OCTOBER 2013
McKinsey Quarterly

Mastering the building blocks of strategy

Chris Bradley, Angus Dawson, and Antoine Montard

Increase your likelihood of developing effective strategies through an approach that's thorough, action-oriented, and comfortable with debate and ambiguity.

Left unchecked, market forces continually conspire to deplete profits. Powerful business strategies can counteract those tendencies, but good strategy is difficult to formulate.[1] Indeed, the latest McKinsey research (see "The strategic yardstick you can't afford to ignore," on mckinsey.com) finds that a very small number of companies create most economic profit.[2] The research also shows that a significant number of good companies outperform even in so-called bad industries, where the average economic profit is less than the market average.

How do they do it? In other words, where do powerful strategies come from? Sometimes it's luck, or good timing, or a stroke of inspiration. In our experience, it's also possible to load the dice in favor of developing good strategies by focusing on the core building blocks that often get overlooked. One is the need to gain agreement—before creating strategy—on the essential decisions and the criteria for making them. Another is to ensure that the company is prepared and willing to act on a strategy once it is adopted. Too much of what passes for strategy development, we find, consists of hurried efforts

[1] A 2011 McKinsey survey asked executives to evaluate their strategies against ten objective tests of business strategy. It found that 65 percent of companies passed just three or fewer tests. For more, see Chris Bradley, Martin Hirt, and Sven Smit, "Have you tested your strategy lately?," *McKinsey Quarterly*, January 2011, mckinsey.com.

[2] What's left over after subtracting the cost of capital from net operating profit.

that skip one or more of the essentials. The resulting strategies are often flawed from the start.

It's also easy, though, to go too far in the other direction and make the creation of strategy a rigid, box-checking exercise. Appealing as a formula-driven approach might be, it ignores the truth that strategy creation is a journey—and an inherently messy one at that. Proprietary insights are hard to come by. Shaping keen insights into good strategies requires deep interpersonal engagement and debate from senior executives, as well as the ability to deal with ambiguity in charged and often stressful circumstances. When would-be strategists overlook these dynamics, they cover the essentials in name only. Consequently, they miss opportunities and threats, or create great paper strategies that remain unfinished in practice.

In this article, we'll outline a middle path—an end-to-end way of thinking that views the creation of strategy as a journey, not a project. This method, developed through our work with some 900 global companies over the past five years, can help senior executives approach strategy in a rigorous and complete way. We'll also describe some principles that strategists should keep in mind as they use the method to ensure that their strategic-planning processes embody the spirit of debate and engagement, which, in turn, yields inspiration. By better understanding both the method and how to get the most out of it, companies can boost the odds that the strategies they create will beat the market.

Do justice to strategy's building blocks

Most companies we're familiar with demonstrate a variety of good habits when they create strategies, and they get many things right. But what they miss can be critical. Consider these examples:

- a technology company that prided itself on analytical rigor but never accurately diagnosed how difficult it would be for a targeted customer group to provide reasonable returns

- a beer company that rightly focused on industry structure in its core business but made a losing bet on a related business—wine—after failing to forecast declining returns stemming from structural shifts there

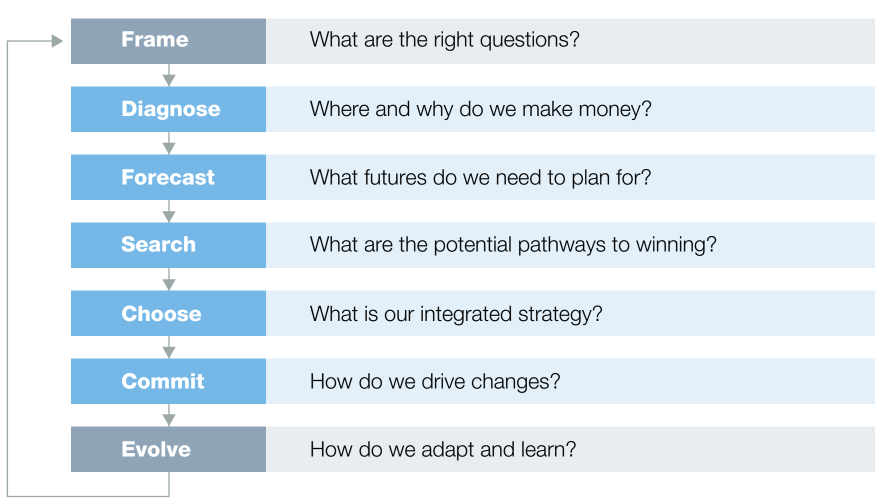
- a telecommunications company's strategy team, which recognized the importance of involving senior managers but ended up alienating them by holding a series of time-consuming workshops that focused on alignment around strategic choices, though the full set of choices hadn't yet been identified

These problems don't have to happen. We find that companies do better when they ground all their strategy-development efforts and processes in an understanding of the building blocks of strategy. These straightforward modes of activity (exhibit) track the progression of a strategy from its roots as an idea through its emergence as an operational reality.

One central building block is deep insight into the starting position of the company: where and why it creates—or destroys—value (diagnose). Executives also need a point of view on how the future may unfold (forecast). By combining insights into a company's starting position with a perspective on the future, the company can develop and explore alternative ways to win (search) and ultimately decide which alternative to pursue (choose). With the strategy selected, the company needs to create an action plan and reallocate resources to deliver it (commit).

Exhibit

The building blocks of strategy help companies make strategic choices and carry them through to operational reality.



These five core building blocks are book-ended by two others. One is an initial block (frame) to ensure that the team properly identifies and agrees to both the questions asked and the decisions made as the strategy is developed. The final block (evolve) is dedicated to the constant monitoring and refreshing of the strategy as conditions change and new information becomes available.

To some extent, the building blocks simply represent a thorough list of activities that all good strategists perform. And while all are important and should be included in the creation of strategy, slavishly following this or any other framework won't bring success. Depending on the situation, some blocks will be more critical than others and therefore require more attention (see sidebar, "Re-create, recommit, and refresh").

That's why taking some time to frame issues at the outset is so important. When strategists do so, they are better able to identify the real choices and constraints facing their organizations and to see which building blocks are likely to matter most given the situation at hand. Unfortunately, many executives feel that taking the time to frame strategy choices thoughtfully and to decide where to focus strategy-development efforts is a luxury they don't have.

We've seen evidence of this pressure firsthand and in the responses to an executive survey we've been conducting as part of an ongoing research project. Fully two-thirds of the 200 executives we've surveyed so far report that they feel rushed to provide outputs in their strategic-planning processes. This pressure is understandable in today's always-on, fast-changing environment, but it can be hazardous to a company's strategic health. That's especially true in the all-too-common situations when it's not immediately obvious what factors will determine the success or failure of a change to strategy.

A financial-services institution in the Asia–Pacific region, for example, was investigating a growth opportunity involving the creation of an online business. Changing the company's focus in this way would be a big undertaking, but the upside potential was large. Moreover, the members of the strategy team could already see that demonstrating the channel's significant potential to the top team would be straightforward. Before doing that, however, they stepped back to spend some time thinking through the idea's broader strategic context—framing, in other words.

When they did, they saw a serious risk of cannibalization for one of the company's existing businesses. The new venture would also require substantial funding over the next three to five years before it contributed financially. This had important implications, and the team's members needed to convince themselves that the risk was worth taking. Moreover, if the company made the move, would it

Re-create, recommit, and refresh

For a number of years, we, our colleagues, and many others who are engaged in the practice of strategy have been pointing out how ill-suited traditional strategic-planning processes are to the dynamism and pace of 21st-century business life. Less clear is what should happen to many organizations' well-oiled approaches. Shut them down? Morph them into budgeting and operational-planning processes? Use them to synthesize the valuable insights emerging from more frequent strategic dialogues involving larger numbers of executives?

The building blocks of strategy shed fresh light on what strategic planning should and shouldn't try to do. For starters, we'd emphasize that periodically—perhaps as often as every three to five years, if new competitors arrive or markets unexpectedly shift—companies must *re-create* their strategies. This cannot be accomplished through typical planning processes, as it requires broader skills, wider engagement, and more flexibility to make big strategic choices than they allow. So forget about strategic planning when you need to revamp your strategy; instead, take a more immersive strategy-development approach using all of the seven building blocks described in this article.

At the other end of the spectrum is what we would describe as the need to *recommit* organizations to established strategies. Traditional strategic planning is tailor-made for this purpose, and thinking about the task in these terms helps elevate it above the glorified budgeting exercise into which some processes lapse. Two of the building blocks we have described in this article—

stick with the effort when the time came to provide funding for people and technology?

Instead of steaming ahead with analytical work to prove the potential, the team recognized that it would be critical to invest a disproportionate amount of time and effort to the commit building block. The strategy team did this, in part, by developing a powerful multimedia concept prototype to capture the imaginations of the top team and the executives representing key support functions. The

commit and evolve—are useful reminders of what any such strategic-planning process should accomplish: the constant monitoring of strategy, the reallocation of resources, the alignment of management on strategic priorities, and the creation of targets, budgets, and operational plans.

Between these two extremes lies the strategic *refresh*, which is particularly relevant for organizations where a lot of valuable, ongoing strategy dialogue takes place among members of the top team. Such engagement can highlight nagging issues that might one day necessitate a strategic redo but certainly merit attention now. For example, if signs suggesting that one or more key assumptions have become less valid emerge from strategic dialogues at the business-unit level, it might be time to update the company's perspective on long-term trends. This exercise could be elevated in importance by making it a core theme of the upcoming strategic-planning process. In such situations, it's a good idea to check all seven building blocks quickly, with an emphasis on understanding the strategic implications of underlying changes. If they are big enough, that could be a red flag signaling the need to re-create the strategy and thus to elevate the discussion beyond strategic-planning parameters.

For a closer look at how to improve strategic planning, see "Managing the strategy journey" and "Dynamic management: Better decisions in uncertain times," on mckinsey.com.

team's focus on gaining commitment was prescient; the prototype and the communication around it helped convince the leaders that the concept was so compelling for consumers that if the company didn't cannibalize its existing business, a competitor would probably come up with the idea. The effort also helped motivate the leaders of the finance and IT functions to support the new offer. The company launched it in record time, to promising early results in both customer acquisition and levels of customer engagement.

In retrospect, the team credits the conversations and debates held during this framing period as necessary to identify and resolve the potential stumbling blocks related to the organization's strategic direction. Although messy at times, this activity helped build an organizational commitment to the strategy and its importance to the company.

Myth-bust your story

A focus on strategic building blocks also can help companies develop penetrating insights. While "insight" conjures up visions of research, data crunching, and "aha" moments, real strategic insight also rests on a seemingly mundane and easy-to-overlook factor: a thorough understanding of how and why a company, its competitors, and others in the industry value chain make money. Absent dumb luck, a strategy that doesn't tap directly into such an understanding will underperform.

The difficulty, as professor Phil Rosenzweig of the International Institute for Management Development has explained so well,[3] is that a company's performance—good or bad—creates strong impressions that powerfully shape the way people perceive strategies, leaders, cultures, and organizational effectiveness. A commodity company, for instance, might falsely attribute its strong performance to the efficiency of its operations. Yet despite its efficiency, the economics of those operations could be swamped by market-structure changes that have significant pricing implications or by unexpectedly volatile demand.

[3] See Phil Rosenzweig, "The halo effect, and other managerial delusions," *McKinsey Quarterly*, February 2007, mckinsey.com.

One way senior executives can address the challenge, we find, is explicitly questioning received corporate wisdom—much as the popular US television show *MythBusters* does when it takes apparent axioms, urban legends, and popular assumptions and (in entertaining fashion) tries to prove or disprove them. In the creation of strategy, this approach means dispassionately identifying the elements that contribute to performance, while discounting any factor contaminated by perceptions of the company's supposed greatness. It also requires a curiosity that's woefully lacking in some strategic-planning processes. Nearly eight in ten executives we surveyed, for example, say that the processes of their companies are more geared to confirming existing hypotheses than to testing new ones.

To see how these dynamics play out in practice, consider the experience of a global retailer that was revisiting its strategy after the previous one had delivered five years of strong earnings. The positive results, most in the company believed, reflected good execution and the success of a recent initiative to refresh the store format. Still, the leader of the business felt there could be more to the story and worried that continuing along the same path might not produce the same results in the future. To determine what was actually driving performance, the leader met with the company's strategy team, as well as other executives.

This was time well spent. The resulting discussions sparked important insights—revealing, for example, that while overall performance was good, there were problems under the surface. On the positive side, the company was steadily improving its margins and winning customers from a higher-cost competitor. Nonetheless, the solid network growth at the top-line level appeared to be masking a

Nearly eight in ten executives say that the processes of their companies are more geared to confirming existing hypotheses than to testing new ones.

worrisome decline in the productivity of older stores. The big drag on performance, the team discovered, was the loss of mainstream customers to a cheaper competitor, which careful analysis showed to have an unassailable advantage on cost. Increasing promotional activity had so far seemed to stem the march of this aggressive rival, but the retailer was running out of steam and hitting practical limits. Significant changes would be necessary.

Let them grapple

This realization was the product of more than just number crunching. The thoughtful argument and debate surrounding the analysis from day one played a vital part in generating the insights. In our experience, many companies forget this truth when they create strategy. Instead, they put too much emphasis on preparing documents and completing analyses and not enough on stimulating the productive debates that lead to better decisions.

Getting executives to grapple with the issues can be a messy process, and the debates may be quite personal. After all, formulating good strategies typically involves revisiting fundamental and deeply held beliefs about a company's past and future, and people tend not to shift their views without a fight.[4] But without the necessary fights, and without the use of carefully designed decision-making techniques, companies may end up with rubber-stamped strategies whose flaws are exposed during implementation—or afterward, by competitors.

When companies find ways to get executives grappling—throughout the strategy-development process—with the choices that matter, they make better, less biased decisions. They also improve the likelihood that the relevant stakeholders will be on board when the time comes to make and act on choices.[5]

[4] We also know that executives exhibit a number of biases that lead them to be overconfident about their beliefs and adept at finding facts to confirm them and reject challenges. To learn more about addressing this problem, see Dan Lovallo and Olivier Sibony, "The case for behavioral strategy," *McKinsey Quarterly*, March 2010, mckinsey.com.

[5] The importance of gaining social support for a strategy is often overlooked. Fully 62 percent of executives in our survey say that their strategy processes focus on the strategy itself, not on building a support base of influencers who will drive implementation.

To exemplify our point, let's look again at the retailer's strategy team as it engaged with the company's broader leadership group to share its observations. Most strategy teams interact with decision makers by presenting management with a summary report and recommendations. But this team understood that senior managers needed time to debate the issues themselves and reach their own conclusions—and that such collective discussions would improve the resulting strategy.

Because the senior managers had a very hands-on attitude, the strategy team designed a series of weekly meetings called think tanks to let them work through a profit-deconstruction exercise illuminating the company's past. In each session, the analysis was tabled after a certain point, and the management team's members took turns drawing out conclusions or identifying further questions that needed answering. The strategy team was prohibited from bringing any conclusions of the analysis to these meetings, much to its discomfort. This ensured that company leaders were invested in the decision-making process and could challenge the strategy team with new ideas.

Through a series of small-group meetings, the leadership team (with analytical help from the strategy team) debated the reasons for the company's past success and how to continue it. By unpacking these complex dynamics together, the leadership team arrived at an accurate, sharp diagnosis: the company needed to restore mainstream shoppers' trust in its prices. The result was a simple, focused strategy for delivering "value" products and reinforcing that market position with customers. Furthermore, because the management team was deeply involved in the diagnosis, its members had a strong incentive to drive implementation.

Don't leave the strategy unfinished

In conversations with senior executives, we occasionally hear some version of this saying: "I'd rather have a good strategy and great execution than vice versa." We believe that this attitude reflects confusion about what great strategy is. Such a strategy creates a path for action and is inherently incomplete without it. Yet many companies fail to get the conditions for successful implementation right, and fully two-thirds of the executives in our survey admit that their companies struggle with the issue.

It's a crucial struggle. No strategy, however brilliant, can be implemented successfully unless the people who have the most important jobs know what they need to do differently, understand how and why they should do it, and have the necessary resources. An added challenge, of course, is that strategic choices often involve big changes over long, three- to five-year time frames.

Finishing a strategy, therefore, requires creating tangible, proximate goals that connect to the longer-term strategy. It's easy to create a high-level list of next steps and things to do differently on Monday morning. It's much harder to roll back the future and connect it to the present so that people understand what they need to do differently and actually do it.

When companies fail to set proximate goals, the results can be disappointing. An Asian telecommunications company, for example, had landed on an intriguing and counterintuitive strategy involving two big shifts: it wanted to move its target customer base from big business to the midmarket and to standardize its products rather than provide customized service to large clients. Making the changes work, however, would require salespeople to start saying no to new business from large and complex clients so that the company could redirect its efforts to midmarket customers. The short-term pain (lower revenues and higher costs) would ultimately lead the company to a market-beating position.

The management team understood and encouraged the shift and was ready to act. But the strategy team did not do enough to prepare the organization for the moves, instead spending its time on detailed initiative-planning exercises. Absent any effort to translate the company's strategic desires into proximate goals for its employees, those employees balked at the changes.

Sales managers, for example, not only viewed saying no to larger customers as a short-term loss for the business but also were simply not as excited about pursuing midmarket customers with simpler needs. They understood the strategy intellectually and believed the analysis, but their skills, incentives, and ways of working and even thinking had not changed. Without such changes, they couldn't connect the necessary steps to a longer-term goal and naturally reverted to their old ways, creating a backlash that inevitably undermined the strategy. Only afterward did the team recognize the kinds of activities that might have helped—for example, changing the salespeople's goals, resetting the overall budget to acknowledge the transition from one customer segment to another, and using the reallocated funding to generate a new product-development road map.

• • •

Creating strategy in today's environment of complexity, ever-changing priorities, and conflicting agendas is a daunting task. Yet when senior executives invest the time and effort to develop a more thorough, thoughtful approach to strategy, they not only increase the odds of building a winning business but also often enjoy a positive spin-off: the gifts of simplicity and focus, as well as the conviction to get things done.

The authors wish to thank Matthew Chapman, Pia Mortensen, and Victoria Newman for their contributions to the development of this article.

Chris Bradley is a principal in McKinsey's Sydney office, where **Angus Dawson** is a director and **Antoine Montard** is a senior expert.