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BOARD GOVERNANCE IN THE ERA OF DISRUPTION

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Rapid shifts in global business demand place new challenges on boards

The pace of change in the global economy is faster than ever before. Accelerating technological disruption, shifting sources of global growth, and rising friction between business and society are creating unprecedented challenges for companies—but also vast opportunities.

In this charged environment, directors' duties are expanding in both scope and complexity. However, we see vast differences in the level of governance professionalism and effectiveness around the globe. In the Middle East, where almost two-thirds of businesses are family-run, strong corporate governance has not yet received the attention it deserves. Here, board directorships often have been perceived as honorary positions with responsibilities limited to fiduciary and regulatory responsibilities.

Boards in the region need to step up their game, starting with understanding the big shifts underway. A major study by our colleagues found that the trends transforming the future of business are being driven by nine global forces, grouped into three categories.[1]

[1] See Ezra Greenberg, Martin Hirt & Sven Smit, "The Global Forces Defining a New Narrative of Progress", McKinsey Quarterly, April 2017, McKinsey.com.

Shifting (growth) sands: The first three forces reflect changes in the engines of global growth. While traditional trade and financial flows have stalled, the globalization of digital products and services is surging. The emergence of billion-person markets in India, China, Africa, and Southeast Asia is moving the focus away from the earlier BRIC model. The Middle East and North Africa (MENA) region also is powering forward, with 2016 GDP growth of 4.9 percent compared to 1.9 percent for the European Union.[2] Meanwhile, technology is boosting resource productivity and shifting focus to new sources of energy and materials. Naturally, this shift has significant implications for the Middle East, as more oil production coming from previously unviable sources, combined with lower consumption, is depressing commodity prices and capital flow into the region.

Radical disruption: The second category reflects widespread industry transformations as new technologies, such as genetic sequencing and blockchains, combine different disciplines to radical effect. In addition, digitization is increasingly putting consumers in the driver's seat, enabling them to get more value, faster and often for free. The growth of digital ecosystem players such as Amazon, Souq, and Alibaba, meanwhile, is erasing industry borders while putting pressure on companies to develop their own platform strategies.

Society 4.0: As these forces play out, collaboration between business and government will become essential to address the growing discontent among the global middle class. Cooperation also will be needed to combat the "dark side"—in the form of terrorism and cybercrime—of the openness that globalization and digitization have fostered, and to launch the economic experiments needed to identify new ways to boost growth. In the region, a large and growing young population is seeking a stronger voice in policy—as exemplified by the appointment of youth ministers in the UAE—and pushing governments to find creative ways to boost growth and create employment.

These forces have wide-ranging implications for both company management and boards, but a recent survey of more than 1,100 board directors around the world revealed that few boards are actively addressing the potential disruptions to their industries and companies. Digitization is on the agendas of only about half[3] the boards, and cybersecurity and geopolitical threats at just 37 percent and 36 percent respectively. In short, many boards haven't grappled with the potential fallout of these global forces, which may make them poorly prepared to guide their companies in responding to them.

The changing role of boards

As the pace and complexity of global business rises, the function boards serve is also evolving. Once primarily focused on management oversight, directors today need to engage more deeply in issues ranging from business and digital strategy to M&A, risk, talent, and culture. In light of this broadening scope of responsibilities, boards of directors with diverse experiences and expertise, an open culture of trust, and significant time commitments to their duties are becoming sources of important competitive advantage. According to our recent global survey, boards with superior dynamics and processes, as well as those that execute core activities more effectively, self-report stronger financial performance compared to their peers.[4]

In addition, the growing focus among global companies on longer-term performance horizons is putting more pressure on boards to become more

2 See Worldbank, "GDP growth (annual %) by country", https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?view=chart, 2016; Stats for MENA year 2016 average across 21 countries

3 See Martin Hirt, Frithjof Lund & Nina Spielmann, "A time for boards to act", McKinsey Quarterly, March 2018, McKinsey.com

4 See Martin Hirt, Frithjof Lund & Nina Spielmann, "A time for boards to act", McKinsey Quarterly, March 2018, McKinsey.com

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forward-looking. In our region, this is due in large part to some governments' ambitions to leapfrog foreign competitors, attract more investment and better prepare for coming disruptions. When the GCC Board Directors Institute recently surveyed its membership, 64 percent reported that board composition was a barrier to success.[5]

Recommendations for enhancing board value

Based on our extensive research on boards and experience working with directors and executives in various ownership structures around the globe, we believe boards of directors in the region should focus on five areas to further professionalize their companies' governance.

1. Create value through focus on the long term

Board members are in a position to look further out than company management, yet many boards put a disproportionate focus on short-term financial results. Instead, directors should assist management teams in ensuring that capital and resource allocation is balanced between long-term initiatives critical to the company's future and more immediate drivers of financial returns. The empirical evidence shows companies that re-allocate capital fastest outperform peers by greater than 100%, based on market cap over a 20-year period. Those long-term investments often need to be significant to deliver real shareholder value, and may not pay off for a long time, requiring boards to have patience and an eye toward long-term strategic priorities.

2. Enhance board diversity

Board composition trends in the region have not changed much over the years—only 2 percent of directors are female, and 40 percent of boards lack independent directors. What's more, foreign directors are rare despite many companies having ambitions of expansion abroad.[6]

[5] See GCC Board Directors Institute, "Board effectiveness review, A decade of change in GCC boardrooms, Progress and challenges ahead", September 2017

Poor board diversity isn't just a problem in the Middle East: globally, only 43 percent of directors report that their boards are sufficiently diverse to ensure relevant perspectives are represented in decisions.[7] Yet board diversity can deliver major payoffs. Research shows, for example, that companies whose boards have higher gender diversity respond to their customers better and make decisions more effectively.[8]

To strengthen diversity, boards in the region should start by reviewing their composition in light of the company's three- to -five-year strategy. What director skills and experiences will help the company fulfill its plan? The most effective boards have a mix of relevant industry experience, functional and geographic expertise, and a good balance of personal characteristics including level of independence, gender, age and ethnicity. Many boards today also are adding directors with digital technology expertise, skills in talent management, and experience outside the company's core industry to better spot and prepare for potential disruptions.

3. Adopt a fluid strategy-development process

The traditional strategy process involves the CEO presenting the strategic vision to the board once a year, which the board then discusses and typically approves during the same meeting. In today's fast-changing environment, however, an annual strategy discussion is not sufficient. Management needs to regularly review the strategy with the board and update the plans as circumstances change. Effective boards are adding strategy to the agenda of every board meeting, weighing alternatives, reviewing progress, considering market shifts, and pressure-testing assumptions. Here, board diversity can be a major advantage, as directors can bring valuable external perspectives, unique market insights, and lessons from other industries and regions.[9]

4. Prioritize talent development

The board's most important task is appointing the CEO, but few boards in the region have effective CEO succession and leadership development strategies in place. Boards around the world are recognizing the importance of talent management, culture and organization, with time spent on these topics slowly increasing from 9 percent in 2015 to 13 percent in 2017.[10] But there is still significant room for improvement. Several disruptive forces, including digitization, automation or population growth are putting severe pressure on companies to rethink their people agenda. According to recent estimates, for example, automation is set to displace 400 million to 800 million jobs globally producing a significant impact on the skills workers of the future will need.[11]

Boards should ensure that executives put in place a suitable framework for the development, deployment, retention and succession of top talent. Most companies are proficient in, and apply significant time to, analyzing the best uses for financial capital, but far fewer apply the same rigor to human capital decisions. Both are required to prepare a company for long-term success. According to the recently published book Talent Wins, management should identify the top 2 percent of individuals who create disproportionate enterprise value, and map them to the company's value creation plan.[12]

[6] See GCC Board Directors Institute, "Board effectiveness review, A decade of change in GCC boardrooms, Progress and challenges ahead", September 2017

[7] See Martin Hirt, Frithjof Lund & Nina Spielmann, "A time for boards to act", McKinsey Quarterly, March 2018, McKinsey.com

[8] See Celia Huber & Sara O'Reilly, "How to accelerate gender diversity on boards", McKinsey Quarterly, Jan 2017, McKinsey.com

[9] See Chris Bradley, Martin Hirt & Sven Smit, "Strategy beyond the hockey stick", McKinsey & Company 2018

[10] See Martin Hirt, Frithjof Lund & Nina Spielmann, "A time for boards to act", McKinsey Quarterly, March 2018, McKinsey.com

[11] See James Manyika et al, "Jobs lost, jobs gained: workforce transitions in a time of automation," MGI December 2017

[12] See Dominic Barton, Ram Charan & Dennis C Carey, "Talent Wins", Harvard Business Press, 2018

5. Re-think the annual board agenda

There is increasing pressure on directors to dedicate more time to board work. As important as the amount of time is ensuring that the board's work aligns with the company's strategic priorities. Many boards in the region report that their ability to spend time on strategic issues is constrained by compliance priorities. Setting an annual board agenda can be an effective way to ensure time is well balanced between fiduciary tasks and value-adding activities such as strategy, talent and risk management.[13] That said, directors shouldn't become prisoners of their own agendas; they need to retain flexibility to deal with urgent events and new challenges.

Conclusion

In a time of rapid change, boards need to become thought partners to the executive team, helping management prepare for accelerating industry disruptions, geopolitical risks and emerging trends or threats. Focusing on the above five priority areas will enable boards to significantly enhance the value they bring to companies and their shareholders

[12] See GCC Board Directors Institute, "Board effectiveness review, A decade of change in GCC boardrooms, Progress and challenges ahead", September 2017