

Digital strategy: Understanding the economics of disruption

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Responding to digital disruption isn't about creating a list of digitization priorities; it's about identifying where you are vulnerable and where you can create value.

Amid digital disruption, companies must evaluate the most effective ways to create value, rather than trying to guess which disruptors are going to be the next big start-up. In this episode of the *McKinsey Podcast*, directors Angus Dawson and Martin Hirt talk with *McKinsey Quarterly* editor in chief Allen Webb about the value of companies focusing on the fundamentals of supply, demand, and the ways they might be disrupted by digitization.

Podcast transcript

Allen Webb: Hi, I'm Allen Webb, editor in chief of the *McKinsey Quarterly*. I'm in Seattle today, and I'm delighted to be speaking with Angus Dawson, a McKinsey director and leader of the firm's Strategy Practice, based in Sydney, and Martin Hirt, a Taipei-based director of the firm who is responsible for the Strategy Practice's global knowledge-development efforts.

Angus and Martin, along with their colleague Jay Scanlan, were the coauthors of a recent *McKinsey Quarterly* article on digital strategy, which lays out how to identify opportunities, respond to threats, and navigate disruptive change.¹ Angus and Martin, thank you very much for spending some time with us today.

Angus Dawson: Very happy to. Hi, Allen.

Martin Hirt: It's a pleasure.

Allen Webb: There is a lot of talk these days about the pace of industry disruption due to digitization. My first question is whether you think some of that talk is overblown. How real do you think the risk of digital disruption is for most industries?

Martin Hirt: Digital disruption, at some level, affects every industry, although to very different levels. Some industries have progressed very, very far in terms of digitization—think about music and music distribution. But some of them have barely been affected, for example, some basic materials, mining operations.

¹ See Angus Dawson, Martin Hirt, and Jay Scanlan, "The economic essentials of digital strategy," *McKinsey Quarterly*, March 2016, McKinsey.com.

Angus Dawson: I would add that the fact that disruption is happening at different speeds for different industries shouldn't lead those industries where it's happening slower to assume it's not happening. The worst thing would be to feel like it's not hitting your industry and to wake up in five years and find out that, actually, the fundamentals have changed. The other thing is, disruption is not all negative. For some players, disruption represents huge opportunity and upside. Whereas, for others, it's really about containing damage.

Martin Hirt: Angus, I think it's very interesting that you're talking about these different speeds at which disruption happens. When we reflect on a portfolio of clients that we have been serving on digital strategies over the past few years, I think it's even within a client's business that disruption happens at different speeds.

There are parts of your product portfolio and your business portfolio that might barely be affected: take a retailer's grocery business. There are other parts of the business that could be severely disrupted: take its consumer-electronics business. So even within a business like retail, you have different parts of the product spectrum go at very different speeds.

Allen Webb: You both talked about speed, and you're also strategists. There's a view that strategy takes time and involves reflection. How much time is there to do real strategy these days, given the pace of change that you're describing? How do you strike the right balance between assessment and action?

Angus Dawson: In a period of great uncertainty and great change, it's more important than ever to have real strategy. That's not a plan and a set of priorities and initiatives. It's real strategy, which is based on an understanding of fundamentally how value's going to get created and what you need to do to win.

In this particular time, you may have lots of short-term changes, lots of different attackers you're worried about. New companies come on the radar every week that suddenly you've got to get across. It's more important than ever in that environment that you've taken the time to step back and understand what is going on. Yes, time is tight, and it's tough for executives to find space to do it, but we would encourage them to find the time to do that.

Martin Hirt: It's also interesting to see how people talk about digital strategy or strategy in the digital age. They're always referring to examples like Google, Amazon, Tencent. They're always referring to digital natives, attackers who reshape entire industries or swathes of industries, and their strategies. We find these have little relevance to the way an incumbent ought to think about its digital strategy, about being attacked by 50 different digital natives or start-ups.

When you look at these shapers, these digital natives, often they have a broadly articulated vision—"We want to be the platform of something or another"—and they act opportunistically to execute against that. Take some of the Chinese major shapers, like Tencent or Alibaba. They do hundreds of acquisitions every year. Not all of these acquisitions are part of a major, thoughtful strategy. Many of these things are very opportunistic, just making sure that they stay ahead of these attackers and preempt them from building platforms on their own.

This is very different from how an incumbent ought to think about strategy. There is much more to the point that Angus made about being thoughtful about which of these threats out there are relevant to my business and how best to respond. How do I take advantage of some opportunities that disruptions open for me?

Allen Webb: Your article presents a framework for assessing opportunities and threats. Why do you think it's important for leaders to have a framework in their back pockets when they're thinking about the impact of digitization?

Angus Dawson: I was having a conversation with a client a couple of weeks ago. They went through what they were describing as their digital strategy. Having explored it a bit with them, we ended up coming to an agreement that what they had wasn't a digital strategy, it was a list of priorities for digitization. Explicitly, it was how are we going to reduce the cycle time in our end-to-end processes, how are we going to improve the customer experience and build new apps, and so forth. It was about how they digitize. It was not actually the choices they were making about a big disruptive economic force, which is the changes that are made possible by digital technologies.

When we stepped back and said, well, what's actually going on, one of the conclusions they came to was that there were parts of their business they're fundamentally overinvesting in because digital forces are going to render the economic profit in that entire part of the value chain that they're participating in to be significantly less.

The word "strategy" is used too loosely with digital to mean our priorities for digitization, not the choices we're going to make in terms of where we compete and how we compete in the face of a big disruptive force that we've faced before with deregulation and electrification 100 years ago and the rise of consumer middle classes.

Allen Webb: The trend's been going on for awhile. I wonder why it is that the conversation has turned to it so strongly over the past year or so. What shifted in the environment, in your mind, to make disruptive change the word of the hour?

Martin Hirt: It's quite simple. If you look at all industries and go back to the start of this discussion, where we stated that different industries are at very different stages of digitization, we're now at the stage where a lot *more* industries are being affected.

Initially, it was a few industries that were suitable for electronic distribution, like books and music. But now a much broader set of industries is being affected. It's the sheer breadth of impact of these disruptions that makes this a much more prominent topic today.

Allen Webb: Let's talk a little bit about the framework in your article. It rests on the core economic concepts of supply and demand. Is that an old-school way of understanding the digital world? Why do you think supply and demand are so relevant for digital disruption?

Angus Dawson: It is a somewhat old-school way of thinking about it, but supply and demand are the fundamentals of any market. Ultimately, the impact of digital forces is to reset some

of our expectations around supply and demand and to open up new possibilities around the intersection of them in terms of the way markets move.

When we look back at those industries that have been hit with waves of disruption, we can boil it down to those effects that have been felt on supply and demand, and the intersection of those. This is still relatively early days. When we look back in 30 or 40 years, we'll see a several-decade period of dramatic disruption.

In the early days of this, stepping back and having a fundamentals-based framework is the best way to help executive teams understand what's going on before all the data's in, frankly, in terms of the way the impact works. We're trying to give people a fundamentals-based predictive framework, rather than explaining in hindsight how a car crash might have happened.

Martin Hirt: There was a bank in London. There was a steel maker in India. There was a high-tech manufacturer in Taiwan. All of them struggled with the same question. They all looked at the emerging disruptive context in the industry, the possible angles of attack. They were overwhelmed with the sheer magnitude and number of possible angles. The bank in London I think counted 515 financial-technology start-ups that could potentially be a threat.

They essentially threw up their hands and said, how do I think about this? How should I sort through this and figure out what my two, three, four priorities should be when I think about my strategy in the digital age and when I think about how to respond to these threats?

We realized that trying to predict who of these attackers would be successful, with all of them attacking from a slightly different angle and with slightly different chances of success over time, it's a very high-uncertainty space. Trying to look at what's happening and trying to predict the future turned out to be very hard. We found that going back to the fundamentals of economics, trying to understand where there is economic room to be attacked, where your open flank is, or where you could thrust a spearhead, was a much more useful way to approach the problem and simplify the problem and focus on the right priorities.

Angus Dawson: In Australia, there was a period where it was a bit of a contest to name the latest kinds of potential cool Silicon Valley start-ups. Boards were making tours, and management teams were making tours, and it became a game of one-upmanship to talk about all the different start-ups. Executives started getting frustrated with it. For those of us who lived through the first dot-com boom, and you look back at the slides that we produced of all the start-ups that were attacking various industries in those days, and you try and find out how many of them still exist, it's a pretty small number.

There was a futility to this whole game of predicting the next start-up or to naming the next disruptor. We needed to take, in some ways, the conversation away from those people touring Silicon Valley and out of the technology suite, into the language of all executives. That is the language of the basics of the markets they're operating in, which is the essentials: What do customers want, and how can we supply it?

Martin Hirt: They do find it very helpful, Angus. Although I would say that the go-and-see tours in Silicon Valley serve a purpose. They don't clarify strategic thinking, but they do help energize an organization to take these threats seriously and step out of a state of denial.

A lot of people I talk to find this all very confusing because of the complexity of the external environment and its development, and therefore retreat to saying, "We are who we are, we have a product, we have customers. Let's just keep going for now." They do not step back to think fundamentally about where a threat could come from and be a real threat to them. And they continue in a state of denial.

Allen Webb: Martin, you were speaking about awareness of threats, which gets to what I found a very interesting idea in your article. It's something you call collateral damage, where traditional companies, say, camera makers, lose out to smartphone makers, just because it becomes possible to put a camera in a phone. How do you think a company can tell in advance that it might become the collateral damage of a disruptor that wasn't even aiming at its business particularly?

Martin Hirt: This gets to the very point of why we structured the framework the way we did. A company can find out whether they're open to an attack like that by going through, in a very strategic way, their own economics of supply and demand. Which markets are they serving? What supply are they providing? Why are customers buying it? Where are costs in their business that could potentially be taken out by an attack like that? As you go through the economics of your own business, of your own market, understanding the supply and the demand side in a very structured way, you can identify these spaces.

If you take some of the ones that you mentioned, like camera makers losing out to smartphone makers, it was a device that, because of the miniaturization of components, was able to integrate something that took a whole device in itself before.

If you take the mapping industry, the people who produced printed maps, they had a product that was essentially information. They were open to attack by somebody who would be able to take out the distribution cost and the production cost entirely by providing digital maps. If you realize that you have a product that could be in that way digitized and severely disrupted, or if you have a product that could be miniaturized and integrated into somebody else's platform—I think platform is the big notion here—then I think you're at risk.

Angus Dawson: In some ways, that's again a fundamental supply-and-demand view of things. On the demand side, is it possible for someone to offer the value proposition that you currently offer to customers as part of something else that that customer already has?

This is why the smartphone players, for example, getting into the payment space is potentially such a scare for financial institutions. But on the other side of it, on the supply side, what are some of the barriers that might be insurmountable?

For example, regulation of deposit-taking institutions in most developed markets is going to make it very difficult for the technology players to take out the banks. If you can't get

the deposits as a bank, then you can't lend money. The idea of loans being swamped by the technology players is still some way out. Understanding those demand-and-supply fundamentals can help you assess it.

Now, what could the digital-camera players have done in advance of the smartphone attack? Part of what they should have done is get capital out of that part of the business because there was no way to stop the tsunami that hit them for mainstream cameras.

Allen Webb: You're starting to talk about resource reallocation, which has got to be one of the hardest problems in strategy in general, especially when you've got shifts of this magnitude going on. What advice do you have for companies that feel like they're struggling to move resources until it's too late to get out of things and into things, as the pace of change is so rapid?

Angus Dawson: To start with, it's stepping back and asking the question, does digital mean that there are some businesses we're in today that might be less attractive in the future that we don't want to be in at all or as much? Are there some parts of our portfolio that have the potential to become a lot more attractive?

It's good old-fashioned corporate-strategy-based resource allocation and portfolio review that has to be adapted to a new discontinuity. Then, within that, how do I organize to make sure that the various things we need to do to respond to digital are happening? That's actually more challenging. A lot of companies are spending a lot of money on efforts associated with digital without clear paths to value creation.

Being able to say we've allocated X percent of our capex to digitization-related initiatives I think is going to lead to a big hangover in a few years, rather than to those initiatives that are very much anchored in a confident strategy about what's going on with customers and how to make sure the value propositions evolve with customer expectations being lifted every day by digital natives. On the supply side, companies need to be able to get to a fundamentally lower cost base or a fundamentally more advantaged supply chain to be able to compete.

Allen Webb: That's helpful. Martin, you spoke a moment ago about platforms and about some of the big platform players like Amazon and Google. Reading between the lines, I think you were suggesting that's not a play that's available to a lot of people. What is the platform lesson for the average company that's not likely to have a massive scaling platform over millions or billions of people?

Martin Hirt: You're asking the question exactly in the right way: How likely is it? Everybody could build a hyperscaling platform. Even incumbents. But the reality is that out of all the companies who try to go down that journey, only a very small handful, less than ten in the world, were able to achieve that. It's exactly as you ask, a matter of probability. If you're willing and your shareholders are willing to place a 1 in 100,000 or 1 in 500,000 bet, be my guest.

The reality is that most companies will not be able to build a hyperscaling platform. However, these hyperscaling platforms do play a critical role in the growth of many businesses in the

digital space. What we see is those who embrace them, embrace them for collaborating, for example, on advertising, on exploiting the analytic capabilities that these platform players have, to better segment, target, and deliver their messages to their customers, who use those platforms to streamline their supply chains, who use the platforms to outcompete competitors in terms of the speed they have in getting to the market, or in getting their products and services to the market, or in disrupting the cost of their product creation and service delivery.

Allen Webb: Terrific. You suggest in your article that established companies can become digital disruptors. We don't see a lot of them doing it, though. I wonder why not and if you've got any final tips for an established player hoping to disrupt in some space of its business.

Angus Dawson: By far, the hardest thing for an established company to do, first of all, is to disrupt itself because the economics are just so challenging, and all of the corporate instincts go against it. If you look at, for example, the media industry, all over the world, the local newspapers used to control classifieds.

There's really only one or two examples, like Schibsted in Norway, that actually managed to make the leap and cannibalize itself and disrupt itself. We should just acknowledge that it's actually a very, very difficult and very courageous thing to do. But if you actually have clarity about what's fundamentally going to happen to the industry, and the markers of that, then it can actually give you the courage to do it.

In terms of incumbents or established players finding other sources of disruption, that's more exciting: for example, payments players trying to get into loyalty platforms with consumers. Shopping malls trying to think about to what extent they can become digital intermediaries as well as physical intermediaries. Telecom players thinking about the extent to which connectivity can give them the chance to bring new disruptive models to things like healthcare and transportation.

Martin Hirt: Also, to be very practical, I see companies who successfully set off on a journey toward either facing a disruption aggressively or toward becoming a disruptor themselves by doing three things. One is setting appropriate targets. Being a disruptor to yourself or to others is a form of innovation. The one thing that's foundational about innovation that we have learned is, unless you set a target that's unachievable without innovation, people don't go for it. Innovations are fraught with risk. Disruptions are fraught with risk. Unless you have a target, a business target for the company and for individual businesses and managers that is actually stretching them beyond what their current business can possibly do—that they have to disrupt—they will not do it.

Second, organization. Unless the CEO elevates digital to his level, ie, putting a chief digital officer in charge of leading the transformation and elevating the leaders of digital businesses with the mission to either disrupt others or even themselves, to direct reports to him or herself, it's not working. So there's a need to have an organizational intervention to create these roles and give them the appropriate power and authority in the business.

And third, it's strategy. Do not just think digitization. Think digital strategy. How will the economics of my business change in the future? How can I change the economics of other businesses? And, therefore, what should my strategy in the digital age be?

Allen Webb: That's a good practical note to end on, Angus and Martin. Thanks very much to both of you for your time today. And good luck as you continue applying the fundamentals to digital strategy.

Angus Dawson: Thanks, Allen.

Martin Hirt: Thank you. □

Angus Dawson is a director in McKinsey's Sydney office, and **Martin Hirt** is a director in the Taipei office; **Allen Webb**, editor in chief of *McKinsey Quarterly*, is based in the Seattle office.