of what leaders should know, be, and do. These companies' leaders are easily distinguished from their competitors'. Former McKinsey employees, for instance, consistently approach strategy from a unique consulting perspective; they take pride in the number of the firm's alumni who become CEOs of large companies. In October 2003, [*The Economist* noted that 19 GE stars immediately cumulatively added an astonishing $24.5 billion to the share prices of the companies that hired them. You can track your organization's leadership brand by monitoring the pool of future leaders. How many backups do you have for your top 100 employees? In one company, the substitute-to-star ratio dropped from about 3:1 to about 0.7:1 (less than one qualified backup for each of the top 100 employees) after a restructuring and the elimination of certain development assignments. Seeing the damage to its leadership bench, the company's executives encouraged potential leaders to participate in temporary teams, cross-functional assignments, and action-based training activities, thus increasing its leadership bend to about 1.0:1

Customer connectivity: We are good at building enduring relationships of trust with targeted customers. Since it's frequently the case that 20% of customers account for 80% of profits, the ability to connect with targeted customers is a strength. Customer connectivity may come from databases that track preferences, dedicated account teams, or the involvment of customers in HR practices such as staffing, training, and compensation. When a large portion of the employee population has meaningful exposure to or interaction with customers, connectivity is enhanced. To monitor this capability, identify your key accounts and track the share of those key accounts over time. Regular customer-service surveys may also offer insight on how the customer perceives your connectivity.

Strategic unity: We are good at articulating and sharing a strategic point of view. Strategic unity is created at three levels: intellectual, behavioral, and procedural. To monitor such unity at the intellectual level, make sure employees from top to bottom know what the strategy is and why it is important. You can reinforce this sort of shared understanding by repeating simple messages; you can measure it by noting how consistently employees respond when asked about the company's strategy. To gauge strategic accord at the behavioral level, ask employees how much of their time is spent in support of the strategy and whether their suggestions for improvement are heard and acted on. When it comes to process, continually invest in procedures that are essential to your strategy. For example, Disney must pay constant attention to any practices relating to the customer-service experience, such as ensuring that amusement parks are always safe and clean and that guests can successfully ask any employee for directions.

Innovation: We are good at doing something new in both content and process. Innovation—whether in products, administrative processes, business strategies, channel strategies, geographies, brand identity, or customer service—focuses on the future rather than on past successes. It excites employees, delights customers, and builds confidence among investors. This capability may be tracked through a vitality index (for instance, one that records revenues or profits from products or services created in the last three years).

Efficiency: We are good at managing costs. While it's not possible to save your way to prosperity, leaders who fail to manage costs will not likely have the opportunity to grow the top line. Efficiency may be the easiest capability to track. Inventories, direct and indirect labor, capital employed, and costs of goods sold can all be viewed from balance sheets and income statements.

Conducting an Organizational Audit

Just as a financial audit tracks cash flow and a leadership 360 assesses leadership behaviors, an organizational audit can help you monitor organizational capabilities. It will highlight which capabilities are most important given the company's history and strategy, measure how well the company delivers on these capabilities, and lead to an action plan for improvement. This exercise can work for an entire organization, a business unit, or a region—indeed, any part of a company that has a strategy to produce financial or customer-related results can do an audit, as long as it has the backing of the leadership team. We'll walk through the process below, describing as we go the experiences of two companies that recently performed organizational audits—InterContinental Hotels Group and medical device manufacturer Boston Scientific—and what they did as a result of their findings.

Boston Scientific has enjoyed strong growth over the past 25 years. In particular, its international group delivers about 45% of company revenues and 55% of company profits. Yet in 2003, the company's executive board wanted to find ways to improve on their success, so Edward Northup, president of Boston Scientific International, decided to engage his leadership team in an organizational audit.

The first step was to identify the capabilities that would be critical in meeting the group's goals. Using the 11 generic capabilities defined above as a starting point, leaders at Boston Scientific adapted the language to suit the business requirements at hand. (However you create the list, the capabilities you audit should reflect those needed to deliver on your company's strategic promises.) Next, to evaluate the organization's performance on these capabilities, the international division's executive team, along with their bosses, employees, and peer executives, completed a short online survey—adapted from the generic questionnaire shown in the exhibit "How to Perform a Capability Audit"—comprising 20 questions, with space for comments. For each capability, respondents were asked to rate on a scale of one to five the group's current performance as well as the level of achievement the division would need in order to meet its goals. This exercise showed gaps between current and desired capability. For example, on strategic unity—the extent to which employees understood and agreed upon strategy—the score for actual achievement was 0.91 points lower than the score for desired performance. Respondents also chose two capabilities from the list that would most affect the group's ability to deliver on its customer-related and financial promises.

The leaders discussed the survey findings at an off-site meeting. To address the strategic-unity gap, they developed a clearer statement of strategy that sharpened the group's focus on service and profitability. Then before forming an overall improvement plan, they defined the capabilities that would be most critical to executing that strategy. They didn't necessarily choose capabilities with low scores. The group showed relative weakness in innovation and learning, for example, but since the international division is primarily a sales, marketing, and distribution arm of Boston Scientific, the leadership team didn't see those capabilities as essential to meeting group goals. However, even though the division scored high on talent (see "Does the Talent Deliver?"), leaders chose to invest in further developing this capability since it would be critical to success; in particular, they focused on strengthening marketing skills and building talent that would allow them to target a broader set of customers. They also launched an effort to create a leadership brand, starting with a new model of high performance. Finally, they began to assess bench strength in support of that leadership brand, starting with the organization's three regional presidents.

The idea, in short, is not necessarily to boost weak capabilities but to identify and build capabilities that will have the strongest and most direct impact on execution of strategy.

Does the Talent Deliver?

In an online survey designed to gauge their division's capabilities, executives of Boston Scientific International asked stakeholders to rate the following question on a scale of one to five: Do International leaders ensure that they have the best talent required to accomplish their strategy? The responses were positive but nonetheless indicated room for improvement in this key area.

Executive Committee Member		4.00
Operations Committee Member		3.50
Senior Marketing Leader		4.00
International Senior Staff		4.60
Other Functional Leader		3.67
Overall		3.95

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This exercise made the intangible strengths and weaknesses of the international group tangible. It compared how executives from different parts of Boston Scientific—inside and outside the international group—viewed the division's capabilities; it revealed areas for improvement; and it provided a baseline score against which to measure the impact of future investments in these capabilities. Leaders plan to revisit the effort after a year to learn whether their investments have made a difference.

InterContinental Hotels Group conducted its audit across the entire company. In late 2002, the organization—recently demerged from Bass Group—faced bloated overhead costs in the competitive hotel industry, experienced a decline in business and vacation travel due to the global economic downturn and the SARS (Severe Acute Respiratory Syndrome) crisis, underwent a brand name change from Six Continents to InterContinental Hotels Group (IHG), and battled a hostile takeover attempt by British entrepreneur Hugh Osmond. Back then, the *Financial Times* declared that "current IHG leaders did not have the skills and the company did not have the culture to do what it would take to effect a turnaround." In an effort to improve performance, CEO Richard North initiated an "organization review."

As at Boston Scientific International, the IHG audit process started with the collection of feedback from multiple sources—executives, employees at all levels, and franchisees who owned and managed individual hotels. The information was gathered by an organization review design team made up of high-potential employees from all regions. Supported by external consultants, team members worked on the review process full-time for several months before making recommendations to the IHG executive committee. Based on this review, the capability of efficiency, or reducing costs, quickly became a priority. The company's costs were 15% to 20% higher than the industry average, and IHG swiftly took measures to streamline operations among the various regions, creating a shared services center and aligning finance, human resources, and corporate functions.

IHG executives also looked at what capabilities would be essential for future success, dividing current and desired capabilities into three areas: where the company requires world-class skill; where it needs to demonstrate industry superiority; and where it needs to achieve industry parity for optimal cost-efficiency. (For a visual breakdown of these categories, see the exhibit "A Snapshot of IHG's Capability Audit Results.") These capabilities supported the overarching priority of efficiency. Leaders decided, for example, that the company should achieve world-class performance in collaboration. As part of this strategic push, IHG shifted from a regional structure, where each region operated independently and was responsible for its own budget and operation, to a unified corporate entity, where the regions needed to work together to solve budget shortfalls, information technology challenges, and the like. By collaborating across regions and hotels, IHG streamlined operations and saved more than $100 million a year. By focusing on the gap between actual and desired capabilities, company leaders were able to determine where to invest leadership attention. This new focus allowed IHG to fend off the hostile takeover, demerge successfully, increase its share price by 71% from April 2003 to February 2004, and outperform the FTSE 100 by a factor of two, while re-energizing the company culture. A survey showed dramatic increases in employee morale and confidence in company leadership. Now, the quality of management at the company is no longer a matter of public debate.

Lessons Learned

No two audits will look exactly the same, but our experience has shown us that, in general, there are good and bad ways to approach the process. You'll be on the right track if you observe a few guidelines:

Get focused. It's better to excel at a few targeted capabilities than to diffuse leadership energy over many. Leaders should choose no more than three on which to spend their time and attention; they should aim to make at least two world-class. This means identifying which capabilities will have the most impact and will be easiest to implement, and prioritizing accordingly. (Boston Scientific chose talent, leadership, and speed. IHG zeroed in on collaboration and speed since the company's leaders felt that working across boundaries faster would enable them to reach their strategic and financial goals.) The remaining capabilities identified in the audit should meet standards of industry parity. Investors seldom seek assurance that an organization is average or slightly above average in every area; rather, they want the organization to have a distinct identity that aligns with its strategy.

Recognize interdependence of capabilities. While you need to be focused, it's important to understand that capabilities depend on one another. So even though you should target no more than three for primary attention, the most important ones often need to be combined. For example, speed won't be enough on its own; you will likely need fast learning, fast innovation, or fast collaboration. As any capability improves, it will probably improve others in turn. We assume that no capabilities are built without leaders, so working on any one of them builds leadership. As quality of leadership improves, talent and collaboration issues often surface—and in the process of resolving those problems, accountability and learning are usually strengthened.

Learn from the best. Compare your organization with companies that have world-class performance in your target capabilities. Quite possibly, these companies won't be in the same industry as your organization. It's often helpful, therefore, to look for analogous industries where companies may have developed extraordinary strength in the capability you desire. For example, lodging and airlines have many differences, but they're comparable when it comes to several driving forces: stretching capital assets, pleasing travelers, employing direct-service workers, and so on. The advantage of looking outside your own industry for models is that you can emulate them without competing with them. They're far more likely than your top competitors to share insights with you.

Create a virtuous cycle of assessment and investment. A rigorous assessment helps company executives figure out what capabilities will be required for success, which helps them determine where to invest. Over time, repetitions of the assess-invest cycle result in a baseline for benchmarking.

Compare capability perceptions. Like 360-degree feedback in leadership assessments, organizational audits may reveal differing views of the organization. It's instructive, for example, when top leaders perceive a shared mind-set but employees or customers do not. Involve stakeholders in improvement plans. If investors rank the firm low on capability, for instance, the CEO or CFO may meet with the investors to discuss specific action plans for moving forward.

Match capability with delivery. Leaders need not only to talk about capability, but to demonstrate it in results; rhetoric shouldn't exceed action. Outline expectations in a detailed plan. One approach is to bring together leaders for a half-day session to generate questions for the plan to address: What measurable outcome do we want to accomplish with this capability? Who is responsible for delivering on it? How will we monitor our progress in attaining or boosting this capability? What decisions can we make immediately to foster improvement? What actions can we as leaders take to promote this capability? Such actions may include developing education or training programs, designing new systems for performance management, and implementing structural changes to house the needed capabilities. The best capability plans specify actions and results that will occur within a 90-day window. HR professionals may be the architects, but managers are responsible for executing these plans.

Avoid underinvestment in organization intangibles. Often, leaders fall into the trap of focusing on what is easy to measure instead of what is in most need of repair. They read balance sheets that report earnings, EVA, or other economic data, but miss the underlying organizational factors that may add value. At times the capability goals can be very concrete, as with IHG's focus on efficiency.

Don't confuse capabilities with activities. An organizational capability is a bundle of activities, not any single pursuit. So leadership training, for instance, needs to be understood in terms of the capability to which it contributes, not just the activity that takes place. Instead of asking what percent of leaders received 40 hours of training, ask what capabilities the leadership training created. To build speed, IHG leaders made changes in the organization's structure, budgeting processes, compensation system, and other management practices. Attending to capabilities helps leaders avoid looking for single, simple solutions to complex business problems.

Few would dispute that intangible assets matter. But it can be quite difficult to measure them and even harder to communicate their value to stakeholders. The organizational audit is a way of making capabilities visible and meaningful. It helps executives to assess overall company strengths and weaknesses, senior leaders to define strategy, mid-level managers to execute strategy, and frontline leaders to make things happen. And it helps customers, investors, and employees alike to recognize the organization's intangible value.

How to Perform a Capability Audit

Directions: Select a business unit (plant, division, region, zone, industry). Using the following questions as a guide and--keeping in mind your overall business strategy – rank the unit's performance in each organizational capability (0=worst; 10=best).			
Organizational Capabilities	**Questions**	*Rankings*	**Assessments**
Talent	Do our employees have the competencies and the commitment required to deliver the business strategy in question?		
. Speed	Can we move quickly to make important things happen fast?		
Shared mindset	Do we have a culture or identity that reflects what we stand for and how we work? Is it shared by both customers and employees?		
Accountability	Does high performance matter here to the extent that we can ensure execution of strategy?		
Collaboration	How well do we collaborate to gain both efficiency and leverage?		
Learning	Are we good at generating new ideas with impact and generalizing those ideas across boundaries?		
Leadership	Do we have a leadership brand that directs managers on what results to deliver and how to deliver them?		
Customer connectivity	Do we form enduring relationships of trust with targeted customers?		
Strategic unity	Do our employees share an intellectual, behavioral, and procedural agenda for our strategy?		
Innovation	How well do we innovate in product, strategy, channel, service, and administration?		
Efficiency	Do we reduce costs by closely managing process, people, and projects?		
TOTAL SCORE			

A Snapshot of IHG's Capability Audit Results

[Sidebar]

Step by Step Through the Audit Process

While the particulars of a capability audit will differ from company to company, the process should unfold over these five basic steps:

1. Determine which part of the business to audit. This can be a division, a region, the entire company—any unit responsible for delivering on a strategy.
2. Create the content of the audit. Adapt the 11 generic capabilities outlined in this article to the requirements for the organization. (You may want to add quality, for example.) A tailor-made audit template will yield the most precise information.
3. Gather data from multiple groups on current and desired capabilities. This information may be collected by degrees:
    - For a 90-degree assessment, collect data from only the leadership team of the unit being audited. This method is quick but often deceptive, as the leaders' self-reports may be biased.
    - For a 360-degree assessment, collect data from multiple groups within the company. Different groups may tell very different stories, as happened with Boston Scientific International, and can provide insights that might otherwise be missed.
    - For a 720-degree assessment, collect information not only from inside the company but from outside groups. External assessors might include investors, customers, or suppliers. These groups are important because it is in their eyes that the organization's intangible value matters most. InterContinental Hotels Group did a 720-degree assessment to some extent by including franchisees in its data sample.
4. Synthesize the data to identify the most critical capabilities requiring managerial attention. Look for patterns in the data and focus leadership attention on no more than three capabilities required to deliver on strategy goals. You'll need to identify which capabilities will have the most impact and which will be the easiest to implement.
5. Put together an action plan with clear steps to take and measures to monitor, and assign a team to the job of delivering on the critical capabilities. Actions might include coordinating education or training events, setting performance standards, creating task forces or other organizational units to house those doing the work, or investing in technology to sustain the capability. The best capability plans specify actions and results that will occur within a 90-day window.